Investment Tax Management and Roth Conversions

Presented by…
Savant Capital Management, Inc.
Brent A. Lindell CTFA
Tawn M. Jacobs MST, CPA, CFP®
Brent A. Lindell  CTFA

Financial Advisor

- 16 years of experience as trust officer and financial advisor
- Works out of Savant’s Madison location
- Certified Trust & Financial Advisor (CTFA)
- Currently pursuing Certified Financial Planner (CFP®)
- Joined Team Savant in March 2007
Tawn M. Jacobs  MST, CPA, CFP®

Senior Financial Planner/ Director of Financial Planning

- Extensive experience consulting on tax issues and tax planning
- Prior to joining Team Savant, Tawn owned her own accounting firm and later spent many years as a senior manager in the tax and wealth management departments of a major CPA firm.
- Holds a Master of Science in Taxation (MST)
- Joined Team Savant in June 2004
Today’s Agenda

I. Continually Changing Tax Rules

II. Tax Management Techniques

III. Roth Conversion

IV. Questions and Discussion
“There is nothing certain in life but death and taxes.”

– Benjamin Franklin
Politicians Are Fickle:
Tax Rates and Rules Change Continually

Current Maximum 2008 Tax Rates
35% Ordinary Income and Interest
15% Long-Term Capital Gain and Dividend*
Tax Law Changes in 2009

- No RMD requirement for 2009 only
- Making work pay credit ($400/person)
- Cash for clunkers ($3,500/$4,500 not taxable-federal)
- Unemployment benefits not taxed up to $2,400
- 1st Time Homebuyer credit (up to $8,000)
- Alternative Minimum Tax (AMT) exemption increased
- Standard mileage rate (55cents)
- American Opportunity Credit $2,500 (formerly Hope Education Credit)
Today’s Agenda

I. Continually Changing Tax Rules

II. Tax Management Techniques

III. Roth Conversion

IV. Questions and Discussion
Investment Tax Management

How do you control taxes and effectively enhance the returns on your portfolio?
1. **Passive Management/Turnover**
2. **Charitable Gifting of Appreciated Stock**
   - Donor Advised Fund
3. **Tax Loss Arbitrage (Loss Harvesting)**
4. **Asset Location**
   - SISTEM (Savant Indexed Separate Tax-Efficient Manager)
5. **Systematic Rebalancing**
6. **Municipal Bond (Qualification)**
7. **IRA Distributions to Charity**
8. **Tax Efficient Distribution Planning**
Expected Annualized After-Tax Returns of Different Equity Fund Strategies

Develop Tax Strategies

(Assumes 20-year holding period with liquidation at end)

Source: Savant Analysis, Morningstar Principia; See Endnotes 1, 2, and 3.
Tax Management: Taxes and Internal Fund Expenses Reduce Net Returns

Indexed Mutual Funds[^2]

- 8.50% Net Return
- 0.15% Expense Ratio
- 0.02% Transaction Costs
- 0.95% Total Taxes
- 1.12% Total Annual Costs

Conventional Mutual Funds[^3]

- 6.36% Net Return
- 1.22% Expense Ratio
- 0.50% Transaction Costs
- 1.54% Total Taxes
- 3.26% Total Annual Costs

(Assumed 9.62% Gross Annual Return)[^1]

Source: Savant Analysis, Morningstar Principia; See Endnotes 1, 2, and 3.
**Tax Management Techniques**

1. Passive Management/Turnover
2. **Charitable Gifting of Appreciated Stock**
   - Donor Advised Fund
3. Tax Loss Arbitrage (Loss Harvesting)
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# Annual Gifting With Cash

<table>
<thead>
<tr>
<th>YEAR</th>
<th>MARGINAL TAX RATE</th>
<th>DESCRIPTION</th>
<th>CASH DISBURSED</th>
<th>TAX SAVINGS</th>
<th>NET COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>35%</td>
<td>Cash to Charity</td>
<td>$ 5,000</td>
<td>$ 1,750</td>
<td>$ 3,250</td>
</tr>
<tr>
<td>2</td>
<td>15%</td>
<td>Cash to Charity</td>
<td>5,000</td>
<td>750</td>
<td>4,250</td>
</tr>
<tr>
<td>3</td>
<td>15%</td>
<td>Cash to Charity</td>
<td>5,000</td>
<td>750</td>
<td>4,250</td>
</tr>
</tbody>
</table>

| Totals |                  |                  | $ 15,000       | $ 3,250     | $ 11,750 |
## Alternative Gifting Strategy: Gift Appreciated Securities to a Donor Advised Fund (DAF)

<table>
<thead>
<tr>
<th>YEAR</th>
<th>MARGINAL TAX RATE</th>
<th>DESCRIPTION</th>
<th>CASH DISBURSED</th>
<th>TAX SAVINGS</th>
<th>NET COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>35%</td>
<td>Gift $15,000 in Stock to DAF (Cost Basis of $7,500)</td>
<td>$ 0</td>
<td>$ 6,375</td>
<td>$ 8,625</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Direct $5000 from DAF to Charity</td>
<td>5,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>15%</td>
<td>Direct $5000 from DAF to Charity</td>
<td>5,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>15%</td>
<td>Direct $5000 from DAF to Charity</td>
<td>5,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td><strong>Totals</strong></td>
<td><strong>$ 15,000</strong></td>
<td><strong>+</strong></td>
<td><strong>$ 6,375</strong></td>
<td><strong>=</strong></td>
</tr>
</tbody>
</table>

**Tax-Advantage of DAF Strategy**  
$ 11,750 - $ 8,625 = $ 3,125
Tax Management Techniques

1. Passive Management/Turnover
2. Charitable Gifting of Appreciated Stock
   • Donor Advised Fund
3. **Tax Loss Arbitrage (Loss Harvesting)**
4. Asset Location
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7. IRA Distributions to Charity
8. Tax Efficient Distribution Planning
The Concept: Sell investments with “unrealized” capital losses and buy back “nearly” identical investments to “book” the tax deduction.

The Goal: Create tax deductions that offset other taxable gains and inventory excess losses (that cannot be used in current year) to reduce future year’s tax bill.

The Benefit: Reduce taxes with relatively no cost and/or risk.
Examples of “Loss Harvesting”

• Sell Vanguard 500 & buy iShares S&P 500 = $12,500 loss.

• Sell Vanguard Europe Index, sell Vanguard Pacific Index & buy Vanguard Developed Markets Index = $12,500 loss.

