

POSSIBILITIES

FINANCIAL INSIGHTS FOR INDIVIDUALS AND BUSINESSES OCTOBER 2011



Recharacterizing IRA Contributions and Roth Conversions

Qualified distributions from Roth IRAs are free from income tax at the federal level. If you convert your traditional individual retirement account (IRA), simplified employee pension (SEP) IRA, or SIMPLE IRA to a Roth IRA, therefore, federal income tax is due for the year of the conversion. You pay tax now on the taxable portion of your traditional (or other) IRA. In return, you enjoy income-tax-free distributions from your Roth IRA in the future. Unfortunately, what may seem like a tax-wise move right now might prove to be an income tax nightmare when it's time to file your federal income tax return for the year. If so, you may be able to reverse or rescind your conversion if circumstances warrant it (and if you meet all of the necessary requirements). Such a rescission is known as a Roth IRA recharacterization.

In addition to reversing Roth IRA conversions, you may be able to “undo” or recharacterize regular (i.e., non-rollover) IRA contributions. In effect, you get to treat a contribution to one IRA as having been made directly to a different IRA.

Caution: State (and local) income tax treatment of Roth IRAs may differ from federal income tax treatment. Consult a tax professional to determine the tax treatment for your state.

What is a Recharacterization?

A recharacterization is an election to change the nature of your IRA contribution. The opportunity to recharacterize a contribution from one IRA to another type of IRA is designed to help taxpayers who change their minds or are ineligible for one type of IRA and

want to switch to another. Generally, you may recharacterize (correct) an IRA contribution or Roth IRA conversion by making a trustee-to-trustee transfer of the contribution (plus any related earnings) from one IRA to another type of IRA within certain deadlines.

Tip: When an individual recharacterizes an IRA contribution, the contribution is treated as though it had never been made to the original IRA; rather, the contribution is treated as having been made (as of the date of the original contribution to the original IRA) to the IRA to which the recharacterized funds are transferred. When an individual recharacterizes a Roth conversion, in effect, it is as though the conversion never occurred, and the funds are treated as having never left the traditional IRA.

Example(s): For instance, assume you converted a traditional IRA to a Roth IRA on August 1, and then recharacterized the conversion on December 1. For federal income tax purposes, you'll be treated as though you never made a contribution to the Roth IRA; it will be as though your funds were in a traditional IRA from August 1 on. Any earnings generated on the funds (or losses suffered) while they were in the Roth IRA will be treated as if they had occurred within the traditional IRA.

How do Recharacterized Earnings and Losses Affect Normal IRA Contribution Limits?

The amount recharacterized from one IRA to another must include related earnings or be reduced by any loss. However, earnings

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that are transferred with a recharacterized contribution don't affect the otherwise maximum IRA contribution limit.

Example(s): Assume John contributes \$1,000 to his traditional IRA for 2011. Before the deadline for filing his 2011 federal income tax return, John decides to recharacterize his contribution (plus the \$50 in earnings allocable to it) to a Roth IRA. Through a trustee-to-trustee transfer, \$1,050 is switched to his Roth IRA. If John is otherwise eligible, he can contribute an additional \$4,000 (\$5,000 if he is age 50 or older) by the end of the tax year to his Roth IRA for 2011. The \$50 of earnings is treated as having been earned in the Roth IRA.

Similarly, losses attributable to a recharacterized contribution don't increase the contribution limit to the second IRA.



Why Might You Want to “Undo” or Rescind a Conversion to a Roth IRA?

If your IRA investments experience a significant decline after the conversion date, you may be able to minimize your tax hit by reversing (recharacterizing) your conversion. When you convert a traditional IRA to a Roth IRA, you must pay federal income tax on the taxable portion of your traditional IRA for the year of the conversion. The amount of income tax you pay is based on the value of your IRA on the date you converted it. Therefore, you may want to recharacterize your contribution to a Roth IRA if your Roth IRA decreases in value (e.g., through a stock market downturn) after the conversion date.

