# Roth Conversion Opportunities in 2010

### The Facts

An exciting new financial planning opportunity is on the horizon. Beginning January 1, 2010, you can convert your traditional IRA to a Roth IRA regardless of your income level. Long admired for their tax-free distributions, Roth IRAs are attractive retirement savings vehicles, for a variety of reasons.

### The Changes

Historically, Roths were only available to individuals whose modified adjusted gross income was $100,000 or less. For couples who filed joint tax returns in 2009, the cutoff was $176,000.

Beginning in 2010, the income limits that have prevented many individuals from converting a traditional IRA or employer-sponsored retirement plan (so long as that plan is eligible for distributions) to a Roth will be eliminated. This means that regardless of your filing status or how much you earn, you'll be able to convert a traditional IRA into a Roth IRA.

This change not only makes it easier for people with higher incomes to invest through Roth accounts, it will also enable more retirees—who rolled over their holdings from 401(k)s and other workplace savings plans into IRAs—to convert to Roths. In addition, SEP and SIMPLE IRAs can also be converted.

### The Advantages

Withdrawals of your converted assets are income tax-free. However, you must meet the rules for minimum holding periods and age requirements to avoid paying any penalties. Specifically, if you are under age 59½ you have to hold converted assets in the Roth IRA for five years. Any withdrawals would be subject to penalty, but not to tax, unless they are made for qualifying purpose such as disability or a first time home purchase. If you are over 59½, as long as the five year rule is satisfied, withdrawals on your conversion may be made at any time without penalty or tax.

## Reasons To Consider A Conversion In 2010

### More Control over Future Taxes

Although there is no way to predict the future, it is quite possible that income tax rates could be higher in the future than they are today. By paying income taxes on the conversion now, you can potentially avoid having to pay higher taxes later. In addition, Roths can provide a much greater level of control of how much tax you will pay in the future and when you will pay it. Having both an IRA with pretax money and a Roth gives you a choice: in years when you anticipate being in a higher tax bracket, you can take more tax-free money from your Roth.

### IRA Values are Low

The best time to consider a conversion from a traditional IRA to a Roth IRA is when IRA values are down. Why? Because the taxes you pay on a Roth conversion are based on the value of your account. Once the conversion is completed, any potential appreciation in the securities afterward is income tax-free. If you wait until your IRA value increases, taxes on your conversion will be based on the higher value. With both historically low income tax rates and IRA values down (due to market performance) this may be a good time to consider a Roth conversion.

*But what if I convert and the value of my account drops?* An allowance in the IRA rules permits for a 're-characterization' of your Roth assets back to traditional IRA assets. If, for example, the value of the assets drops, the assets could be 're-characterized' and then re-converted at the lower value to pay lower taxes. Note: there are some limitations to this strategy and the deadline for re-characterizing a Roth conversion is your tax-filing deadline, plus extensions.

### Income Taxes

The new rules allow some flexibility on the timing of tax payments. You can report the amount you convert in 2010 on your tax return for that year. Or, you can spread the amount converted equally across your 2011 and 2012 tax returns, paying any resulting tax in those years. For example, if you convert $50,000 next year, you can elect to pay all your income taxes on the conversion in 2010 or you can wait and declare the income as $25,000 on your 2011 tax return and the remaining $25,000 on your 2012 tax return. If you expect to be in a higher tax bracket in 2011 and 2012, it may be in your best interest to elect to pay the taxes in 2010. This two-year income tax payment option is a one-time offer for 2010 conversions only.

When calculating taxes due on a conversion you need to be aware of the aggregation rule. If your traditional IRA has any after-tax contributions, these will not be subjected to a second level of income tax, but you will have to aggregate all of your traditional IRAs to determine how this capital is recovered. For example, assume that you have two IRAs, one with $50,000, which is entirely after-tax contributions, and another with $200,000, which has no after-tax contributions. If you elect to convert only the smaller traditional IRA, thinking it might be accomplished at no tax cost, you may get a nasty surprise. The aggregation rule allows you to treat only $10,000 as a tax-free return of capital [$50,000 X (50/250)] and the remaining $40,000 will be taxed as ordinary income when the conversion occurs.

## The Impact On Beneficiaries

### No Required Minimum Distributions (RMDs)

Roth IRAs have no Required Minimum Distributions (RMDs) while you are alive. With traditional IRAs, you must begin taking distributions from your IRA account after reaching age 70½, in effect increasing your taxable income starting in your 70s (note that all RMDs have been temporarily suspended for 2009). Because Roth Accounts have no RMDs for the investor or their surviving spouse, there is less need to leave liquid reserves in place to meet distributions. Therefore you won't have to worry about your taxable income increasing at a point in your life when you may be living on a fixed income.

