



Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

Certified Public Accountants and Financial Advisors

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Winter 2010

Roth IRA Conversion Isn't All Or Nothing Proposition

With all of the recent buzz about Roth IRA conversions, it's easy to get the wrong impression. While for many people establishing a Roth IRA is a great way to get tax-free retirement income, moving assets from a traditional IRA to a Roth doesn't make sense in every case. And even if the positives outweigh the negatives, it may be best to convert only a portion of your IRA assets.



The Roth IRA, created in 1997, can be a remarkable retirement planning vehicle. Qualified distributions from a Roth that has existed for at least five years are completely exempt from income tax. You're eligible to receive this income once you reach age 59½, and qualified distributions are also possible in case of death or disability or to pay up to \$10,000 of first-time homebuyer expenses. And with a Roth IRA, you never have to make withdrawals during your lifetime. That contrasts with a traditional IRA, which requires mandatory distributions after age 70½. With a Roth, if you don't need the money, investment gains can continue to compound throughout your lifetime, and your heirs can enjoy the tax-free income (though they'll have to take required minimum distribution).

Before 2010, you could convert a traditional IRA to a Roth only in a year in which your modified adjusted gross income didn't exceed \$100,000. Thanks to the Tax Increase Prevention and Reconciliation Act of 2005, this dollar cap has been removed, and now all

retirement savers, even those with stratospheric incomes, are eligible to switch.

The primary reason not to convert is the price tag. Income tax is inescapable, and if you didn't pay tax on contributions to your traditional IRA, you'll have to pay up later—either when you move the money to a tax-free Roth IRA, or when mandatory distributions begin. In both cases, you'll be taxed at

ordinary income rates, and if you convert a large account, that flood of income may push you into the highest tax bracket (if you're not already there). The only consolation is you can spread out the tax on 2010 conversions over 2011 and 2012. Tax on conversions in later years will have to be paid right away.

Deciding whether to convert your traditional IRA, and how much to move to a Roth, means analyzing many interconnected variables. One of the most important involves tax rates—how much you'll pay on a conversion versus what you would pay if you left the assets in a traditional IRA and withdrew the money during retirement. You might ordinarily expect taxes to be lower during retirement (because you'll likely earn less then), and that could reduce the value of a Roth's tax-free income. But higher tax rates may be coming, particularly for top earners. You'll also need to factor in these other variables.

- Your age and the ages of your spouse and the potential heirs of your IRAs

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Happy Anniversary Kane Company P.C.!

Kane Company, P.C. recently celebrated its 20th year of providing tax and financial guidance. Our continued growth is due to customers like you, who have faithfully supported us through your patronage and referrals. We appreciate your trust, and we'll do our best to continue to provide the kind of service you deserve. Thank you for your business!

We have been busy attending income tax workshops to stay current and learn new planning ideas to help you minimize your tax burden for 2010 and beyond. It is important to finish any remaining tax planning soon, so contact us for any income tax estimates, planning ideas, or to discuss any year-end questions you may have.

Remember! December 31 is the deadline for Roth IRA conversions and College Savings Iowa contributions. We can also assist you in pension and IRA rollovers or required minimum distributions you may need to complete before year-end.

Our office will be closed December 24 for the Christmas holiday. Also, beginning in January, our office hours will be extended to Monday through Friday from 8 a.m. to 5 p.m. and Saturdays from 8 a.m. to 12 p.m.

We wish you a wonderful holiday season as well as a prosperous New Year!

Steven L. Kane, CPA/PFS, CFP®

Inflation-Protected Bonds Are Still Bonds

One major threat to fixed-income investments—and to the retirees who depend on various kinds of bonds to deliver cash to pay their bills and support their lifestyle—is inflation. When the cost of living rises, a dollar doesn't go as far as it did before, and your savings may not last as long as you'd hoped. A special kind of investment—Treasury Inflation-Protected Securities, or TIPS—addresses that risk directly, by adjusting bond principal to keep pace with changes in the Consumer Price Index (CPI). Yet while TIPS may have a place in many portfolios, they're not a cure-all. TIPS are still bonds, and they're still subject to non-inflation risks that can hurt their value.