• “Loss Harvesting” generated a total of a $25,000 long-term loss.
## Application of Tax Loss Harvesting

<table>
<thead>
<tr>
<th>Name</th>
<th>Allocation</th>
<th>Taxable</th>
<th>2008 Realized Loss</th>
<th>2009 Realized Loss</th>
<th>2008-2009 Total Realized Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio 1</td>
<td>60% Stock/40% Bond</td>
<td>$1,490,000</td>
<td>$47,713</td>
<td>$348,527</td>
<td>$396,240</td>
</tr>
<tr>
<td>Portfolio 2</td>
<td>80% Stock/20% Bond</td>
<td>$5,722,717</td>
<td>$1,374,021</td>
<td>$432,483</td>
<td>$1,806,504</td>
</tr>
<tr>
<td>Portfolio 3</td>
<td>70% Stock/30% Bond</td>
<td>$1,113,061</td>
<td>$427,079</td>
<td>$142,950</td>
<td>$570,029</td>
</tr>
</tbody>
</table>

Information drawn from actual Savant client data; for illustrative purposes only.
Tax Management Techniques

1. Passive Management/Turnover
2. Charitable Gifting of Appreciated Stock
   • Donor Advised Fund
3. Tax Loss Arbitrage (Loss Harvesting)
4. **Asset Location**
   • SISTEM (Savant Indexed Separate Tax-Efficient Manager)
5. Systematic Rebalancing
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8. Tax Efficient Distribution Planning
### Asset Location

**Asset Returns Are Taxed Differently**

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Tax Rate/Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term Capital Gains</td>
<td>15% for most investors / 0% for investors in the 10% and 15% tax brackets</td>
</tr>
<tr>
<td>Short-term Capital Gains</td>
<td>Ordinary income tax rates up to 35%</td>
</tr>
<tr>
<td>Qualified Dividends</td>
<td>Same as long-term capital gains</td>
</tr>
<tr>
<td>Ordinary Dividends</td>
<td>Ordinary income tax rates up to 35%</td>
</tr>
</tbody>
</table>

**Note:** In order for a dividend to be considered “Qualified,” it must be paid by a U.S. corporation and have been held for at least 60 days.
## Asset Location

### Asset Location in Different Types of Accounts

<table>
<thead>
<tr>
<th>Roth IRA</th>
<th>Traditional IRA</th>
<th>Taxable</th>
</tr>
</thead>
</table>
## Asset Location in Different Types of Accounts

<table>
<thead>
<tr>
<th>Type</th>
<th>Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Roth IRA</strong></td>
<td>Assets grow tax-free with no tax at withdrawal</td>
</tr>
</tbody>
</table>
| **Ideal Asset Characteristics:** | • High Ordinary Income  
• Highest Expected Growth  
• High Distributions |
| **Traditional IRA** | Assets grow tax-deferred with withdrawals taxed at ordinary income rates |
| **Ideal Asset Characteristics:** | • High Ordinary Income  
• Lowest Expected Growth  
• High Distributions |
| **Taxable**    | Both Income and Capital gains taxed                                                |
| **Ideal Asset Characteristics:** | • Low Ordinary Income  
• High Growth OK (Taxed at Capital Gains Rates) |
### Asset Location in Different Types of Accounts

**Example: Typical 70/30 Portfolio with assets in all three account types**

<table>
<thead>
<tr>
<th>Roth IRA</th>
<th>Traditional IRA</th>
<th>Taxable</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Small Value Stocks</td>
<td>• Commodities</td>
<td>• Small Value Stocks</td>
</tr>
<tr>
<td>• Emerging Markets Stocks</td>
<td>• Intermediate-term Bonds</td>
<td>• Emerging Markets Stocks</td>
</tr>
<tr>
<td></td>
<td>• Inflation-Protected Bonds (TIPS)</td>
<td>• U.S. Large Value Stocks</td>
</tr>
<tr>
<td></td>
<td>• Short-term Bonds</td>
<td>• International Large Value Stocks</td>
</tr>
<tr>
<td></td>
<td>• REITs</td>
<td>• U.S. Small Stocks</td>
</tr>
<tr>
<td></td>
<td>• International Large Stocks</td>
<td>• International Small Stocks</td>
</tr>
<tr>
<td></td>
<td>• U.S. Large Stocks</td>
<td>• International Small Value Stocks</td>
</tr>
</tbody>
</table>

- **U.S. Large Stocks**
SISTEM is a separate account solution that allows clients with sizably taxable equity accounts to hold individual securities.

**Benefits Include**

- Tax efficiency using tax loss harvesting which offsets gains with losses whenever possible.
- The ability to create a diversified portfolio around a highly concentrated asset class.
- The ability to move a highly concentrated stock position to a diversified portfolio in a tax-efficient manner.
- The ability to maintain a socially or morally conscious portfolio if desired.
Tax Management Techniques

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What is rebalancing?

- Systematic buying low and selling high
- Maintaining assets to target allocation within tax efficient parameters

Why is rebalancing critical?

- Commitment to long-term risk-reduction strategy
- Discipline over human emotion
- Increased return – research indicates ≈ 0.5% gain
Systematic Rebalancing
Rebalancing Added Return and Reduced Risk

Risk and Return of
Rebalanced and Non-Rebalanced Portfolios
1/1/1999 – 12/31/2008

