

Roth IRA Conversions ~ Richard D. Gates, President

Tax rates are scheduled to rise in 2011 both on ordinary income and capital gains as the Bush tax cuts sunset. For instance, the top marginal personal tax rate will rise from 35% to 39.6% and long term capital gain rates from 15% to 20%. While conventional wisdom remains to defer taxes as long as possible, an expectation of rising tax rates might indicate differently in certain situations.

One tax planning opportunity to consider is converting an individual retirement account to a Roth IRA. Roth conversions are especially attractive to retirees who plan to preserve their IRAs for their children and grandchildren. By converting to a Roth, the retirees can avoid having to make mandatory withdrawals each year and the heirs' withdrawals will be income tax free.

The best candidate for a Roth conversion is a person who:

- a. is, and will continue, to be in the highest tax bracket
- b. will likely be subject to the estate tax, or
- c. is currently in a low income tax bracket but will likely be in a higher income tax bracket in future years.

Advantages of a Roth IRA

1. Distributions are tax-free if made (a) after five years and (b) after age 59 ½ or death.
2. Contributions to a Roth IRA are possible after age 70 ½.
3. There are no required distributions from a Roth IRA after age 70 ½.
4. Roth accounts can reduce the size of a person's taxable estate by paying the applicable income tax from other assets.

Normally, taxable income will be recognized in the year of conversion. A special rule applies for conversions in the year 2010. Generally a taxpayer will not have to report any taxable income in the year 2010, but instead the amount of the conversion will be reported ratably in the years 2011 and 2012. A taxpayer can, instead, elect to have the entire amount taxed in 2010.

If a Roth IRA conversion proves to be an unwise transaction because of developments that occur after the conversion, it can be undone if acted upon prior to the due date (plus extensions) for filing the individual's federal income tax return.

Examples of subsequent developments that might warrant undoing

1. The value of the investments may have plummeted after the conversion, which could trigger an inflated income tax liability on deflated assets.
2. The individual does not have the cash to pay the tax.

A Roth IRA conversion can generate the greatest amount of taxable income that a person might ever have in his or her lifetime.

Planning strategies to reduce the tax bite and maximize the benefits

1. Since the 2010 federal income tax return isn't due until April 15, 2011 (October 15 with an extension), a taxpayer will have ample time to determine whether it is better to elect to have the entire conversion taxed in 2010 compared to reporting the income in 2011 and 2012.
2. Make charitable contributions so that the charitable income tax deduction is obtained in the highest income year to offset some of the higher taxes.
3. Try to convert when market values are low.
4. Avoid using assets in the Roth IRA to pay the income tax liability.

While a Roth IRA conversion is not for everyone, it could be an attractive tax planning opportunity in the right circumstance. As always, we urge you to secure professional tax advice prior to acting on any ideas discussed above. ■

Markets in the Crosshairs ~ Allan Keyes, Chief Investment Officer

After the pretty spectacular show that world markets staged in calendar 2009, and in spite of the scary markets in the U.S. on May 6, investors continue to remain cautiously optimistic in the early going this year as markets continue to push higher. Analysts have described most investors as surprisingly upbeat but perhaps apprehensive – reflecting the view that somewhere, sometime, there has to be a “payback” as economic activity adjusts to the period of monetary and fiscal stimulus that occurred around the world in 2008. For some time this anxiety has been on the minds of investors because higher interest rates, higher taxes and higher levels of inflation would seem to be in our future, and those kinds of hurdles would not seem to be consistent with higher and higher stock prices. Again, one would not know that by taking a quick look at these markets since mid-March a year ago.

In spite of recent declines in U.S. markets since March of 2009, U.S. markets are still ahead almost 35%. International markets during this period are also up in the period, but have given considerable ground reflecting much of recent euro-zone debt pressures. In an attempt to sort this out, investors must consider just how the world-wide de-leveraging process will likely unfold, and what impact, if any, this unwinding period will have on longer-term expected returns.

