

Conversions of Retirement accounts to Roth IRA Accounts:

I was recently asked to speak to a group of investors regarding Roth Conversions. To prepare for the presentation I enlisted the help of our team to develop several financial and tax models to look at the economics for a 30 year age range. To my surprise, with few exceptions, the investor was better off converting their retirement account to a Roth IRA than retaining their traditional tax-deferred retirement account. Most of our clients could not make Roth contributions in the past because of a limitation based on Gross Income. It was simply too low to work for most clients. The gross income limit on **Roth conversions** is lifted effective in 2010.

For those of you who are not familiar with Roth IRA accounts, these accounts are provide for non-deductible contributions, but the earnings inside the Roth account are never taxed; that means **never taxed!**

Roth conversions are particularly attractive now that the estate tax is reinstated effective January 1, 2011. If you pass away with a tax deferred retirement account (Qualified Plan, 401k, 403b, Traditional IRA, Simple IRA, etc.), the retirement account is includable in your taxable estate and your heirs pay tax on the income as they receive it. The after tax yield to the ultimate beneficiary can be under 20% of the account value at death.

The hand outs used in this presentation follow. They highlight the conversion rules and provide some interesting illustrations comparing conversion of some or all of an IRA to a Roth IRA for persons of various ages and income levels. I encourage our readers to mimic these illustrations to see if it makes sense for you. Chances are, it will!

The greatest opportunity for a Roth Conversion is between now and December 31, 2010 because you have the option to pay the tax on the conversion in 2010 or split the conversion income between 2011 and 2012. There is also the opportunity to use hindsight if the Roth account should decline in value to "recharacterize" the account back to a normal retirement account and avoid the tax. If a Roth conversion is of interest to you, I suggest you call your tax professional before Thanksgiving to allow sufficient time for analysis, planning and setting up accounts before December 31, 2010.

Roth IRA Conversions:

Rules:

Starting in 2010 No more AGI Cap

For 2010 Conversions Only

Tax Option:

Report and Pay in 2010 –at 2010 rates– No Penalty

or

Report ½ in 2011 and pay 2011 rates and ½ in 2012 and pay 2012 rates–
No Penalty

For 2011 and later years:

Report 100% of conversion in year converted and pay tax in that year; No Penalty.

No AGI Cap

Most likely converters:

- 1) Young taxpayers with high earnings or high earning expectations
- 2) Any well sheltered taxpayer who could convert at a low tax cost
- 3) Wealthy taxpayers who will always be in a high tax bracket
- 4) Wealthy taxpayers who have a taxable estate and will likely not use up their IRA accounts before death
- 5) Any taxpayers who believe their tax rates will be the same or higher when they retire.
The reason NOT to convert related to this is taxpayers who believe they will be in a low tax bracket when they draw retirement funds. Don't forget about taxable Social Security!

Accounts eligible for Roth Conversions:

- 1) Traditional IRA's
- 2) Qualified Plan funds – including 401(k) plans*, 403(b) or 457 governmental plans
- 3) SEP-IRA's**
- 4) Simple IRA's**

* per recent update

** 3 & 4 are eligible only after the 2-year period beginning on the date on which the taxpayer first participated in any SIMPLE IRA maintained by the taxpayer's employer.

Some Advantages of Roth IRA's over Traditional IRA's:

- Contributions can be withdrawn without penalty if you are 59½ and the Roth account is at least 5 years old (3 exceptions).
- No tax on earnings.
- Continuous contribution throughout life as long as taxpayer has "earned income".
- No age rules regarding minimum distributions at age 70½.
- No income with respect to a decedent when a Roth is inherited.
- When ordering distributions, Roth contributions are first followed by earnings. Thus early (non-qualified) distributions will not be subject to the 10% penalty until all distributions of contributions are made.