Source: Morningstar EnCorr
Risk Adjusted Return = Annual Return/Standard Deviation
<table>
<thead>
<tr>
<th>Class Name</th>
<th>Target</th>
<th>Actual</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and Equivalents</td>
<td>0.00%</td>
<td>0.37%</td>
<td>-0.37%</td>
</tr>
<tr>
<td>U.S. Large Cap</td>
<td>15.00%</td>
<td>14.83%</td>
<td>0.17%</td>
</tr>
<tr>
<td>U.S. Large Value</td>
<td>13.70%</td>
<td>13.82%</td>
<td>-0.12%</td>
</tr>
<tr>
<td>U.S. Small Cap</td>
<td>8.00%</td>
<td>8.07%</td>
<td>-0.07%</td>
</tr>
<tr>
<td>U.S. Small Value</td>
<td>9.10%</td>
<td>9.09%</td>
<td>0.01%</td>
</tr>
<tr>
<td>International Large Cap</td>
<td>3.10%</td>
<td>3.15%</td>
<td>-0.05%</td>
</tr>
<tr>
<td>International Large Value</td>
<td>4.20%</td>
<td>4.32%</td>
<td>-0.12%</td>
</tr>
<tr>
<td>International Small Company</td>
<td>3.60%</td>
<td>3.71%</td>
<td>-0.11%</td>
</tr>
<tr>
<td>International Small Value</td>
<td>3.70%</td>
<td>3.89%</td>
<td>-0.19%</td>
</tr>
<tr>
<td>International Emerging Markets</td>
<td>5.00%</td>
<td>4.88%</td>
<td>0.12%</td>
</tr>
<tr>
<td>Fixed Income – Intermediate</td>
<td>10.10%</td>
<td>9.76%</td>
<td>0.34%</td>
</tr>
<tr>
<td>Fixed Income – Short Term</td>
<td>10.10%</td>
<td>9.79%</td>
<td>0.31%</td>
</tr>
<tr>
<td>Fixed Income – Inflation Adjusted</td>
<td>6.80%</td>
<td>6.63%</td>
<td>0.17%</td>
</tr>
<tr>
<td>Real Estate – Domestic</td>
<td>3.00%</td>
<td>3.49%</td>
<td>-0.49%</td>
</tr>
<tr>
<td>Real Estate – International</td>
<td>1.60%</td>
<td>1.19%</td>
<td>0.41%</td>
</tr>
<tr>
<td>Commodities</td>
<td>3.00%</td>
<td>3.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.00%</strong></td>
<td><strong>100.00%</strong></td>
<td></td>
</tr>
</tbody>
</table>
Tax Management Techniques

1. Passive Management/Turnover
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6. **Municipal Bond (Qualification)**
7. IRA Distributions to Charity
8. Tax Efficient Distribution Planning
2009 Tax Tables

<table>
<thead>
<tr>
<th>MARGINAL FEDERAL TAX RATE</th>
<th>SINGLE</th>
<th>Married Filing Jointly</th>
<th>Married Filing Separate</th>
<th>Head of Household</th>
<th>Trust &amp; Estates</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$\leq 8,350$</td>
<td>$\leq 16,700$</td>
<td>$\leq 8,350$</td>
<td>$\leq 11,950$</td>
<td>N/A</td>
</tr>
<tr>
<td>15%</td>
<td>$8,351 – 33,950$</td>
<td>$16,701 – 67,900$</td>
<td>$8,351 – 33,950$</td>
<td>$11,951 – 45,500$</td>
<td>$&lt; 2,200$</td>
</tr>
<tr>
<td>35% *</td>
<td>$372,951 +</td>
<td>$372,951 +</td>
<td>$186,476 +</td>
<td>$372,951 +</td>
<td>$10,701 +</td>
</tr>
</tbody>
</table>

* Marginal effective tax rate may be higher due to phaseouts of personal exemptions, itemized deductions and imposition of Alternative Minimum Taxes (AMT).
Investors in the 33% and 35% tax bracket would prefer a 3.5% municipal bond over a similar risk 5% taxable bond.

<table>
<thead>
<tr>
<th>MUNICIPAL TAX-FREE YIELD</th>
<th>10%</th>
<th>15%</th>
<th>25%</th>
<th>28%</th>
<th>33%</th>
<th>35%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0</td>
<td>1.11%</td>
<td>1.18%</td>
<td>1.33%</td>
<td>1.39%</td>
<td>1.49%</td>
<td>1.54%</td>
</tr>
<tr>
<td>1.5</td>
<td>1.67%</td>
<td>1.76%</td>
<td>2.00%</td>
<td>2.08%</td>
<td>2.24%</td>
<td>2.31%</td>
</tr>
<tr>
<td>2.0</td>
<td>2.22%</td>
<td>2.35%</td>
<td>2.67%</td>
<td>2.78%</td>
<td>2.99%</td>
<td>3.08%</td>
</tr>
<tr>
<td>2.5</td>
<td>2.78%</td>
<td>2.94%</td>
<td>3.33%</td>
<td>3.47%</td>
<td>3.73%</td>
<td>3.85%</td>
</tr>
<tr>
<td>3.0</td>
<td>3.33%</td>
<td>3.53%</td>
<td>4.00%</td>
<td>4.17%</td>
<td>4.48%</td>
<td>4.62%</td>
</tr>
<tr>
<td>3.5</td>
<td>3.89%</td>
<td>4.12%</td>
<td>4.67%</td>
<td>4.86%</td>
<td>5.22%</td>
<td>5.38%</td>
</tr>
<tr>
<td>4.0</td>
<td>4.44%</td>
<td>4.71%</td>
<td>5.33%</td>
<td>5.59%</td>
<td>5.97%</td>
<td>6.15%</td>
</tr>
<tr>
<td>4.5</td>
<td>5.00%</td>
<td>5.29%</td>
<td>6.00%</td>
<td>6.25%</td>
<td>6.72%</td>
<td>6.92%</td>
</tr>
<tr>
<td>5.0</td>
<td>5.56%</td>
<td>5.86%</td>
<td>6.67%</td>
<td>6.94%</td>
<td>7.46%</td>
<td>7.69%</td>
</tr>
<tr>
<td>5.5</td>
<td>6.11%</td>
<td>6.47%</td>
<td>7.33%</td>
<td>7.64%</td>
<td>8.21%</td>
<td>8.45%</td>
</tr>
<tr>
<td>6.0</td>
<td>6.67%</td>
<td>7.06%</td>
<td>8.00%</td>
<td>8.33%</td>
<td>8.96%</td>
<td>9.23%</td>
</tr>
</tbody>
</table>
Muni Bond Qualification Checklist

John                 Jane       Doe
Filing Status      MFJ  (use drop down)  

☐ Use prior year’s tax return

John   DOB: 6/1/1943   Age: 66.5
Jane   DOB: 12/16/1947  Age: 61.9

☐ Calculate the average tax rate

Total Tax (line 61) divided by AGI (line 37)               20%

$225,016           $1,103,417

☐ Determine the maximum muni income

Taxable Income (line 43)             $928,873
Less:
Qualified Dividends (line 9b)          (204,292)
LT Capital Gains (line 13)               (177,356)
Marginal Rate
Total Ordinary Income                  $547,000               35%
Less: 33% Marginal Tax Limit $ (208,850)
Maximum Muni Income                   $338,375
Tax Management Techniques

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7. **IRA Distributions to Charity**
8. Tax Efficient Distribution Planning
Qualified Charitable Distributions (QCD)

Requirements

- The gift has to go directly from the IRA to the charity
- Taxpayer must be over 70 ½
- Amount up to $100,000
- For joint filers, each spouse can make a QCD of up to $100,000
- No charitable deduction on Schedule A for QCD
- QCD counts as a Required Minimum Distribution (RMD)
- Expires 12-31-2009
Tax Management Techniques

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Tax Efficient Distributions by Asset Location

**Roth IRA**
Assets grow tax-free with no tax at withdrawal

**Traditional IRA**
Assets grow tax-deferred with withdrawals taxed at ordinary income rates

**Taxable**
Both Income and Capital gains taxed
P A V E  Objective

To provide directionally-sound advice to clients, aiding them in achievement of their financial goals.

