

Preparing for an unprecedented opportunity in Roth conversions

On January 1, 2010, nearly \$1.4 trillion of retirement assets will immediately become eligible to be converted to a Roth IRA¹. Thanks to the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), higher income individuals will be able to take advantage of a conversion opportunity once limited to those taxpayers with an adjusted gross income less than \$100,000.

THE ROTH CONVERSION RULES

- Currently, taxpayers can convert traditional IRAs and qualified retirement accounts, such as 401(k) accounts, to a Roth IRA as long as their adjusted gross income is under \$100,000. In 2010, and for all subsequent tax years, the \$100,000 limit is eliminated and **all taxpayers will be permitted to convert their retirement assets to a Roth IRA.**
- The amount converted to a Roth IRA will be included as ordinary income for the year in which the account was converted. However, for conversion in 2010 only, taxpayers can elect to defer half of their tax liability to 2011 and the other half to 2012.
The Roth IRA can grow and be distributed tax-free as long as distributions are not taken within five years of the first contribution or conversion, and not until after age 59½.

ROTH CONVERSION CONSIDERATIONS

All taxpayers should discuss with their advisers whether and how much of their retirement assets should be converted to a Roth IRA. The factors to consider when converting retirement assets to a Roth include investment timeline; available assets to pay the resulting income taxes; current income tax bracket; anticipated income tax bracket in retirement; and whether income tax rates might be higher or lower in the future. Whether a Roth conversion makes sense will depend on some of these factors and each individual’s specific financial and estate planning goals and objectives.

WHY CONVERT RETIREMENT ASSETS TO A ROTH? HERE ARE 9 POTENTIAL REASONS:

1	The current market provides a low-cost conversion opportunity
2	Social Security planning
3	Gross up the value of retirement accounts
4	Tax diversification
5	Hedge against increasing income tax rates
6	Tax loss harvesting
7	Reduce taxable estate
8	Trust planning
9	Tax-free stretch

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1. The Current Market Provides a Low-Cost Conversion Opportunity

The current market may give some savvy investors a unique opportunity to pay taxes at today's low rates. Retirement accounts generally grow tax deferred. The investor, or his or her heirs, will eventually have to pay taxes on the value of those retirement accounts. The higher the value of those accounts, the more taxes owed. Considering many investors have lost 30%, 40%, and even 50% of the value of their retirement accounts over the last 18 months, now may be a perfect time to recognize the income tax liability. An IRA worth \$100,000 in 2007 may now be worth \$60,000. By converting the \$60,000 retirement account to a Roth IRA, the taxpayer is locking in his tax liability at the lower amount. Should the \$60,000 Roth IRA eventually recover its losses and grow back to \$100,000, the taxpayer will avoid paying taxes on the \$40,000 difference.

What if the Roth IRA continues to lose value after the conversion?

Surprisingly, you can ask the IRS for a "do over". A retirement account converted to a Roth IRA can be recharacterized back into a traditional IRA with no tax consequences. In golfing terms, the IRS allows the taxpayer to "take a Mulligan." The rules of recharacterization are relatively straightforward. A Roth IRA can be recharacterized back into a traditional IRA up to the tax filing deadline, plus extensions. For example, if an investor converts her traditional IRA to a Roth IRA in January 2009, she will have until October 15, 2010 to decide whether to take the "do over". In other words, she will have up to 21½ months to decide whether to keep the IRA as a Roth.

For instance, let's assume that an individual decides to convert an IRA that was once worth \$100,000, but is now worth \$60,000. She would pay the income taxes on the conversion when she files her income tax return. Since she has until October 15 of the following year to file her tax return, she will have this amount of time to decide whether to recharacterize the Roth IRA. A recharacterization resets the account as if the conversion never took place. Therefore, should the Roth IRA be worth less by the October 15 deadline, she could simply recharacterize the Roth IRA back to a traditional IRA at no cost. Of course, should the Roth IRA recover its losses, all and any subsequent growth would be tax-free.