Miscellaneous Rules:

- Converted Roth IRA – 5 year holding period begins on January 1 in the conversion year. Each conversion has its own 5 year holding period.
- When converting a Non-deductible IRA to a Roth IRA, the earnings which have been tax deferred will be subject to tax, but not the non-deductible portion.
- Roth Conversions must be completed by year end, Not April 15 or the extended due date. In other words, to take advantage of the 2010 ONLY tax option (see page 1) you must complete the conversion by 12-31-10.
- Cannot avoid RMD in year of conversion from a qualified plan or a traditional IRA.

- **Contribution Limits:**
Remember, there is one annual limit for each taxpayer; currently \$5000 plus a \$1000 catch up contribution for taxpayers age 50 or older. This single limit applies to Traditional IRA's, Roth IRA's and Non-deductible IRA's. Thus if a taxpayer wanted to make a Traditional IRA contribution and a Roth IRA contribution, the \$5000 or \$6000 limit would have to be allocated between the Traditional IRA contribution and the Roth IRA contribution. The AGI limitation for Roth IRA contributions still applies – see below.
- **California Conformity**
The state of California has conformed so Roth conversions in 2010 and later are not subject to the AGI limit or the 10% penalty
- **For new (Non-Conversion) contributions, gross income limitations still apply:**
 - Roth “Phase out” amount; 2010:

Single	\$105,000 - \$120,000
Married/Joint	\$167,000-\$177,000

Recharacterizations:

You may recharacterize a previously converted Roth IRA account back to a Traditional IRA account by the due date of your return for the year of the conversion including extensions.

Thus, you could convert a Traditional IRA to a Roth IRA on January 2, 2010 and, if you decided it was a bad idea in October, 2011, you could re-characterize it by October 15, 2011 and avoid the tax on the recharacterization.

TIP

Convert now, diversify investments. In October 2011, recharacterize the losers.

AN ILLUSTRATION:
Recharacterization

Traditional IRA Available
for recharacterization \$100,000
Cash required for taxes ± \$37,000

Invest in 5 Roth IRA's, \$20,000 each

	<u>Converted 1-2-10</u>	<u>Value 9-30-11</u>
Roth # 1	\$ 20,000	\$ 35,000
Roth # 2	\$ 20,000	\$ 22,000
Roth # 3	\$ 20,000	\$ 16,000
Roth # 4	\$ 20,000	\$ 18,000
Roth # 5	\$ 20,000	\$ 21,000

Assume you would recharacterize
3 & 4; pay tax on 1, 2 & 5.

Tax is: \$22,000

Appreciation is: \$18,000

Not a bad play!

We “did the math” for Three Theoretical Taxpayers

Warning!

All illustrations provided examples designed to show how IRA Conversions to Roth IRA's and recharacterizations of previously converted Roth IRA's to Traditional IRA's work.

There is no guarantee that actual results will be similar.

We recommend the following if you want to convert:

1) Write down your assumptions:

- Income over the rest of your life
- Investment return assumptions
- Incremental tax rate assumptions
- Etc.

2) Review assumptions with your trusted advisors:

- Investment advisor/broker
- Tax professional

Nothing in this life is certain but death and taxes!

30 YEAR OLD

Converted in 2010 \$8,836
 Years until RMD 40.5

AT AGE 70 1/2		
	Partial Conversion	No Conversion
Roth	\$96,820	0
IRA	231,906	\$328,726
Tax Money	0	3,000
Tax Money (interest)	0	11,820
Totals	328,726	343,546
tax*	92,762	136,218
After tax	\$235,964	\$207,328
RMD at 70 1/2	\$8,464	\$11,997

Roth Conversion Benefit \$ 28,636
Return on tax paid 24%

2010 Assumptions

\$80,000 Annual Salary
\$30,000 IRA balance
\$3,000 Savings

*Convert all possible with cash available in savings,
 the rest remains in Traditional IRA*

** Assumed Tax Rates at age 70 1/2*

<i>Fed</i>	<i>30%</i>
<i>State</i>	<i>10%</i>
	<hr/> <i>40%</i>

45 YEAR OLD

Converted in 2010 \$42,804
 Years until RMD 25.5

AT AGE 70 1/2		
	Partial Conversion	No Conversion
Roth	\$191,119	0
IRA	344,678	\$535,797
Tax Money	0	18,000
Tax Money (interest)	0	28,473
Totals	535,797	582,270
tax*	137,871	225,708
After tax	\$397,926	\$356,562
RMD at 70 1/2	\$12,579	\$19,555