P A V E Pyramid

Legacy Planning
Asset Quality Roth Conversion
Withdrawal Strategy
Standard of Living Adjustment
“The Enough” Question?
Withdrawal Strategy

Old Logic

1\textsuperscript{st} Taxable Account
2\textsuperscript{nd} Traditional IRAs/Annuities/RMDs (70 \frac{1}{2})
3\textsuperscript{rd} Roth IRAs
Withdrawal Strategy

New Logic

1st **Taxable Account**

2nd **Traditional IRAs/Annuities/RMDs (70 ½)**

3rd **Roth IRAs**

We pick and choose for a combination that produces long-term value.
PAVE

VALUE - ENHANCING ANALYSIS

Provides Insight to Portfolio Withdrawal Planning
Value-Enhancing Analysis

Withdrawal alternatives seek to enhance the value of one of the following targets:

- DOD balance (before taxes)
- DOD balance (after taxes)
- Potential Heir Lifetime Value

10,000 withdrawal scenarios are tested in search of a directionally-sound course of action.
## P A V E Base Analysis

During the PAVE analysis, different end balances can be targeted to achieve an enhanced value or “VE”

**John and Jane Doe**

<table>
<thead>
<tr>
<th>Priority Withdrawal, Static Return</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis Date</td>
<td>12/31/07</td>
</tr>
<tr>
<td>Tax Structure:</td>
<td>Current</td>
</tr>
<tr>
<td>Analysis Yrs:</td>
<td>25</td>
</tr>
<tr>
<td>Living Expense Index</td>
<td>3.00%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(Base Analysis)</th>
<th>Disc $</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Balance</strong></td>
<td>$1,440,000 $1,440,000</td>
</tr>
<tr>
<td>DOD Balance</td>
<td>$2,377,186 $1,135,357</td>
</tr>
<tr>
<td>DOD IRA &amp; Annuity Tax</td>
<td>$(808,200) $(386,001)</td>
</tr>
<tr>
<td>DOD Estate Tax</td>
<td>- $ -</td>
</tr>
<tr>
<td><strong>DOD Balance After Taxes</strong></td>
<td>$1,568,986 $749,356</td>
</tr>
<tr>
<td>Potential Heir Lifetime Value</td>
<td>$4,220,428 $1,382,658</td>
</tr>
</tbody>
</table>

This chart is based on hypothetical data and is for illustration purposes only.
This chart is based on hypothetical data and is for illustration purposes only.
Target: Enhance DOD Balance (After-Tax, No Roth Conv)

This chart is based on hypothetical data and is for illustration purposes only.
BASE Scenario  
Value-Enhanced  
[Enhance DOD After Tax, With Roth Conv]

Target: Enhance DOD Balance 
(After-Tax, With Roth Conv)

This chart is based on hypothetical data and is for illustration purposes only.
Today’s Agenda

I. Continually Changing Tax Rules

II. Tax Management Techniques

III. Roth Conversion

IV. Questions and Discussion
Roth IRA

• Taxpayer Relief Act of 1997 created the Roth IRA effective for tax year 1998.

• Prior to 2010, to fund a Roth IRA by means of a conversion, an individual's Modified Adjusted Gross Income (MAGI) had to be $100,000 or less

• Up to the end of 2004, many taxpayers of RMD age were ineligible to convert to a Roth IRA because their RMD amounts were added to their MAGI, causing their MAGI to exceed the $100,000 limit. This rule requiring the MAGI to include RMD amounts from Traditional, SEP and SIMPLE IRAs no longer applies to RMD for tax years beginning Jan 1, 2005.
Conversion Rules for 2010

- No income limits for a Roth conversion
  - Can do a partial conversion
- Income Tax is due on pre-tax amounts for conversion
  - Can pay on 2010 tax return, or
  - Elect to split the income 50/50 between 2011 and 2012 (all-or-nothing election)
- If after-tax money in traditional IRA, you have to convert prorata amounts of deductible and after-tax (can’t pick and choose after-tax)
- If over 70 ½, can’t convert RMD amounts
Roth Conversion – Recharacterization

- Can change your mind “recharacterize” any time up to the income tax filing deadline for the tax year of your conversion, including extensions
  - Example: Converted in 2010, you can undo as late as October 15, 2011
  - To turn back into a Roth:
    1. Must be 1 year after initial Roth conversion
    2. Must be 31 days after recharacterization
As of this date (October 29, 2009), Wisconsin has not adopted the provisions of federal P.L. 109-222 related to converting a regular IRA to a Roth IRA in 2010. Until Wisconsin adopts P.L. 109-222, taxpayers who make the conversion from a regular IRA to a Roth IRA in 2010 will have different tax treatments for federal and state income tax purposes.

For federal income tax purposes, persons who make the conversion in 2010 may elect to postpone payment of tax on the converted amount until they file their 2011 and 2012 income tax returns. Because Wisconsin has not adopted the provisions of P.L. 109-222, the tax on the converted amount will be due with 2010 Wisconsin income tax returns.

Persons who make the conversion and who have modified adjusted gross income over $100,000 will be subject to certain Wisconsin penalties.

If the person is under age 59 1/2, the person would be subject to an early distribution penalty. The penalty is equal to 3.33% of the amount converted. The person would also be subject to a 2% penalty for an excess contribution to the Roth IRA. This penalty would be applied each year until the excess contribution is withdrawn. Persons age 59 1/2 or over would only be subject to the excess contribution penalty.

The department will publish further guidance on this issue if P.L. 109-222 is adopted in the next legislative session that begins in January 2010.

Roth Conversion

How do you best determine whether or not to do a Roth Conversion?

What are the tax consequences?