2. Social Security Planning

A tax-diversified retirement portfolio also helps with Social Security planning. Up to 85% of Social Security benefits are taxable. However, if a married couple's Modified Adjusted Gross Income (MAGI) is under \$32,000, Social Security benefits will be tax-free. For couples with a MAGI between \$32,000 and \$44,000, only half of Social Security benefits will be taxable. When calculating MAGI for Social Security purposes, the taxpayer needs to include all taxable and tax-exempt income and 50% of their Social Security benefits. Interestingly, although tax-exempt income is included in this calculation, Roth IRA distributions are not. Therefore, having a Roth IRA to supplement retirement income will be very important in managing the taxability of Social Security benefits.

3. Gross Up the Value of Retirement Accounts

When paying the tax liability for the Roth conversion, the taxpayer could either use assets from the IRA or

Example of Roth Conversion			
IF THE ACCOUNT GOES UP		IF THE ACCOUNT GOES DOWN	
January 2009 \$100,000 account value	October 2010 \$150,000 account value	January 2009 \$100,000 account value	October 2010 \$60,000 account value
Keep the Roth, No additional taxes due		Recharacterize the Roth, no taxes due and reconvert to a Roth at the \$60,000 sum*	

*A waiting period of at least 30 days applies before reconverting.

outside of the IRA. Of course, by using IRA assets to pay the tax liability, there will be less in the Roth IRA and fewer assets that will then grow tax-free. Furthermore, should the IRA owner be under age 59½, using IRA assets to pay the conversion tax would result in a 10% early withdrawal penalty. That is why it is often preferred to pay the resulting taxes out of pocket, assuming the taxpayer has enough assets outside of the IRA to do so. By paying the taxes out of pocket, the IRA owner is in essence grossing up the value of the IRA. For instance, what would a \$1,000,000 traditional IRA be worth on an after-tax basis to the average IRA owner? From purely a federal income tax perspective, the \$1,000,000 IRA would be worth no more than \$650,000 to the taxpayer. In other words, if the \$1,000,000 traditional IRA were liquidated, the IRS would get about 35%, or about \$350,000, and the taxpayer would be left with about \$650,000. By converting the traditional IRA into a Roth IRA and paying the resulting \$350,000 income tax liability from assets outside of the IRA, the IRA owner grossed up the value of the IRA from \$650,000 to \$1,000,000. It's almost as if the IRA owner made a \$350,000 "catch-up" contribution to the IRA. He converted \$350,000 of a taxable investment into a tax-free investment.

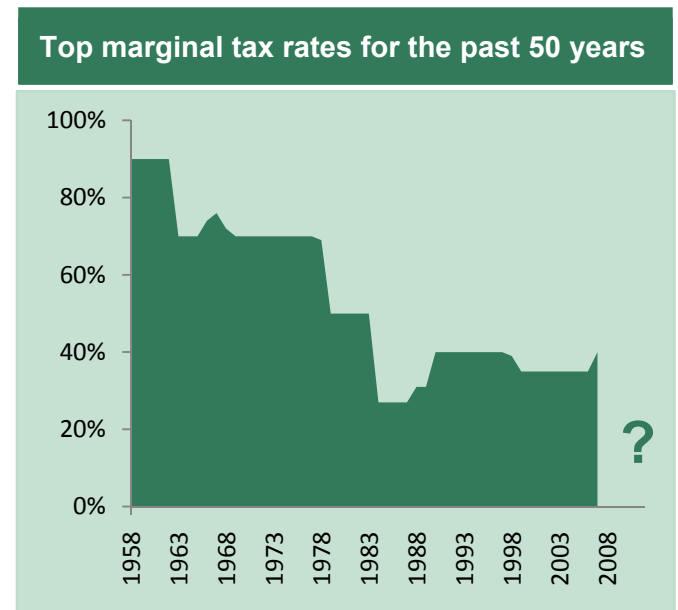
4. Tax Diversification

Other than tax-exempt municipal bonds, very few investments grow tax-free. The Roth IRA is the exception. There are advantages to having a tax-free Roth account to draw from in retirement. Just as asset allocation and investment diversification are cornerstones of proper financial planning, it will become increasingly more important to have tax diversification, especially during retirement. By being able to supplement retirement income with tax-free income, retirees increase their likelihood of keeping themselves in a lower-income tax bracket. For instance, let's say a married couple needs \$100,000 of income to live in retirement. For 2009, a married couple filing jointly, taking the standard deduction, can have up to \$79,300 of income and still be in the 15% tax bracket.