Example(s): Assume you converted your \$100,000 traditional IRA to a Roth IRA in May. By December, your Roth IRA is worth only \$60,000—it has lost 40 percent of its value. Nevertheless, you'll pay income taxes based on the conversion date value of \$100,000. To get around this, you may be able to undo or recharacterize your Roth conversion. After the appropriate waiting period, you may be able to do a new conversion based on the new account value.

How do You Recharacterize an IRA Contribution or Roth Conversion?

To recharacterize an IRA contribution or Roth conversion, you should take the following steps:

Establish Another IRA (If Necessary)

Generally, you'll either need to establish an IRA or use an existing IRA to accept the withdrawn IRA funds. Recharacterizations made with the same IRA trustee can be made by redesignating the first IRA as the second IRA, rather than transferring the account balance to a new account.

Tip: You can't recharacterize employer contributions (including your elective deferrals) under a SEP-IRA or SIMPLE IRA plan as contributions to another IRA. However, if you converted SEP-IRA or SIMPLE IRA contributions to a Roth IRA,

you can recharacterize those contributions back to a SEP-IRA or SIMPLE IRA.

Inform Both Financial Institutions That You Want to Recharacterize

If more than one financial institution is involved, you must notify both financial institutions—the one servicing your present IRA and the one that will accept the recharacterized funds—that you intend to effect a recharacterization. (Only one notification is required if both IRAs are maintained by the same trustee.) Transferring your funds without such a notice may invalidate the recharacterization. You must provide the notice on or before the date of the transfer.

Caution: A valid recharacterization of IRA funds generally must be accomplished through a trustee-to-trustee transfer. You can't withdraw money from your IRA and roll it over to a new IRA within 60 days—the funds must be transferred directly from one IRA to the other.

If your IRA provider doesn't have a standard form for recharacterizations, you should consult a tax professional to create one. Your form should include all required information, including the following:

- An appropriate heading, such as “Notice of Election to Recharacterize IRA Contribution/Conversion.”
- Your name, address, telephone number, IRA account number, and Social Security number.
- The name of the first IRA trustee and the name of the second (new) IRA custodian/trustee.
- The type and amount of the contribution to the first IRA that you now want to recharacterize. Inform the first IRA trustee that you want your contribution, plus any net income (or net loss) allocable to that contribution to be recharacterized. (See below for more information on calculating net income/loss.)
- The date on which the contribution was made to the first IRA, and the year for which it was made (if applicable)
- A direction to the first IRA custodian/trustee that you want to make a direct, trustee-to-trustee transfer of funds from your present IRA

to a new IRA by a specified date. (Include the account number of the new IRA, as well as the name, address, and telephone number of the new IRA custodian/trustee.)

Send a copy of your recharacterization notice to both IRA custodians/trustees. In addition, you should follow up with both of them to ensure that the transfer is accomplished on time.

Meet All Applicable Deadlines

The deadline for recharacterizing an IRA contribution or Roth IRA conversion is the due date of your federal income tax return, including extensions, for the year of the original contribution. (The year of the original contribution means the year to which the contribution relates—not the year the contribution was actually made.) So, if you file for an automatic extension, you have until October 15 to recharacterize a contribution for the preceding year.

But what if you filed your income tax return on or before April 15 and now want to recharacterize a Roth IRA contribution? In such a case, you would have already paid the conversion tax. If you follow a special procedure, you'll be allowed to recharacterize the Roth IRA contribution up until October 15 even if you already filed your income tax return on time and didn't obtain a filing extension. To take advantage of this rule, you'll have to file an amended return (IRS Form 1040-X) and write “Filed pursuant to Section 301.9100-2” on the return. You'll be able to obtain a refund for any tax paid on the conversion. You'll also need to include a new or amended Form 8606.

Caution: You can use this special procedure only if you filed your income tax return on time (i.e., either by April 15, or within the extension period if you filed for an extension in a timely manner).

Don't confuse the amended return date with the recharacterization due date. An amended return can be filed as late as three years after the original return was filed. However, the deadline for recharacterizing your Roth IRA funds (i.e.,

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for transferring the funds) is the October 15, following your April 15 tax-return-filing deadline for the prior tax year.