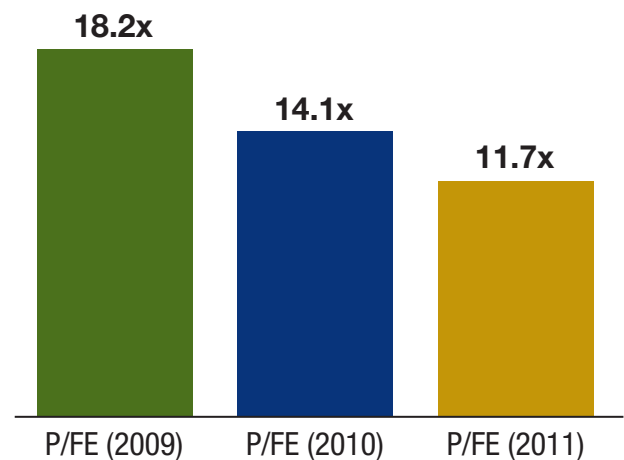
The U.S., as well as Europe and Asia, are experiencing a strengthening of economic activity, albeit at a modest pace. News at the end of the first quarter in the U.S. was encouraging as non-farm payrolls rose at the same time that the non-manufacturing ISM jumped to a three-year high, suggesting that the service sector of the U.S. economy is slowly recovering. This follows the manufacturing report two weeks earlier which also was stronger. Credit conditions, while still constrained, are improving, and consumer sentiment is also slowly improving. These are all positives, however, are somewhat offset by continuing joblessness, caution on the part of bankers, and a tentative mindset on the part of businessmen.

In the end, a lot of this comes down to the environment for businesses and expectations for earnings, and the

relative health of corporations as the economy continues to emerge from recession. In that regard, consensus estimates for operating earnings for the S&P 500 are in the neighborhood of \$65.00 for 2010 and about \$75.00 for 2011. Should these numbers prove to be close to actual results, valuation levels would not appear inexpensive, but not off the page either. Using these estimates, domestic markets are trading at about 17 times these 2010 estimates. Tracking earnings estimates around the world, valuation levels also seem restrained (see chart below). As for the health of U.S. corporations, balance sheets have never been better, as cash levels on balance sheets have never been higher. Also, there is abundant cash still on the sidelines available for permanent investments – a plus in terms of future demand for securities.

If earnings improve as expected, stocks should grow more attractive

Price to Earnings MSCI World: 2009, 2010, 2011



Current estimates do not guarantee future results.

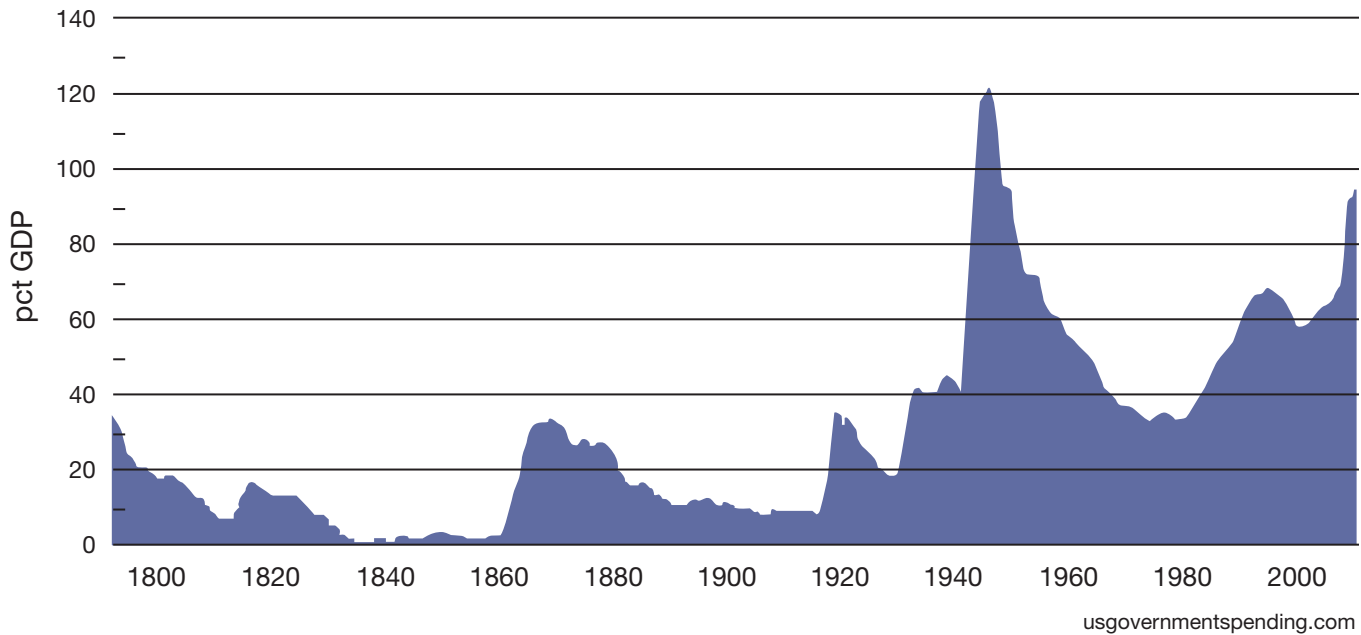
As of December 31, 2009

Price to forward earnings measures a company's current stock price divided by earnings estimates. It is used to compare current earnings to estimates future earnings. If earnings are expected to grow, in the future, the forward P/E will be lower than the current P/E.