TIPS were created in 1997 as a variation on garden-variety U.S. government bonds. Like regular Treasuries, TIPS have a fixed interest rate or coupon that determines how much income they'll provide until they mature. But the principal of TIPS adjusts up or down every month as the CPI rises or falls. If inflation rises, so does the

principal, and the fixed return on that larger amount means additional income for the bondholder. When TIPS mature, the government pays you the adjusted principal (or the original amount, in the unlikely event that the CPI has fallen during the bond's term).



These bonds' prices and yields factor in an expectation that inflation will rise. That's why, recently, the yield on a 10-year Treasury was about two and a half times the yield on a 10-year TIPS. The only reason to accept the much lower current return on the TIPS is if you expect its principal, and thus its effective yield and its total return, to rise significantly during

the time you own the inflation-protected bond. If consumer prices rise less than expected, that 10-year Treasury may turn out to have been a better deal.

But mild inflation isn't the only risk that these bonds bring. Because TIPS are bonds, interest rates are also part of the equation. When real interest rates rise, newly issued bonds will offer higher yields. That reduces demand for existing bonds' below-market yields, and lower demand translates into lower prices. That's why it's often said that bond prices and yields move in opposite directions.

It's not clear when, and how quickly, inflation may accelerate. But almost everyone believes interest rates are on their way up from what have been very low levels. That means the prices of bonds—including TIPS—will suffer. And while TIPS can help diversify a bond portfolio, and could serve as a hedge against inflation, deciding whether to add them to your investment mix is complicated. We can help you consider your options in light of your financial situation and goals. ●

The Right Way To Manage Money

In any relationship between financial advisor and client, trust is crucial. But in the post-Bernard Madoff era, it's not enough to sense that an advisor or a financial firm is reliable. Everyone trusted Madoff. His clients recommended him to their friends, who lined up for the privilege of having him manage their money. Yet all of those trusting clients ended up on the losing end of a \$50 billion Ponzi scheme, and several other recent frauds have further shaken investor confidence. These days, trust requires proof, delivered regularly. Keeping your investments in the custody of a major financial firm can help provide that proof.

Madoff didn't use an outside custodian. Client funds were reportedly handled by a custodian at a remote storefront office that had few employees and no independent auditor. That left Madoff with unfettered access to clients' money and little or no accountability. It now appears he claimed to have made trades that never occurred and exaggerated returns from other transactions. But without reports or account statements from an independent custodian, there was no way for clients to know there was a problem.

Although Madoff's firm was a registered investment advisor, that kind

of set-up is extremely unusual among RIAs, which are regulated by the Securities and Exchange Commission or the individual states. More than nine out of 10 RIAs serving individual clients work with independent custodial firms that have physical possession of client assets, monitor their value, and provide trade confirmations and account statements directly to clients, who can also check on investments by logging in to their account on the custodian's website.

Custodians, such as Fidelity, Schwab Institutional, TD Ameritrade Institutional, Pershing, and others, provide other kinds of security as well.

The New Health Law & Business Owners

The massive new health care legislation passed last spring—the Patient Protection and Affordable Care Act of 2010—will have a long-lasting impact on businesses. Most companies will soon have to provide health insurance for employees, though some small businesses will be able to use tax credits to offset the cost of this benefit. And while some provisions take effect right away, others will be phased in over the next few years. Here are the likely new rules in several important areas.

Coverage requirements. After 2013, employers with 50 or more full-time employees will be subject to “play or pay” rules—if the companies don’t provide “minimum essential coverage” to full-time employees, companies will have to pay a penalty. For this purpose, a full-time employee is anyone who works at least 30 hours a week. The monthly penalty will be based on an annual amount of \$2,000 for every full-time employee, not just the ones without coverage, though the first 30 employees will be subtracted from the calculation.

Help for owners of small businesses. From 2010 through 2013, a business with 10 or fewer employees and average annual wages of less than \$25,000 can claim a tax credit to offset the cost of mandated health coverage. A smaller credit applies to companies with

as many as 25 employees and average annual wages of up to \$50,000.

Health insurance exchanges. Beginning in 2014, state-based insurance exchanges and the Small Business Health Options Program (SHOP) will offer coverage to individuals and small businesses with up to 100 employees. States may allow companies with more than 100 employees to purchase coverage in the SHOP exchange after 2016.

