



December 31, 2009

**D3 Business Update:**

Happy New Year! We look forward to 2010 and the new decade. Despite the rally in the financial markets in 2009, we still expect that new opportunities AND risks will present themselves in 2010. We look forward to helping you take advantage of the opportunities and avoid the risks.

Speaking of potential opportunities and risks, you should begin hearing and reading a lot of ads proposing the conversion of a Traditional IRA to a Roth IRA, since the \$100,000 personal income limit to be eligible for the conversion disappears in 2010. We have attached a summary of the 2010 Roth Conversion tax rules. This may be an opportunity for anyone who expects to be in a lower tax bracket in 2011 and 2012, or anyone that wants to leave a tax free portfolio of investments to their heirs. If you have any questions after reading the summary, please call us. **We will definitely contact you if we think this could be beneficial in your situation.**

**D3 Market Comments:**

The financial services industry has clearly rebounded from the abyss this year, due to the huge financial assistance provided by the Federal Government. However, many Americans aren't experiencing this same rebound, and many still question whether the economy is likely to improve in 2010. We thought it helpful to show some U.S. economic statistics that we find insightful, comparing current data with data from one year ago.

	<b>2008</b>	<b>2009</b>
GDP (gross domestic product) 4th Quarter 2008=	-6.3%	3 <sup>rd</sup> Quarter 2009= 2.2%
Leading Economic Indicators 4th Quarter 2008=	-1.1%	3 <sup>rd</sup> Quarter 2009= 2.4%
Consumer Confidence (November level )	38.0	52.9
ISM Composite Index of Manufacturing Activity	36.6	53.6
Existing Home Sales (Nov. annual change)	-10.6%	44.2%
Home Prices (Nov. annual change)	-13.2%	-4.3%
Housing Starts (Nov. annual change)	-45.0%	-12.4%
Unemployment Rate (November)	6.8%	10.0%
Non Farm Payrolls (November jobs lost)	-533,000	-11,000

The numbers clearly reinforce the perspective that the economy is improving. The fact that the unemployment rate is still so high, and not falling, does not surprise us. This is

5151 Mochel Drive, Suite 301, Downers Grove, IL 60515  
 (630) 271-0033 Phone / (866) 385-8998 Fax  
[www.D3FinancialCounselors.com](http://www.D3FinancialCounselors.com)



consistent with previous deep recessions. Labor is still an expensive resource in the U.S., and companies will remain reluctant to hire new workers until they see sustained increases in sales. However, many manufacturing companies are starting to increase production levels, after allowing their inventories to drop to very low levels. There is no doubt that lower interest rates have contributed to rising home sales, which has reduced the inventory of unsold homes. By driving interest rates to record low levels, and flooding the banking system with excess money, the government presented hundreds of companies with the opportunity to refinance their old, more expensive debt, and raise cash to strengthen their financial health, and be opportunistic when the economy improves.

With that being said, there are plenty of headwinds facing the U.S. economy. Much of the growth in the U.S. economy, after the 2001-2002 stock market downturn, was driven by consumer spending, as consumers borrowed too much money against the equity in their homes, and spent it. Now Americans are saving more and paying down their debts, which reduces the likelihood that consumer spending will stimulate economic growth. Also, the unemployment rate is likely to fall at a very slow rate, which will also hurt consumer spending. The auto industry has contracted dramatically with GM and Chrysler filing for bankruptcy, and an estimated 500,000 auto related jobs have been lost since December, 2007. The massive contraction in the housing industry caused job losses not only in the construction industry, but also in the realty and mortgage financing industries, and an estimated 1 million jobs have been lost. Job losses in these industries could be permanent. Taxes are very likely to rise on January 1, 2011, with the expiration of the tax cuts passed by the Bush Administration several years ago. Historically, rising taxes negatively impacts economic growth. Lastly, interest rates are starting to rise, as the economy starts to recover. How far do rates have to rise before they negatively impact growth? We're not sure.

**To summarize, we think that the U.S. economy has to grow at a faster rate for the stock market to continue to rally in 2010.** The current debate among economists is whether economic growth can be sustained without government stimulus AND weak consumer spending in 2010. Historically, the U.S. economy grows at a rate higher than 6% as it emerges from a recession, with a rebound in the housing industry leading the economic recovery. However, with the housing market currently in a weakened condition, most economists expect economic growth in the range of 2% to 4% in 2010, for reasons mentioned earlier. The stock market could be vulnerable if growth is closer to 2% next year.

5151 Mochel Drive, Suite 301, Downers Grove, IL 60515  
(630) 271-0033 Phone / (866) 385-8998 Fax  
[www.D3FinancialCounselors.com](http://www.D3FinancialCounselors.com)



However, over the long term, slower growth is healthier because it reduces the likelihood of a rapid increase in inflation and overheated financial asset prices. **The major risk we see in 2010 is that investors may get weary of earning next to nothing on their CDs and money market funds, leading them to over invest in riskier assets that don't reflect the goals in their financial plans.**

**Our Current Strategy:**

As we mentioned earlier, federal income taxes are expected to rise by an average of 4.5% for each tax bracket in 2011 and 2012. In fact, if people convert to a Roth IRA, and exercise the option to spread the tax impact over 2011 and 2012, they will automatically pay more in total taxes than if they converted in 2009 (if their taxable income isn't lower). **Also, 2010 is the last year for a 0% capital gains rate for people in the 15% or lower tax brackets. Starting in 2011, all capital gains will be taxed at 20%.**