### Tax-Free Distributions for Beneficiaries

Roth beneficiaries do have to take distributions across their life expectancies, and Roth assets are still included in an estate's value and therefore subject to any applicable estate taxes. However, your heirs don't owe income tax on withdrawals. And if they choose to take only the minimum withdrawals permitted by the IRS, your heirs could potentially stretch their IRA distributions over their own life expectancy, resulting in additional potential growth and tax-free distributions over a longer period. That can be a significant advantage for middle-aged beneficiaries who have significant sources of other income and it has led some older adults to consider Roth conversions as a strategic alternative to life insurance.

### Roth Accounts Can Help with Estate Planning

Taxes owed on a Roth conversion can reduce the size of a taxable estate. For example, if your marginal income tax rate is 35 percent on a Roth IRA valued at $1,000,000, this will result in taxes of $350,000. And if the estate's marginal rate, for example, is 47 percent and subject to Federal estate taxes, then $164,500 ($350,000 X 0.47) will be saved in estate taxes; ultimately resulting in the IRS helping to absorb the costs of the conversion.

## Things To Consider Before You Convert

Roth conversions might not be for everyone. A few things you and your tax advisor should consider before converting include:

### The Money to Pay the Taxes

**The best way to pay for taxes owed on a Roth conversion is with money outside of an IRA, 401(k) or other qualified account.** Taking money out of your

IRA to pay taxes will eliminate the potential for those dollars to grow tax-free and diminish the tax benefit of a Roth conversion.

### You'll be in a Much Lower Tax Bracket After Retirement

Although many people feel that their income and expenses will drop in retirement, they often increase or they stay the same. However, if your post-retirement income declines enough to reduce your marginal tax bracket, paying higher taxes now to convert may not make sense.

### You Need Access to Your Money

The primary benefit of converting to a Roth IRA is to reap the advantages of future tax-free growth over a long period of time. If you expect to need substantial income from your IRA in the near future, you may not have the time to capture enough growth to recover the taxes you paid. Therefore, a Roth conversion may not be beneficial.

### The Tax Rules on Roth Accounts May Change

It is always possible that the federal government could make changes to IRS or tax laws governing Roth IRAs. Although there are no pending or proposed changes at this time, we can work with your tax advisor to keep you informed and help you determine the impact, if any, on your retirement plan, should there be any future changes.

## How To Get Ready

**If you already have a traditional IRA account that you would like to convert, you should begin to set aside money now to pay the taxes on the conversion.** Remember that if you convert in 2010, you can defer the taxes on the conversion into 2011 and 2012. If you have money to invest, you should also consider funding a traditional IRA before December 31, 2009. That way, you can convert those assets to a Roth in early 2010. To help you get ready, you should first consult your tax advisor to get advice tailored to your specific tax situation. Then, we can help you weigh your options and see if a Roth IRA conversion best fits your needs.

### Conversion Scenarios

The following chart represents three hypothetical scenarios, provided for informational purposes only to project the impact of: 1) Keeping your existing IRA, 2) Converting and taking the taxes owed from your IRA balance, and 3) Converting and paying taxes from savings. These scenarios are based on a person 45 years of age, with a $1,000,000 IRA balance, in a 28 percent tax bracket who will retire at age 65 with life expectancy of age 90. Asset projections are based on a 6 percent annual growth rate.

| Roth conversion for a 45 year old with $1,000,000 IRA Balance whose projected life expectancy is age 90 in year 2055 | | Scenario 1<br>Keep the IRA | Scenario 2<br>Convert in 2010 & Pay Taxes From IRA Assets | Scenario 3<br>Convert in 2010 & Pay Taxes From Non-IRA Money |
|---|---|---|---|---|
| Starting Balance | | $1,000,000 | $1,000,000 | $1,000,000 |
| Taxes Owed: Can be Spread Over Two Years | (–) | $0 | ($280,000) | ($280,000) |
| Penalties Owed on Early Distribution, 2010 | (–) | $0 | ($31,111) | $0 |
| **Balance Post Conversion, 2010** | | **$1,000,000** | **$688,889** | **$720,000** |
| Total Withdrawals for RMDs | | $5,409,648 | $0 | $0 |
| Tax Owed on Withdrawals | (–) | ($1,514,702) | $0 | $0 |
| Actual Withdrawals Received | | $3,894,946 | $0 | $0 |
| Balance of Assets in Account in Year 2055 | (+) | $4,725,748 | $10,051,225 | $14,590,487 |
| Lost Growth on $280,000 Used to Pay Taxes on Original Conversion | (–) | $0 | $0 | ($1,878,015) |
| **Net Benefit to Client** | | **$8,620,694** | **$10,051,225** | **$12,712,472** |

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