Free-choice vouchers. Also starting in 2014, employers that provide minimal essential coverage must offer qualified employees a free-choice voucher to enroll in a state health insurance exchange. Qualified employees have household incomes that don’t exceed 400% of the federal poverty level and a required contribution for health insurance premiums of between 8% and 9.5% of household income. The amount of the voucher, provided in lieu of a company’s normal coverage, would equal what the employer would otherwise have to pay for an employee’s insurance.

Automatic enrollment. Eventually—it’s not clear when this provision will take effect—an employer with more than 200 employees will have to automatically enroll full-time employees in its health plan, though workers will be able to opt out of the coverage.

Minimum coverage. Effective in 2014, a health benefits package will have to provide a comprehensive set of services, cover a minimum of 60% of the actuarial value of benefits and limit employees’ annual cost-sharing.

Provisions for “grandfathered” plans. Company-provided health coverage in effect on March 23, 2010, when health reform became law, is exempt from many requirements of the legislation. But these “grandfathered” plans must now extend dependent coverage to age 26, prohibit cancellation of insurance, eliminate waiting periods of more than 90 days, and stop excluding children with pre-existing conditions. The plans have until 2014 to get rid of annual and lifetime limits on coverage.

Retiree health insurance. Through 2013, an employer may offer a temporary health reinsurance program to retirees over age 55 that are not eligible for Medicare.

Flexible spending accounts. Beginning in 2013, companies will have to limit annual contributions to flexible spending accounts (FSAs) for health care to a maximum of \$2,500. (Future increases to that cap will be indexed for inflation.)

Information reporting. Beginning in 2012, a business that provides minimum essential coverage to individuals will have to verify the terms of that insurance in annual information returns to the IRS. The information returns will identify who has insurance, the amount of coverage, and any premiums paid by the covered individual.

These are just some of the many business-related provisions of the new law, and further details about how and when particular parts of the law will be phased in are still to come. But it’s clear that most companies will now have to provide health insurance coverage to their employees, and you’ll need to factor that major expense into your business plan. We can help you calculate the likely impact on your company and discuss strategies for minimizing the financial impact of the new requirements. ●

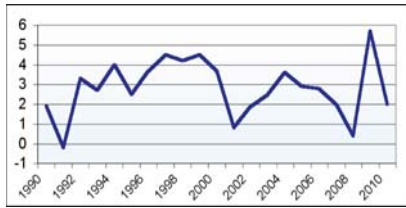
Insurance from the Securities Investor Protection Corporation covers investors for up to \$500,000 of losses of securities and \$100,000 of losses of cash if a custodian becomes insolvent, and custodial firms often also purchase additional insurance. A common level of supplemental coverage is for up to \$5 million of losses of securities. One company provides coverage for losses in securities accounts of up to \$149.5 million and up to \$900,000 in cash accounts. Moreover, most firms have automated systems to monitor client accounts.

To deter fraudulent activity, the



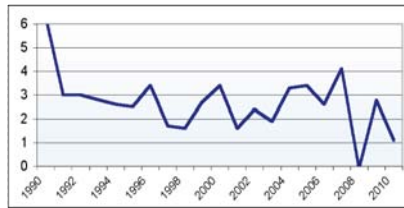
SEC recently proposed a rule change that would require certain RIAs with custody of client assets to use an independent public accountant to conduct surprise audits of client accounts. But you don’t have to wait for a new rule to protect your investments. We work with an independent firm that maintains custody of your assets, and you can easily compare the portfolio performance statements we provide with the custodian’s account statements. This relationship is just one way we are working to prove that we deserve your trust. ●

Economy Watch: 3rd Quarter 2010



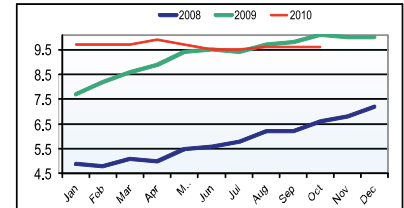
U.S. Economic Growth

Gross domestic product (GDP) expanded at a somewhat slower annualized rate of 2.0% in 3Q2010. Government spending and business investment slowed, leaving consumers as the primary engine of growth.