**We are focused more and more on preserving after-tax wealth.** We continue to look for tax-advantaged investments, such as municipal bond funds and real estate investment trusts, and investments that will react positively to rising inflation. We don't expect inflation to rise significantly in 2010, but we're investing in inflation "protection" before it becomes too expensive. Lastly, as economies in Asia and Latin America continue to grow at rates faster than the U.S. economy, more than half of the world's wealth and productive capacity are now outside the U.S. **Reflecting this fact, we continue to increase our equity allocation to the international sector.**

**Again, Happy New Year to everyone and, thank you for your confidence in us!**

Donald D. Duncan MBA CFA <sup>TM</sup> CPA CFP <sup>®</sup>	Becky Connery MSIA, Financial Planner
Peter Marchese MBA CFA <sup>TM</sup>	Adam Glassberg, Financial Planner
Michael Meyers MBA CFP <sup>®</sup>	Patty Shipinski, Administration



## **Roth IRA Conversion Analysis:**

Starting in 2010, the \$100,000 modified adjusted gross income limit to convert a traditional IRA to a Roth IRA will end.

### **Why Convert?**

A Roth conversion is simply paying income tax on the amount converted now, instead of paying income tax on distributions during retirement. There are a few reasons you may want to do a Roth conversion:

1. If you expect to be in a higher tax bracket when you start taking distributions from your IRA than the tax bracket you will be in the year of conversion. This makes sense from a future tax savings standpoint.
2. A Roth conversion can be an effective legacy planning tool. Assets that are inherited from an IRA by a non-spouse beneficiary are required to be distributed either within 5 years of inheritance, or over the life expectancy of the beneficiary. All of these distributions are taxed at the beneficiary's tax rate. This could result in a hefty tax burden for the beneficiary of the IRA if they are in a high income tax bracket. Assets that are inherited from a Roth IRA by a non-spouse beneficiary are subject to the same distribution rules as an IRA, but the beneficiary does not have to pay any tax on the distributions. If you are converting to a Roth IRA for legacy intentions, you are essentially gifting the income tax that you pay now to your inheritors. This "gift" of taxes effectively reduces your estate without using any of your \$1,000,000 lifetime gift tax exemption.
3. A Roth conversion can be coordinated with other estate tax planning efforts. It is important to remember that from an estate tax viewpoint, the amount of the estate value reduction is only equal to the tax you pay on the conversion. All assets over which one has a power of appointment (i.e. changing beneficiaries) are included in a decedent's estate. This includes traditional IRAs and Roth IRAs because you can change the beneficiary at any time. Life insurance proceeds are also included in an estate for estate tax purposes (unless the policy is in an irrevocable trust). The Roth conversion should be considered in conjunction with these other estate tax planning tools.
4. A Roth conversion is an effective tool for reducing future required minimum distributions (RMD's). Roth IRAs do not have the RMD requirements that traditional IRAs have (traditional IRAs require mandatory distributions starting at age 70 1/2). If you have a large amount of assets in your IRA, this may result in your RMD putting you in a higher tax bracket. For example, if the balance of your IRA was \$2,000,000 when you have to start taking RMD's, you would be required to take about \$70,000 which would likely put you in a higher tax bracket. By converting your traditional IRA to a Roth IRA, you can reduce the assets in your IRA, thus reducing your future RMD's.



### **Strategy for Converting to a Roth IRA**

The sole purpose of converting to a Roth IRA is to pay income tax now to avoid income tax later. You do not want to be in a high tax bracket when you make the conversion, and therefore you should not convert a large amount every year. An effective strategy is to convert the maximum amount you can, while staying in a low tax bracket (preferably 10% or 15%).

### **Special Rule for 2010 Only**

For 2010 only, you may elect to have the taxable income from the conversion spread out over 2 tax years (2011 & 2012). Keep in mind that the **taxable income**, not the tax liability can be spread over two years (i.e. If you chose to make a \$100,000 Roth conversion in 2010, and elect to have the taxable income spread out over two years, you would realize \$0 of income from the conversion in 2010, \$50,000 of income in 2011, and \$50,000 in 2012.) Because tax rates are expected to rise in 2011, spreading the tax liability over the 2011 & 2012 only makes sense if you expect to be in a lower tax bracket in 2011 & 2012 than you will be in 2010.

### **Conclusion**

Because converting a portion of your traditional IRA to a Roth IRA could be an effective legacy planning tool, and could lower future RMD's we would only recommend converting to a Roth IRA only if you are in a lower tax bracket. For people who plan on retiring in 2010, and have little taxable income in 2011 and 2012, converting to a Roth IRA in 2010 and spreading the taxable income over 2011 & 2012 may make sense.

Another situation that may argue in favor of a conversion is if you anticipate large income tax losses from real estate or other business ventures. The income from the conversion would essentially be sheltered by other losses.

To increase the legacy benefit, the taxes on the conversion should be paid from an account other than the IRA. The effect on your overall estate will be the same, but if you pay the taxes out of the converted amount the Roth IRA will be smaller.

One risk you run if you convert in 2010 and spread the taxable income over 2 years, is a large increase in income taxes for 2011 & 2012. If there is a large increase in tax rates, you have until October of 2011 (if you file tax extensions on your personal return) to re-characterize your conversion back to a traditional IRA (undoing the conversion). The option to re-characterize a conversion can mitigate the risk of a large unexpected increase in tax rates.