Report the Recharacterization

If you elect to recharacterize a contribution (either on your federal income tax return or on an amended return), you may have to attach Form 8606 and a statement explaining the recharacterization. You must report the recharacterization on the tax return for the tax year in which you made the original contribution or Roth conversion. See the instructions to Form 8606 for more information.

How Do You Allocate the Earnings When You Recharacterize a Contribution?

When you recharacterize an IRA contribution, you must transfer the contribution, plus any earnings allocable to that contribution to a new IRA.

Tip: In order to make it easier to calculate the amount (specifically, the allocable earnings) you need to transfer back to the traditional IRA in the event you wish to recharacterize (undo) a conversion, it generally makes sense to use a new Roth IRA (rather than an existing Roth IRA) to hold each conversion. It may also make sense to use separate Roth IRAs for each different investment you wish to make. (If you want, you can always combine two or more of your Roth IRAs after the deadline for recharacterizing has passed.)

Full Recharacterization

If your IRA is comprised only of the contribution and earnings that you want to recharacterize, you can simply recharacterize (transfer) the entire IRA. If your IRA has suffered a loss since the time of the original conversion, you don't have to make up the loss when you recharacterize the IRA.

Partial Recharacterization

If you're recharacterizing only part of an IRA, you need to determine how much of the IRA's earnings are attributable to the part you're transferring and how much belong to the portion of the IRA that remains. Here's the formula (note that net income can be negative):

$$\text{Net income} = \text{Contribution} \times [(\text{Adjusted closing balance} - \text{Adjusted opening balance}) / \text{Adjusted opening balance}]$$

The opening balance for this computation is the IRA's fair market value (FMV) immediately before the contribution was made to the account, and the closing balance is the FMV of the account right before the contribution is removed. The "adjusted opening balance" is the opening balance, plus any contributions or transfers (including the amount being recharacterized) made to the account during the computation period. The "adjusted closing balance" is the closing balance, plus any distributions (including recharacterizations) made from the account during the computation period.

Example(s): Assume John has a Roth IRA that is worth \$50,000 on February 1, 2010. On that same date, John decides to convert \$100,000 from a traditional IRA to his existing Roth IRA. Before he files his federal income tax return for 2010, John learns that his income level will render him ineligible to make a Roth conversion contribution in 2010. So, on February 1, 2011, he requests that the \$100,000 be recharacterized to his traditional IRA. On that date, when his Roth IRA is worth \$135,000, the Roth IRA trustee transfers to John's traditional IRA the \$100,000 contribution, plus allocable net income.

Here's how the allocable net income is calculated. The adjusted opening balance of the account is \$150,000 (\$50,000 + \$100,000), and the adjusted closing balance is \$135,000. Therefore, the net income (actually, the net loss) allocable to the \$100,000 contribution is -\$10,000 [$\$100,000 \times (\$135,000 - \$150,000) / \$150,000$]. To recharacterize John's \$100,000 conversion contribution, the Roth IRA trustee must transfer \$90,000 (\$100,000 - \$10,000) from his Roth IRA to his traditional IRA.

Tip: If more than one contribution is being recharacterized, different rules may apply. If multiple contributions for a particular year are eligible for recharacterization, the IRA owner chooses which contribution to recharacterize. And if a series of regular contributions had been made, and consecutive contributions in that series were being recharacterized, the computation period would be determined using a single computation period (based on the first contribution in the series). For more information, consult a tax professional.

Technical Note: Your IRA provider may calculate for you the amount of net income to be transferred. If your provider is unable to do so, direct him or her to IRS Notice 2000-39 and IRS Reg. Section 1.408A-5.

How Long Must You Wait Before You Can Convert or Roll Over Your Funds Back to a Roth IRA?

If you convert funds to a Roth IRA and then switch the funds back to a traditional IRA through a recharacterization, you'll have to wait awhile before you can reconvert those funds to a Roth IRA. You can't convert and reconvert an amount during the same

taxable year, or if later, during the 30-day period following a recharacterization. If you reconvert during either of these periods, the conversion will be a failed one.