If the couple had a Roth IRA, they could take the additional \$21,700 they need from the Roth IRA and still be in the 15% tax bracket. By building a tax-free Roth nest egg, retirees will have more flexibility and control in managing their taxes.

5. Hedge against Increasing Income Tax Rates

For those who believe income tax rates will eventually increase, now may be the perfect time to convert retirement assets to a Roth IRA. For decades, the United States had a top marginal tax rate as high as 50%, 70%, and 90%. As a matter of fact, for the past 50 years there have only been five years (1988 to 1992) where the top marginal tax rate was less than the current 35% rate.



Considering the current budget deficits and the costs of the bailouts and stimulus, many believe that income tax rate increases are inevitable. If you share that belief, then you may wish to realize taxable income now and take advantage of today's historically low income tax rates. Couple this with the fact that we are also in a depressed market, and there are significant strategic advantages to doing a Roth conversion. Pay taxes now when the rates are low and while the taxable value of the account is depressed, as opposed to when the income tax rates are higher and the value of the retirement account increases.

6. Tax Loss Harvesting

Roth conversions can be a useful tool in harvesting certain tax losses. There are times when a taxpayer would like to realize income in order to utilize expiring tax losses and credits. In particular, taxpayers that have Net Operating Loss (NOL) carryforwards, business and other ordinary losses, charitable contributions carryforwards, deductions and exemptions in excess of income, and non-refundable tax credits, would be wise to generate income by converting some of their retirement accounts into a Roth IRA. For instance, a business owner with taxable income of \$75,000 and a NOL of \$100,000 would have an adjusted gross income of negative \$25,000. The business owner may wish to convert up to \$25,000 of taxable retirement assets at little or no tax costs. The Roth conversion helps taxpayers realize favorable tax attributes, while paying little or no income taxes on the conversion.

7. Reduce Taxable Estate

Individuals who intend to leave a significant amount of their retirement accounts to their children and other heirs should contemplate some of the estate planning benefits of a Roth conversion. Although both traditional and Roth IRAs are included in a decedent's taxable estate, a Roth conversion could actually save the estate and heirs taxes. For one, the federal and state income taxes paid because of the conversion would actually reduce the owner's estate. Additionally, heirs inheriting a taxable retirement account are normally entitled to take a deduction against their ordinary income equal to the federal estate taxes attributable to the inherited retirement assets. This is referred to as the Income in Respect of Decedent (IRD) deduction. As a result, paying the income tax on the retirement account while the owner is alive may actually produce a lower overall tax burden.

8. Trust Planning

Roth conversions may also help with trust planning. Trusts are one of the preferred vehicles for transferring wealth from one generation to the next. However, for the unwary, the trust could become a tax trap. Distributions of taxable retirement accounts to a trust

would be taxed at the highest marginal income tax rate of 35%, as soon as the income exceeds \$11,500, for 2009. By comparison, individual taxpayers do not pay taxes at the 35% rate until their income exceeds \$372,950. Therefore, if the purpose of the trust is to hold these retirement assets long term and protect them against the beneficiary's creditors and spendthrift behavior, it may make sense to convert the retirement assets to a Roth IRA prior to death, pay the taxes at a comparatively lower rate and allow the assets to be paid to the trust income tax-free.

9. Tax-Free Stretch

One of the more compelling reasons to convert retirement assets to a Roth IRA is that the beneficiaries of the IRA can stretch the account tax-free over their lifetime. Similar to traditional IRAs, the beneficiary of the Roth IRA can stretch the IRA by taking only the minimum required distribution each year over his or her life expectancy. However, unlike the traditional IRA, the Roth IRA permits the undistributed amount to continue to be invested and grow tax-free, as opposed to merely tax-deferred, over the beneficiary's lifetime. For example, assume a 70-year old with a \$1,000,000 IRA would like to leave as much as possible to his 40-year old daughter at death. Assuming he took only his required minimum distribution at age 70½, died at 86, the account grew at 7% and the daughter stretched the traditional IRA, she would have received a total of \$983,859 of after-tax distributions over her lifetime. However, had the Roth been converted prior to the father's death, the daughter would have received a total of \$1,492,920 of distributions, or 65% more, over her lifetime. Tax-free lifetime investing can be powerful.

Final Thoughts

It is wise to contact a tax professional and financial advisor who understands the rules of Roth conversions and what circumstances make it beneficial to do a Roth conversion.