Is there a measurable, long term benefit that makes this desirable?
P A V E Objective

To provide directionally-sound advice to clients, aiding them in achievement of their financial goals.

P A V E Pyramid

Legacy Planning

Asset Quality Roth Conversion

Withdrawal Strategy

Standard of Living Adjustment

“The Enough” Question?
P A V E Overview

P A V E starts with a client’s current portfolio balance and then integrates:

- Client-Specific Inputs
- Required Minimum Distributions (RMD), Pension, and Social Security
- Modeling for Federal and State Tax Implications
- Portfolio Return
- Withdrawal requirements to meet total expenses

Annual portfolio balances (by account) over the lifetime of the client
### Example: Key Inputs specific to a Client

**John and Jane Doe**   
Start Date Of Analysis: 12/31/2008   
Analysis Years: 26   
Allocation: 70 - 30

#### Birthdates
- Client Birthdate: 1/1/1944
- Spouse Birthdate: 6/1/1946
- Beneficiary Birthdate: 12/1/1970

#### Filing Status and Estate Exemptions
- Income Tax Filing Status: Married
- Total Exemp. incl. Dependent(s): 2
- Estate Exemptions: 2

#### Wages and Other Income Sources
- 7. Wages, Client: $72,000
- 7. Wages, Spouse: $62,000
- 12. Self employment income: $62,000
- SE Income stops at Client Age: 65.0
- Other Cash Income: $62,000
- Other Non-Cash Income: $62,000

#### YR Taxable Events
- IRA Withdrawals - Client: $62,000
- IRA Withdrawals - Spouse: $62,000
- Annuity Withdrawals: $62,000
- Realized Capital Gains/Losses: $62,000
- Capital Loss Carryover: $62,000

#### Current Living Expenses
- Annual Living Expenses: $84,000
- Use Cash Account Interest for Living Expenses: $84,000

#### Current Beginning Portfolio Balances
- Cash Account Balance: $300,000
- IRA Stocks: $210,000
- IRA Stocks Basis: $200,000

#### Other Key Tax-Related Items
- 6. Real Estate Taxes: $4,000
- 10. Mortgage Interest: $2,000
- 19. Charitable Contribution: $3,000
- Gross Misc. Itemized Subj to 2%: $-
- All Other Itemized: $-

#### Social Security, Pension, and SEPP
- Client SS Begins at Age: 62.0
- Client SS Annual Benefit: $20,000
- Spouse SS Begins at Age: 62.0
- Spouse SS Annual Benefit: $10,000

This chart is based on hypothetical data and is for illustration purposes only.
Withdrawal Analysis

Old Logic

1\textsuperscript{st} Taxable Account

2\textsuperscript{nd} Traditional IRAs/Annuities/RMDs (70 \frac{1}{2})

3\textsuperscript{rd} Roth IRAs
This chart is based on hypothetical data and is for illustration purposes only.
This chart is based on hypothetical data and is for illustration purposes only.
PAV E Likelihood Analysis

- Determines likelihood of not running out of money
  - (or Likelihood of Success)
- Applies Variable Return “strings” and Monte Carlo-Style Analysis (10,000 iterations)
  - Likelihood Analysis uses Old Withdrawal logic
  - Determines DOD Portfolio Balances resulting from variable strings of returns for both Stocks and Bonds
    - Unique variable strings are extracted from statistical distributions representative of Stock and Bond returns
  - “Qualifies” a financial analysis
This Process Generates Stock & Bond Return “Strings”

<table>
<thead>
<tr>
<th>Year</th>
<th>Iteration 1 Stocks</th>
<th>Iteration 1 Bonds</th>
<th>Iteration 2 Stocks</th>
<th>Iteration 2 Bonds</th>
<th>Iteration 3 Stocks</th>
<th>Iteration 3 Bonds</th>
<th>Iteration 4 Stocks</th>
<th>Iteration 4 Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>4.33%</td>
<td>3.36%</td>
<td>9.56%</td>
<td>10.79%</td>
<td>12.31%</td>
<td>3.75%</td>
<td>-8.33%</td>
<td>9.14%</td>
</tr>
<tr>
<td>2009</td>
<td>-14.03%</td>
<td>6.79%</td>
<td>16.94%</td>
<td>5.89%</td>
<td>-18.93%</td>
<td>4.15%</td>
<td>-1.21%</td>
<td>6.56%</td>
</tr>
<tr>
<td>2010</td>
<td>12.42%</td>
<td>2.24%</td>
<td>8.22%</td>
<td>8.03%</td>
<td>-14.23%</td>
<td>4.19%</td>
<td>4.60%</td>
<td>5.53%</td>
</tr>
<tr>
<td>2011</td>
<td>2.83%</td>
<td>3.38%</td>
<td>26.43%</td>
<td>8.44%</td>
<td>15.93%</td>
<td>3.11%</td>
<td>19.55%</td>
<td>8.88%</td>
</tr>
<tr>
<td>2012</td>
<td>11.97%</td>
<td>7.93%</td>
<td>11.86%</td>
<td>3.68%</td>
<td>24.90%</td>
<td>7.30%</td>
<td>28.23%</td>
<td>9.46%</td>
</tr>
<tr>
<td>2013</td>
<td>20.03%</td>
<td>6.00%</td>
<td>8.52%</td>
<td>9.30%</td>
<td>30.73%</td>
<td>9.06%</td>
<td>16.19%</td>
<td>4.34%</td>
</tr>
<tr>
<td>2014</td>
<td>32.16%</td>
<td>3.25%</td>
<td>11.81%</td>
<td>0.62%</td>
<td>21.68%</td>
<td>-1.07%</td>
<td>18.19%</td>
<td>12.34%</td>
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<tr>
<td>2015</td>
<td>-28.01%</td>
<td>5.70%</td>
<td>1.99%</td>
<td>6.86%</td>
<td>8.86%</td>
<td>1.73%</td>
<td>8.51%</td>
<td>9.84%</td>
</tr>
<tr>
<td>2016</td>
<td>7.88%</td>
<td>2.76%</td>
<td>6.66%</td>
<td>5.03%</td>
<td>2.85%</td>
<td>5.57%</td>
<td>30.74%</td>
<td>4.67%</td>
</tr>
<tr>
<td>2017</td>
<td>26.98%</td>
<td>8.94%</td>
<td>26.98%</td>
<td>8.94%</td>
<td>30.73%</td>
<td>9.06%</td>
<td>16.19%</td>
<td>4.34%</td>
</tr>
<tr>
<td>2018</td>
<td>1.69%</td>
<td>6.68%</td>
<td>1.69%</td>
<td>6.68%</td>
<td>21.68%</td>
<td>-1.07%</td>
<td>18.19%</td>
<td>12.34%</td>
</tr>
<tr>
<td>2019</td>
<td>-13.44%</td>
<td>7.63%</td>
<td>-6.30%</td>
<td>3.03%</td>
<td>4.06%</td>
<td>4.33%</td>
<td>10.42%</td>
<td>2.73%</td>
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<tr>
<td>2020</td>
<td>-5.37%</td>
<td>-1.12%</td>
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<td>-10.76%</td>
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<td>9.40%</td>
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<td>2021</td>
<td>-1.13%</td>
<td>3.16%</td>
<td>-6.13%</td>
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<td>12.76%</td>
<td>1.57%</td>
<td>6.28%</td>
<td>2.23%</td>
</tr>
<tr>
<td>2022</td>
<td>-7.50%</td>
<td>8.77%</td>
<td>12.21%</td>
<td>5.38%</td>
<td>5.17%</td>
<td>2.72%</td>
<td>-11.05%</td>
<td>-2.40%</td>
</tr>
<tr>
<td>2023</td>
<td>29.08%</td>
<td>7.26%</td>
<td>15.32%</td>
<td>7.64%</td>
<td>22.97%</td>
<td>8.16%</td>
<td>0.95%</td>
<td>5.42%</td>
</tr>
<tr>
<td>2024</td>
<td>1.53%</td>
<td>4.01%</td>
<td>26.44%</td>
<td>1.05%</td>
<td>14.24%</td>
<td>6.27%</td>
<td>1.32%</td>
<td>6.49%</td>
</tr>
<tr>
<td>2025</td>
<td>0.04%</td>
<td>3.01%</td>
<td>19.03%</td>
<td>6.51%</td>
<td>19.64%</td>
<td>6.33%</td>
<td>-15.94%</td>
<td>9.00%</td>
</tr>
<tr>
<td>2026</td>
<td>17.23%</td>
<td>12.10%</td>
<td>6.62%</td>
<td>-1.26%</td>
<td>22.79%</td>
<td>7.76%</td>
<td>6.54%</td>
<td>7.88%</td>
</tr>
<tr>
<td>2027</td>
<td>33.24%</td>
<td>8.21%</td>
<td>15.32%</td>
<td>3.32%</td>
<td>11.48%</td>
<td>6.25%</td>
<td>21.73%</td>
<td>1.90%</td>
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</tbody>
</table>