For example, assume you convert a traditional IRA to a Roth IRA in May of 2011. On August 6, 2011, you recharacterize that Roth IRA to a traditional IRA. You now want to reconvert to a Roth IRA. You won't be able to effect a reconversion until the later of:

- January 1, 2012 (the beginning of the year following the year in which the amount was originally converted to the Roth IRA), or
- September 6, 2011 (the end of the 30-day period following the day on which you

recharacterized the Roth IRA to a traditional IRA)

Because the later of the two dates is what matters, you'll have to wait until at least January 1, 2012, to reconvert.

For more information about Roth IRA conversions and recharacterizations, see IRS Publication 590.

CONTACT

- Talk to your local Eide Bailly financial advisor
- Call 866.740.4100 for more information

Handling Market Volatility

How you choose to invest your money should be consistent with your goals and time horizon. The right approach during all kinds of markets is to be realistic. Have a plan, stick with it, and strike a comfortable balance between risk and return.

Conventional wisdom says that what goes up, must come down. But even if you view market volatility as a normal occurrence, it can be tough to handle when it's your money at stake. Though there's no foolproof way to handle the ups and downs of the stock market, the following common sense tips can help.

Don't Put Your Eggs All in One Basket

Diversifying your investment portfolio is one of the key ways you can handle market volatility. Because asset classes often perform differently under different market conditions, spreading your assets across a variety of investments such as stocks, bonds, and cash alternatives (e.g., money market funds, CDs, and other short-term instruments), has the potential to help reduce your overall risk. Ideally, a decline in one type of asset will be balanced out by a gain in another, but diversification can't eliminate the possibility of market loss.

One way to diversify your portfolio is through asset allocation. Asset allocation involves identifying the asset classes that are appropriate for you and allocating a certain percentage of your investment dollars to each class (e.g., 70 percent to stocks, 20 percent to bonds, 10 percent to cash alternatives). An easy way to decide on an appropriate mix of investments is to use a worksheet or an interactive tool that suggests a model or sample allocation based on your investment objectives, risk tolerance level, and investment time horizon.

Focus on the Forest, Not on the Trees

As the market goes up and down, it's easy to become too focused on day-to-day returns. Instead, keep your eyes on your long-term investing goals and your overall portfolio. Although only you can decide how much investment risk you can handle, if you still have years to invest, don't overestimate the effect of short-term price fluctuations on your portfolio.

Look Before You Leap

When the market goes down and investment losses pile up, you may be tempted to pull out of the stock market altogether and look for less volatile investments. The small returns that

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typically accompany low-risk investments may seem attractive when more risky investments are posting negative returns.

But before you leap into a different investment strategy, make sure you're doing it for the right reasons. How you choose to invest your money should be consistent with your goals and time horizon.

For instance, putting a larger percentage of your investment dollars into vehicles that offer safety of principal and liquidity (the opportunity to easily access your funds) may be the right strategy for you if your investment goals are short-term (e.g., you'll need the money soon to buy a house) or if you're growing close to reaching a long-term goal such as retirement. But if you still have years to invest, keep in mind that stocks have historically outperformed stable value investments over time, although past performance is no guarantee of future results. If you move most or all of your investment dollars into conservative investments, you've not only locked in any losses you might have, but you've also sacrificed the potential for higher returns.

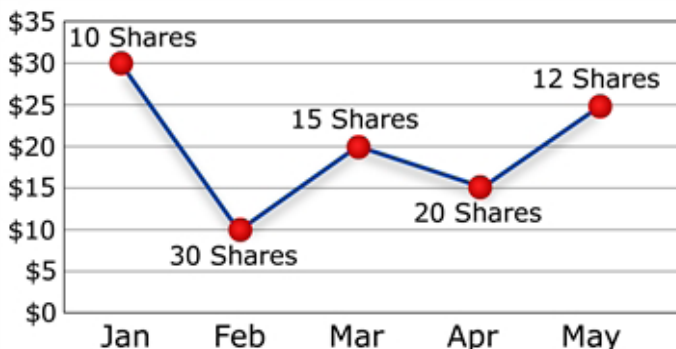
Look for the Silver Lining

A down market, like every cloud, has a silver lining. The silver lining of a down market is the opportunity you have to buy shares of stock at lower prices.

