

# CITY SECURITIES WEALTH ADVISORS

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If you haven't been routinely making annual contributions to your Individual Retirement Account (IRA), there are some really good reasons to make these contributions for 2008 and 2009 now, and then again when 2010 arrives. First, let me describe one of the fundamentals of personal finance - tax diversification - as it will help you understand why making a potentially non-deductible IRA contribution makes sense. Then I'll briefly review our 2010 Roth IRA strategy, and close with a common tax pitfall you need to be aware of when dealing with IRAs.

## *Tax Diversification*

When you boil down the dozen or so ways you can own assets - individual, joint, trusts, 401k, IRA, Roth IRA, 529, etc. - there are only three basic ways your assets are treated for taxes: *Taxable*, *Tax-Deferred* and *Tax-Free*. Taxable assets are taxed every year as you receive income and capital gains from the asset; tax-deferred assets are not taxed now, but will be at some point in the future - usually at retirement; and tax-free assets were taxed when you first received them, but never will be again (we trust) no matter how much they generate in income and capital gains. Which one is best? Well, nobody really knows because it depends on factors in the future that we can't predict, such as your future income level, future tax rates decades from now, life expectancy and other variables. You will find plenty of opinions claiming one asset type is better than another, but these are always based on certain assumptions that may not come true.

So how do you mitigate this uncertainty? The same way we manage most risks in finance...diversification. I encourage clients to allocate their savings with an eye toward equalizing the amount of assets in taxable, tax-deferred and tax-free accounts. This is easier said than done, and many families end up with most assets in their tax-deferred (401k) accounts, modest taxable holdings, and little to none in tax-free accounts such as Roth IRAs since high income earners are often excluded from taking advantage of tax-free accounts. Plus, it wouldn't be wise to stop 401k plan contributions and lose out on an employer match just to achieve tax diversification. This is why I said "with an eye toward" diversification. It won't result in perfect equalization between the three asset types, but tax diversification will help inform the saving decisions you make and will serve you well now and in the future.

## *2010 Roth IRA Strategy*

Roth assets, which include the Roth IRA and Roth 401(k), are one of the only tax-free asset types (there are a couple of education and healthcare-related tax-free accounts as well). But since the creation of the Roth IRA in 1997, most high income families have not been permitted to contribute to Roths or to convert other assets into a Roth IRA. The Roth 401(k), created in 2006, has given Roth access to some high wage earners, but it is dependent on your employer adding the provision to their 401(k) plan, and many have not. However, in 2010 the restriction on converting assets to a Roth IRA for high income families will disappear under current law, enabling clients to achieve greater tax diversification.

How do you take advantage of this strategy in 2010? By making non-deductible traditional IRA contributions now if you don't qualify for Roth IRA or deductible IRA contributions. Then, in 2010, you will be able to convert the IRA assets into Roth IRA assets. The conversion is taxable, but you will only be taxed on the earnings above your non-deductible contribution amounts (IRA basis), and will be able to spread the tax out into 2011 and 2012. From that point forward, you now have more tax-free assets that will be available to you in the future - when tax rates are uncertain and may be much higher than today's tax rates.

#### *IRA Basis Pitfall*

Finally, whenever you make non-deductible contributions to an IRA, be sure to notify your CPA and request that Form 8606 be included in your tax return going forward if it isn't already. If needed, also make sure that all past non-deductible IRA contributions are reported on the form. Form 8606 simply keeps an orderly ongoing record of your IRA basis. I often find this form missing from client tax returns that I know have made past non-deductible contributions. The unintended consequence could be to pay taxes a second time on contributions for which you've already been fully taxed.

If you haven't made a 2008 IRA contribution yet, you have until April 15th to do so; and your 2009 contribution can be done now as well. I'll be sure to remind you of this strategy again as the 2009 and 2010 deadlines approach. In the meantime, please feel free to contact me if you have any questions about this Roth IRA strategy and how it relates to your specific financial situation.

Have a great week!



Kenneth R. Klabunde, MS, CFP®  
Vice President