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This Process Generates Stock & Bond Return “Strings”

<table>
<thead>
<tr>
<th>Year</th>
<th>Stocks</th>
<th>Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>4.33%</td>
<td>3.36%</td>
</tr>
<tr>
<td>2009</td>
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<td>6.79%</td>
</tr>
<tr>
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<td>2.24%</td>
</tr>
<tr>
<td>2011</td>
<td>2.83%</td>
<td>3.36%</td>
</tr>
<tr>
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</tr>
<tr>
<td>2013</td>
<td>20.03%</td>
<td>6.00%</td>
</tr>
<tr>
<td>2014</td>
<td>32.16%</td>
<td>3.25%</td>
</tr>
<tr>
<td>2015</td>
<td>-28.01%</td>
<td>6.70%</td>
</tr>
<tr>
<td>2016</td>
<td>7.89%</td>
<td>2.76%</td>
</tr>
<tr>
<td>2017</td>
<td>26.98%</td>
<td>8.94%</td>
</tr>
<tr>
<td>2018</td>
<td>1.69%</td>
<td>6.68%</td>
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<tr>
<td>2019</td>
<td>-13.44%</td>
<td>7.63%</td>
</tr>
<tr>
<td>2020</td>
<td>-5.37%</td>
<td>-1.12%</td>
</tr>
<tr>
<td>2021</td>
<td>-1.13%</td>
<td>3.16%</td>
</tr>
<tr>
<td>2022</td>
<td>-7.50%</td>
<td>8.77%</td>
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<tr>
<td>2023</td>
<td>29.08%</td>
<td>7.26%</td>
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<tr>
<td>2024</td>
<td>1.53%</td>
<td>4.01%</td>
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<td>2025</td>
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<td>3.01%</td>
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<td>2026</td>
<td>17.23%</td>
<td>12.10%</td>
</tr>
<tr>
<td>2027</td>
<td>33.24%</td>
<td>8.21%</td>
</tr>
</tbody>
</table>

Each Year's Return is Different

This chart is based on hypothetical data and is for illustration purposes only.
## Likelihood Analysis

<table>
<thead>
<tr>
<th>Likelihood %</th>
<th>DOD Balance ≥ This Value</th>
<th>DOD Balance After Tax ≥ This Value</th>
<th>Heir Lifetime Value ≥ This Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>100%</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>95%</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>90%</td>
<td>$128,400</td>
<td>$60,027</td>
<td>$</td>
</tr>
<tr>
<td>85%</td>
<td>$808,680</td>
<td>$509,131</td>
<td>$1,280,862</td>
</tr>
<tr>
<td>80%</td>
<td>$1,377,298</td>
<td>$945,486</td>
<td>$2,296,079</td>
</tr>
<tr>
<td>75%</td>
<td>$1,905,693</td>
<td>$1,428,103</td>
<td>$3,267,402</td>
</tr>
<tr>
<td>50%</td>
<td>$4,554,798</td>
<td>$3,916,143</td>
<td>$8,158,912</td>
</tr>
<tr>
<td>90.8%</td>
<td></td>
<td></td>
<td>Likelihood of Success</td>
</tr>
</tbody>
</table>

This chart is based on hypothetical data and is for illustration purposes only.
The Outcome Provides a Perspective on “Enough?”
Risk Tolerance is Client-Specific

Concern for Enough?

Less than 70%

70%  85%

Enough

More Than Enough

85%  95%

More Than More Than Enough?