Source: FactSet, MSCI, Thomson I/B/E/S and AllianceBernstein

The fact remains, however, that even though the environment for business has improved, skeptics will point out that in the U.S. we are simply no longer in free fall, and economic activity will be burdened for some time by high unemployment and the overhang of debt. These sorts of

US Federal Debt As Percent Of GDP Government Spending in US from FY 1792 to FY 2010



headwinds suggest that expected returns could be more modest over the next few years compared to historical levels. The reality of de-leveraging for governments and central banks will be a challenge for policy makers and the likelihood of higher interest rates, higher taxes and inflation rates are hurdles for markets and expected returns.

Without question, debt has become the topic du jour – the very mention of deleveraging suggests some sort of longer term period of discomfort, and if history serves, with good cause. Not since the Second World War have so many governments borrowed so much so quickly or, as a group, been so heavily in debt, and the fear continues that this debt surge may well not be so temporary (see chart above).

There is also the concern that the world's borrowing binge is taking place before the onset of the arrival of rapidly expanding pension and health care costs of the retiring baby boomers. Economists worry that the coming cost of this demographic bill will be many times larger than the fiscal cost of the financial crisis.

A recent report done by the McKinsey Global Institute,

a research arm of the consulting firm, highlights much of this. Most of the comparisons that have made headlines chart government debt as a percentage of GDP, and these numbers range from as low as 10%-15% to much higher – as high as 75% to 100%. If we compute ratios of total debt to GDP, including households, government, non-financial businesses, and the financial industry, the numbers, of course, seem much more onerous. McKinsey also summarized the history of sustained deleveraging in the aftermath of financial crises in the past – this is not encouraging to say the least. They found that in such periods the unwinding began an average of two years after the crises, and lasted for six to seven years. During the process, in most cases, output shrank considerably in the early years.

Again, all of this suggests investors may well be facing some periods of below trend line expected returns. We expect returns for equities for 2010 to be in the mid-single-digit range and potentially a little lower into 2011. For taxable fixed income markets we expect returns to equal the coupon, and in 2011 we expect bond returns to approximate the coupon less some price. ■

- In January we launched our first major (for us!) advertising campaign in several Virginia magazines: *Virginia Living*, *Albemarle*, *Virginia Sportsman*, and the *Piedmont Virginian*. We are running ads in each 2010 issue of these magazines, so let us know if you see our ads.
- Our Northern Virginia office outgrew its space in Tyson's Corner and moved to spacious offices in McLean in January. Their phone numbers did not change, and their new address is 1320 Old Chain Bridge Road, Ste. 205, McLean VA 22101.
- Don Murfee, head of our Williamsburg office, was honored by the Virginia Symphony at their annual dinner and auction on April 10. The Trust Company has been a longtime supporter of cultural arts and Don, who serves on the Symphony Board, has given generously of his time and money to enhance our corporate support.
- At Poplar Forest, Thomas Jefferson's retreat near Lynchburg, we sponsored the reception before the popular "Conversations with Jefferson," on April 24. Re-enactor Bill Barker portrayed Jefferson and this year had a conversation with Patrick Henry, portrayed by Richard Schumann.
- For the fifteenth year in a row, we sponsored the opening reception for the Virginia Continuing Legal Education Douglas Connor seminar for Trust and Estate attorneys on April 30. The seminar, held at the Homestead, had record attendance.
- On May 4, we held an Antiques Appraisal Fair at the Washington Golf and Country Club in Arlington. Guests brought small artifacts, antiques, or paintings and Ken Farmer, auctioneer and Antique Roadshow star, gave everyone his expert opinion on the provenance and value of the pieces.
- On May 25 we hosted our annual Richmond event at Lewis Ginter Botanical Gardens. This year Thom Horsey, Virginia representative for Rodney Strong Vineyards, conducted a wine school followed by a wine and food pairing.
- In September, Ken Farmer is going to run another Antiques Appraisal Fair in Lynchburg at the Boonsboro Country Club. ■

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