Roth Conversion Benefit \$ 41,364
Return on tax paid 9%

2010 Assumptions

\$200,000 *Annual Salary*

\$120,000 *IRA balance*

\$18,000 *Savings*

*Convert all possible with cash available in savings,
 the rest remains in Traditional IRA*

** Assumed Tax Rates at age 70 1/2*

<i>Fed</i>	<i>30%</i>
<i>State</i>	<i>10%</i>
	<hr/> <i>40%</i>

60 YEAR OLD

Converted in 2010 \$367,100
 Years until RMD 10.5

AT AGE 70 1/2		
	Partial Conversion	No Conversion
Roth	\$667,901	0
IRA	787,617	\$1,455,518
Tax Money	0	160,000
Tax Money (interest)	0	62,454
Totals	1,455,518	1,677,972
tax*	315,047	607,189
After tax	\$1,140,471	\$1,070,783
RMD at 70 1/2	\$28,745	\$53,121

Roth Conversion Benefit \$ 69,688
Return on tax paid 4%

2010 Assumptions

\$400,000 Annual Salary
\$800,000 IRA balance
\$160,000 Savings

*Convert all possible with cash available in savings,
 the rest remains in Traditional IRA*

** Assumed Tax Rates at age 70 1/2*

<i>Fed</i>	<i>30%</i>
<i>State</i>	<i>10%</i>
	<hr/> <i>40%</i>

30 YEAR OLD

Converting entire IRA - *funds for taxes as needed*

Converted in 2010 ** \$21,894
 Years until RMD 40.5

AT AGE 70 1/2		
	Total Conversion	No Conversion
Roth	\$239,902	0
IRA	0	\$328,726
Tax Money	0	3,000
Tax Money (interest)	0	11,820
Totals	239,902	343,546
tax*	0	136,218
After tax	\$239,902	\$207,328
RMD at 70 1/2	\$0	\$11,997

Roth Conversion Benefit \$ 32,574
Return on tax paid 7%

<i>Total tax on Roth Conversion</i>	\$	10,369	
<i>Portion paid with savings</i>		(3,000)	
	\$	7,369	***

<i>Beginning converted IRA balance</i>	\$	30,000	
*** <i>less: taxes paid, withdrawn from IRA</i>		(7,369)	
<i>less: 10% penalty on early withdrawal</i>		(737)	
<i>Ending converted IRA Balance in 2010</i>	\$	21,894	**

2010 Assumptions

- \$80,000 Annual Salary
- \$30,000 IRA balance
- \$3,000 Savings

Convert entire IRA using all savings, balance taken from IRA including 10% penalty

60 YEAR OLD

Converting entire IRA - funds for taxes as needed

Converted in 2010 ** \$604,258
 Years until RMD 10.5

AT AGE 70 1/2		
	Total Conversion	No Conversion
Roth	\$1,099,385	0
IRA	0	\$1,455,518
Tax Money	0	160,000
Tax Money (interest)	0	62,454
Totals	1,099,385	1,677,972
tax*	0	607,189
After tax	\$1,099,385	\$1,070,783
RMD at 70 1/2	\$0	\$53,121

Roth Conversion Benefit \$ 28,602
Return on tax paid 0.77%

<i>Total tax on Roth Conversion</i>	\$ 355,742
<i>Portion paid with savings</i>	(160,000)
	\$ 195,742 ***

<i>Beginning converted IRA balance</i>	\$ 800,000
***less: taxes paid, withdrawn from IRA	(195,742)
<i>Ending converted IRA Balance in 2010</i>	\$ 604,258 **

2010 Assumptions

\$400,000 Annual Salary

\$800,000 IRA balance

\$160,000 Savings

*Convert entire IRA using all savings, balance taken
 from IRA no 10% penalty*