95%  99%

% Likelihood of Success

This chart is based on hypothetical data and is for illustration purposes only.
Value-Enhancement Process

This chart is based on hypothetical data and is for illustration purposes only.
**PAVE Comparison Chart**

**John and Jane Doe**

<table>
<thead>
<tr>
<th>Scenario</th>
<th>DOD Balance</th>
<th>IRA &amp; Annuity Tax</th>
<th>DOD Balance After Taxes</th>
<th>Potential Heir Lifetime Value</th>
<th>Likelihood of Success</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base</td>
<td>Future $2,820,454</td>
<td>($456,067)</td>
<td>$2,364,387</td>
<td>$5,004,197</td>
<td>90.8%</td>
</tr>
<tr>
<td></td>
<td>Today’s $1,076,439</td>
<td>($174,060)</td>
<td>$902,379</td>
<td>$1,270,057</td>
<td></td>
</tr>
<tr>
<td>Roth Conv.-$50k in 2009, 2010, &amp; 2011</td>
<td>Future $2,776,831</td>
<td>($273,879)</td>
<td>$2,502,952</td>
<td>$5,636,864</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Today’s $1,059,790</td>
<td>($104,527)</td>
<td>$955,263</td>
<td>$1,445,913</td>
<td></td>
</tr>
<tr>
<td></td>
<td>VE = $135,565</td>
<td></td>
<td>$632,697</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Value-Enhanced (VE)**
- Your DOD Balance After Taxes and/or your Potential Heir Lifetime Value in the Base Scenario is compared with the alternative scenarios to see how much increase (VE) in those balances can be achieved by Roth conversions.

**Likelihood of Success**
- This Monte Carlo-type factor is used to determine whether a Roth conversion is prudent.
- Typically if the % is less than 70%, a Roth conversion should be postponed unless the tax burden associated with the Roth is minimal to zero.

*This chart is based on hypothetical data and is for illustration purposes only.*
## John and Jane Doe

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Lifestyle Expenses</th>
<th>Roth Amount in Year 1</th>
<th>Estimate of Tax (on Roth conversion) 1st Year</th>
<th>Portfolio Draw (Year)</th>
<th>Future Account Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base</td>
<td>$84,000</td>
<td>$0</td>
<td>$0</td>
<td>2nd 2.85% Taxable</td>
<td>$1,517,406</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10th 4.19% IRA</td>
<td>$1,303,048</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Final 6.41% Roth</td>
<td>$0</td>
</tr>
<tr>
<td>Roth Conv.-$50k in 2009, 2010, &amp; 2011</td>
<td>$84,000</td>
<td>$50,000</td>
<td>$14,000</td>
<td>2nd 4.17% Taxable</td>
<td>$21,862</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10th 4.23% IRA</td>
<td>$782,511</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Final 6.09% Roth</td>
<td>$1,972,458</td>
</tr>
</tbody>
</table>

### Future Account Balances
- Having more than one type of portfolio bucket is desirable. Taxable vs. Traditional IRA vs. Roth IRA accounts each provide different types of tax implications. This gives you more choices and flexibility.

### Portfolio Draw
- Existing literature for retirement portfolio withdrawal rates suggests that a real withdrawal rate of 4% of the initial portfolio is "safe"
  - There tends to be a correlation between Roth conversions and a reduction in the future portfolio draw percent
  - This is sometimes driven by reduced taxes in the future
  - This can lead to an extension of an individual’s portfolio

This chart is based on hypothetical data and is for illustration purposes only.
### Taxes Matter

#### Base Analysis

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Client Age</th>
<th>Base Tax Bracket</th>
<th>AMT (Yes/No)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>65</td>
<td>15%</td>
<td>Yes</td>
</tr>
<tr>
<td>2010</td>
<td>66</td>
<td>15%</td>
<td>Yes</td>
</tr>
<tr>
<td>2011</td>
<td>67</td>
<td>15%</td>
<td>Yes</td>
</tr>
<tr>
<td>2012</td>
<td>68</td>
<td>15%</td>
<td>No</td>
</tr>
<tr>
<td>2013</td>
<td>69</td>
<td>15%</td>
<td>No</td>
</tr>
<tr>
<td>2014</td>
<td>70</td>
<td>25%</td>
<td>Yes</td>
</tr>
<tr>
<td>2015</td>
<td>71</td>
<td>25%</td>
<td>Yes</td>
</tr>
<tr>
<td>2016</td>
<td>72</td>
<td>25%</td>
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</tr>
<tr>
<td>2017</td>
<td>73</td>
<td>25%</td>
<td>Yes</td>
</tr>
<tr>
<td>2018</td>
<td>74</td>
<td>25%</td>
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#### Roth Conversion

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<tr>
<th>YEAR</th>
<th>Client Age</th>
<th>Roth Tax Bracket</th>
<th>AMT (Yes/No)</th>
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</thead>
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---

This chart is based on hypothetical data and is for illustration purposes only.
Growth of Roth IRA

This chart is based on hypothetical data and is for illustration purposes only.
Tax Treatment and the Rules of Roth IRA Distributions

• Qualified Distributions
  – Free from tax and penalties
  – Must meet two categories of requirements
• Non-Qualified Distributions
  – May be subject to income tax and an additional 10% early distribution penalty
Qualified Roth IRA Distributions

**Qualified Distribution Requirements** (must meet both requirements)

1. It occurs at least five years after the Roth IRA owner established and funded his or her first Roth IRA. If multiple Roth IRA accounts – use the earliest account start date to start the five year clock.

2. It is distributed under one of the following circumstances:
   - The Roth IRA holder is at least age 59.5 when the distribution occurs
   - The Roth IRA holder becomes disabled before the distribution.
   - The beneficiary of the Roth IRA holder receives the assets after his or her death.

   • The distributed assets will be used towards the purchase or rebuilding of a first home for the Roth IRA holder or a qualified family member. This is limited to $10,000 per lifetime. Qualified family members include the following:
     - the Roth IRA holder
     - the Roth IRA holder's spouse
     - the children of the Roth IRA holder and/or his or her spouse
     - the grandchild of the Roth IRA holder and/or his or her spouse
     - the parent or other ancestor of the Roth IRA holder and/or his or her spouse
Non-Qualified Distributions
(Tax Implications)

It depends upon the source.