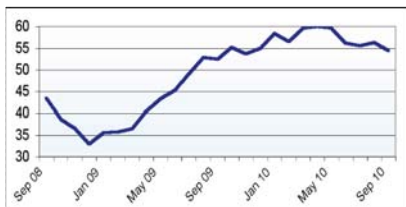
Inflation

Absent of robust demand, inflation in 3Q2010 remained minimal, rising only 0.8% year-over-year after subtracting volatile food and energy prices. Some economists even wondered if slightly higher inflation would be desirable.



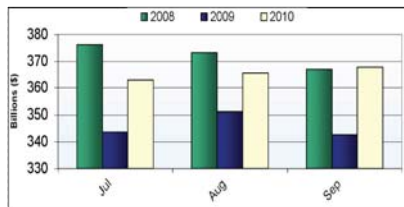
Jobs

The labor market continued to show signs of life in 3Q2010, but substantial improvement in the unemployment rate has proved elusive. Though U.S. companies are hiring, it will take time for the long-term jobless to find new work.



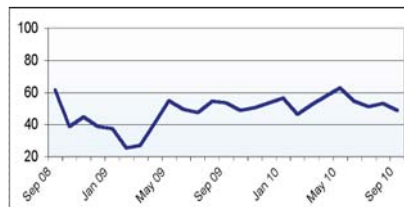
Manufacturing Growth

Activity at U.S. factories persisted at an elevated level throughout the quarter despite indications that the expansion was leveling off. A weaker dollar was positive for exporters, but raised raw materials costs in some sectors.



Consumer Spending

Two years after the credit crunch entered its most pernicious phase with the collapse of Lehman Brothers, household expenditures finally recovered to 2008 levels. All major spending categories strengthened in 3Q2010.



Consumer Confidence

Despite increased spending on staples and discretionary purchases, consumer confidence remains subdued. Job-market worries in particular kept consumers less-than-optimistic about the economy and their own role in it.

Data for the CPI, Unemployment Rate and Non-farm Payrolls are from the Bureau of Labor Statistics. Data for the GDP are from the Bureau of Economic Analysis. The Purchasing Managers Diffusion Index is a release of the Institute of Supply Management. Retail spending data are from the Bureau of the Census. Data for Consumer Confidence comes from the Conference Board.

All Or Nothing Proposition

(Continued from page 1)

- The current value of the IRA assets
- The IRA's projected investment return
- Whether you'll need withdrawals and the projected amounts of withdrawals during your lifetime
- The date of the conversion

Suppose a couple—he's 55 and she's 50—has IRA assets totaling \$750,000 (\$500,000 in his and \$250,000 in hers). Assume the account earns a 4% annual rate of return, they are currently in the 33% tax bracket, and they'll take monthly IRA distributions of \$1,000. Their only child is age 25.

According to the Roth IRA Conversion Optimizer, a tool used by

wealth management professionals to calculate the impact of different conversion scenarios, if the couple transfers the entire \$750,000 IRA to a Roth in 2010, they'll realize a \$1.42 million net benefit over a consumption period of 29 years—the difference between converting to a Roth and keeping the traditional IRA. This is based on the assumption that they remain in the 33% tax bracket and their child is in the 28% tax bracket in the future. Note: The "net benefit" doesn't reflect the opportunity cost of using the funds that are paying taxes for other investment purposes.

Other variables could affect the outcome, however. For instance, this initial calculation assumes the couple is able to pay the entire tax on the conversion with funds not in the IRA.

If they have to dip into IRA assets to foot the tax bill, it will dilute the conversion's benefit. For instance, if they need IRA funds to pay half of the tax, the net benefit of converting all of the assets is reduced to \$809,000. In this case, the optimal net benefit of \$921,000 would be achieved by converting 60% of the assets.

Remember that other wild cards—rising tax rates, inflation, state and local taxes, and changes in tax laws, for starters—could also influence this calculation. For many people, the optimal solution may be to convert only part of the traditional IRA. You might decide to leave the money you'll need during retirement, and convert the rest to a Roth. We can help you decide what makes the most sense in your financial situation. ●