One of the ways you can do this is by using dollar cost averaging. With dollar cost averaging, you don't try to "time the market" by buying shares at the moment when the price is lowest. In fact, you don't worry about price at all. Instead, you invest a specific amount of money at regular intervals over time.

When the price is higher, your investment dollars buy fewer shares of stock, but when the price is lower, the same dollar amount will buy you more shares.

For example, let's say that you decided to invest \$300 each month toward your child's college education. As the illustration shows, your regular monthly investment of \$300 bought more shares when the price was low and fewer shares when the price was high:



Although dollar cost averaging can't guarantee you a profit or avoid a loss, a regular fixed dollar investment may result in a lower average price per share over time, assuming you continue to invest through all types of markets. You should consider your financial and emotional ability to make ongoing purchases, regardless of price fluctuations, however.

(This hypothetical example is for illustrative purposes only and does not represent the performance of any particular investment. Actual results will vary.)

Don't Stick Your Head in the Sand

While focusing too much on short-term gains or losses is unwise, so is ignoring your investments. You should check up on your portfolio at least once a year, more frequently if the market is particularly volatile or when there have been significant changes in your life. You may need to rebalance your portfolio to bring it back in line with your investment goals and risk tolerance. A financial professional can help you decide which investment options are right for you.

Don't Count Your Chickens Before They Hatch

As the market recovers from a down cycle, elation quickly sets in. If the upswing lasts long enough, it's easy to believe that investing in the stock market is a sure thing. But, of course, it never is. As many investors have learned the hard way, becoming overly optimistic about investing during the good times can be as detrimental as worrying too much during the bad times. The right approach during all kinds of markets is to be realistic. Have a plan, stick with it, and strike a comfortable balance between risk and return.

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The Investment Tax Landscape: Countdown to 2013

In December 2010, Congress extended the so-called Bush-era tax cuts by passing the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. However, for investors, the legislation may represent not a pardon but a stay of execution. While it's true that federal tax rates on income, qualifying dividends, and capital gains have been extended through the end of the 2012 tax year, many of the issues that influenced the debate over tax rate extensions will continue to be the subject of heated discussion. As a result, investors have been granted a reprieve while Congress wrestles with those issues. That's time you can use to think about how best to position your portfolio.

The Can Won't Stay Kicked Down the Road Forever

Why should you look at the time between now and 2013 as an opportunity? Because the U.S. budget deficit is at levels that both political parties recognize can't be sustained long-term. In 2010, a presidential budget commission recommended addressing the problem through a combination of spending cuts and tax increases. Though the proposals didn't get enough support to be submitted to Congress, the deficit problem hasn't gone away. Even if Congress can agree on budget cuts, the possibility of higher taxes in the future can't be ruled out.

There are several categories of investors who should be paying particular attention to the planning process in the coming years. They include people with investments that have appreciated substantially in value; people who rely on dividends and bonds to provide them with ordinary living expenses; and people who are considering investing in the newly issued stock of a small business.

Capital Gains and Dividends

The tax cut extensions gave investors who have large unrealized capital gains some breathing room. Rather than a top tax rate of 20%, long-term capital gains will generally continue to be subject to a maximum rate of

15%, and the rate for investors in the lowest two tax brackets will remain at zero. If you own investments that have appreciated substantially in value and that now represent a bigger portion of your portfolio than you'd like, you have another chance to examine whether it makes sense to unwind those investments before the end of 2012. Taxes obviously are only one factor in making such a decision, of course. However, if you've been considering selling an asset anyway, you've got some time to plan and gradually implement a strategy for doing so.