Four possible sources of Roth IRA assets (Removed assets come out in this order):

- Regular participant contributions. **Tax and penalty Free**
- A Roth conversion of taxable **Traditional IRA** assets (i.e. Traditional IRA assets for which a tax deduction was allowed. These assets are taxed when converted to the Roth IRA). **May be subject to early-distribution penalties**
- A Roth conversion of nontaxable Traditional IRA assets (i.e. Traditional IRA assets for which there was no tax deduction. These assets are not subjected to income tax when distributed or converted to a Roth IRA.) **Tax and penalty free**
- Earnings on all Roth IRA assets. **May be subject to income tax and early-distribution penalties**
## Distribution Summary

<table>
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<tr>
<th>Distributed Assets</th>
<th>Qualified Distributions</th>
<th>Nonqualified Distributions</th>
<th>Comment</th>
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<td>Regular participant contributions</td>
<td>Tax free and penalty free</td>
<td>Tax free and penalty free</td>
<td>Income tax and early-distribution penalty are never applied to distributed assets for which no deduction was allowed when the assets were contributed to the IRA.</td>
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<td>Taxable conversion</td>
<td>Tax free and penalty free</td>
<td>Tax free but penalty may apply</td>
<td>These are already taxed when converted. Penalty is waived if any one of the exceptions apply.</td>
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<tr>
<td>Nontaxable conversion</td>
<td>Tax free and penalty free</td>
<td>Tax free and penalty free</td>
<td>Income tax and penalty is never applied to distributed assets for which no deduction was allowed when the assets were initially contributed to the IRA.</td>
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<tr>
<td>Earnings</td>
<td>Tax free and penalty free</td>
<td>Taxes apply and penalty may apply</td>
<td>Penalty is waived if any one of the exceptions apply.</td>
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</table>
Final Key Points on Roth IRA Distributions

• For determining qualified distributions, there is only one five-year period. This never starts over.
• If an IRA holder completes multiple Roth conversions, the five-year period for each Roth conversion is determined separately for each conversion.
• If you are thinking of converting from either one source multiple times or multiple sources – you may want to segregate these for re-characterization purposes.
• If an excess contribution is made to a Roth IRA and later removed, this contribution cannot be used to determine the five-year period for qualified distributions.
Suggested Strategy for Roth Conversions

• Do a partial conversion in early 2010

• In late 2010 when possible tax changes are known for 2011, re-analyze for more potential 2010 conversion (assuming taxes go up in 2011)

• You have until October 15, 2011 to recharacterize
Today’s Agenda

I. Continually Changing Tax Rules

II. Tax Management Techniques

III. Roth Conversion

IV. Questions and Discussion
If you have any questions or would like to meet with an advisor, please call us at 608.831.1300 or 815.227.0300.
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**Indices used in analysis throughout the presentation (unless otherwise noted).**
- Treasury Bills – Ibbotson U.S. 30 Day T-Bill Index
- Short-Term Bonds – Ibbotson U.S. 1 Year Treasury Constant Maturity Appreciation Index
- Aggregate Bond – Lehman Brothers Aggregate Bond Index
- Intermediate-Term Bonds – Lehman Brothers Intermediate Government/Credit Bond Index
- Long-term Bonds – Ibbotson U.S. Long-term Government Index
- Inflation Protected Bonds – 50% Lehman Brothers Intermediate Government/Credit Bond Index and 50% Ibbotson U.S. 1 Year Treasury Constant Maturity Appreciation Index (1/73 – 2/97), Merrill Lynch U.S. Treasury Inflation-Linked Securities Index (after 2/97)
- U.S. Large Stocks – Standard & Poor’s 500 Total Return Index
- U.S. Large Value Stocks – Fama-French Large Value Index
- U.S. Small Stocks – Ibbotson Small Stock Index
- U.S. Small Value Stocks – Fama-French Small Value Index
- Int'l Large Stocks – MSCI EAFE Index
- Int'l Large Value Stocks – MSCI EAFE Index (1/73-12/74), MSCI EAFE Value Index (after 12/74)
- Int'l Small Stocks – DFA International Small Company Index (1/73 – 9/96), S&P/Citigroup EPAC EMI Index (after 9/96)
- REITs – FTSE NAREIT Equity REIT Index
- Commodities – S&P GSCI Commodity Index
We assumed a gross equity return (before expenses) of 9.62% for all equity performance calculations. This applies to index funds and actively managed funds. This return is based on the total return of the S&P 500 Index from 1926-2008 from Morningstar EnCorr.

The after-tax return for index funds or exchange-traded funds (ETFs) assumes investors earn gross equity returns of 9.62% (see endnote #22). We assumed a turnover of 4% and a dividend yield of 1.70%, based on actual values for the Vanguard Total Stock Market Index (Investor Class) from Morningstar Principia as of 12/31/2008. We assumed an expense ratio of .15% again based on the Vanguard Total Stock Market Index (Investor Class), which we took directly from Vanguard’s website at www.vanguard.com as of 12/31/2008. We also assumed the entire position is liquidated at the end of twenty years and that low turnover would generate very small capital gains that would all be taxed at long-term rates. We believe this is a reasonable assumption based on the historical experience of index funds.

To calculate the after-tax return and excess alpha needed by active strategies to match the index strategy, we assumed that investors earn gross equity returns of 9.62% (see endnote #22) reduced by fund expenses, trading costs, and taxes. The estimated after-tax returns are calculated using an algorithm developed in Working Paper 7007 in the National Bureau of Economic Research by John B. Shoven titled “The Location and Allocation of Assets in Pension and Conventional Savings Accounts (March 1999).” Using Morningstar Principia as of 12/31/2008, active domestic equity funds (excluding index funds, exchange-traded funds, funds of funds, and balanced funds) were divided into quartiles. Funds that did not report a turnover ratio were also excluded. “Low Turnover Funds,” reflect an average of the funds in the lowest quartile in terms of turnover. “High Turnover Funds” reflect an average of the highest quartile. “Average Turnover Funds” reflect the total average of all active funds in the study. These groupings were used to calculate average values used throughout the study:

- Low Turnover Funds – Turnover = 22%, Expense Ratio = 1.19%, Dividend Yield = 1.54%
- High Turnover Funds – Turnover = 235%, Expense Ratio = 1.31%, Dividend Yield = .90%
- Average Turnover Funds – Turnover = 100%, Expense Ratio = 1.22%, Dividend Yield = 1.11%

We further estimate that additional trading costs are equal to .50% per annum per 100% portfolio turnover. We also assumed that investors realized both long and short-term capital gains each year, and they are taxed accordingly.

- Low Turnover Funds – assumed 90% long-term / 10% short-term
- High Turnover Funds – assumed 10% long-term / 90% short-term
- Average Turnover Funds – assumed 75% long-term / 25% short-term

For all actively managed strategies, we assumed the entire position is liquidated at the end of twenty years, and the investor pays the maximum long-term capital gains tax on any unrealized appreciation.