Two points worth remembering: first, unless further action is taken, the top long-term capital gains rate will increase to 20% after 2012 (a top rate of 10% will apply to investors in the 15% tax bracket); and second, even at the increased level, the rates on those gains would still be relatively low. As recently as 1986, under President Ronald Reagan, the Tax Reform Act of 1986 provided for capital gains to be taxed at the same rates as ordinary income, with a top rate of 28%. To paraphrase Mark Twain, no one is safe when Congress is in session, and there's no guarantee that the top capital gains rate after 2012 might not be increased beyond the scheduled 20% maximum.

Qualified dividends will continue to be taxed through 2012 at the long-term capital gains rates rather than as ordinary income, as they were before 2003 and are scheduled to be again beginning in 2013. The higher your tax bracket and the more reliant you are on dividends for your income, the more you should be aware of the potential impact if that income were subject to higher taxes. Again, many factors will affect your decision about the role of dividends in your portfolio, including the potential for higher interest rates in the future. However, doing some "what-if" analysis might be useful.

Taxable vs. Tax-free Bonds

Taxable bonds typically pay higher interest rates than municipal bonds. However, if you're in a relatively high tax bracket or

expect to be in one in the future, munis can potentially offer a better after-tax return. They may be worth a second look between now and 2013, when—separate from any potential increase in federal income tax rates—the unearned income of people making \$200,000 a year (\$250,000 for couples filing a joint return) is scheduled to be subject to a new 3.8% Medicare contribution tax. Absent further legislative changes, that could make munis even more attractive for affluent investors.

However, as with any investment decision, there are many factors to consider. Local and state governments have come under severe financial constraints in recent years, and though the default rate on muni bonds has historically been low, default by individual governmental bodies is always possible. Also, the legislation that extended the tax cuts did not authorize continued issuance of Build America Bonds (BABs) beyond 2010. During the almost two years BABs were authorized, many local and state governments used them to tap the taxable bond market; that temporarily reduced the issuance of new tax-free munis. However, since BABs can no longer be issued without further authorization from Congress, the supply of new munis may increase, which could affect prices. Finally, interest rates have been at historic lows since the end of 2008; since bond prices move in the opposite direction from their yields, rising interest rates would not be good news for bond prices.

Tax Break for Qualifying Small Business Stock

To help small businesses raise capital, the Internal Revenue Code offers a tax break for investments in businesses that meet certain qualifications. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the exclusion of 100% of



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any capital gains on the sale of qualified small business stock. The 100% exclusion now applies to qualifying stock issued after September 27, 2010, and before January 1, 2012.

The 100% exclusion is higher than that previously available. Prior to the 2010 legislation, the exclusion amount for a qualifying small business investment was generally 50% of the capital gains on stock issued between August 10, 1993, and February 17, 2009, or 75% for stock issued after February 17, 2009, and before September 28, 2010.

If you're interested in making an investment that qualifies for the exclusion, you should be aware of some of the restrictions that govern it:

- You must hold the stock for more than five years.
- The business must satisfy certain active business requirements.
- The gross assets of the business may not exceed \$50 million before or immediately after issuance of the company's stock.
- The stock must be acquired at original issue rather than purchased through the secondary market. (Exceptions apply, including those relating to qualifying stock acquired through inheritance or as a gift.)
- A qualified investor must be a noncorporate

investor (though passthrough entities such as S corporations and partnerships may qualify).

- You may not sell the stock short during the required five-year holding period and still receive the exclusion.

There are limits on the total amount of gain that is eligible for the exclusion. There also may be special considerations if you roll over the gain from the sale of your stock to another qualified small business stock, or if you receive qualified stock as part of your deferred compensation plan. Consult a financial professional about your specific situation.

2013 and beyond

The nation's financial pressures will almost certainly mean continued adjustments to the tax code as 2013 approaches. Though there are no guarantees about what will happen when the new provisions expire, investors generally have another chance to fine-tune their planning efforts while taxes remain historically low. If a bird in the hand is worth two in the bush, why not get expert help in taking advantage of the opportunities available now? ■

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