

## Roth IRA Conversion . . . Does Taking Action Get You to Point A or Point B

If only it were that simple. There is no black and white here. Everything has its risks and is based on assumptions. Upfront, this is an attempt to summarize a topic that has regained the interest of investors in 2010. Beginning January 1, all taxpayers will be allowed to do conversions, just as those earning less than \$100,000 have been permitted to do since 1998. Income and filing status restrictions on transferring money from a traditional IRA to a Roth IRA have been eliminated. Because everyone's situation is unique and the tax code complicated, we suggest that you work with your tax preparer. Conversions will only make sense for certain taxpayers. Even when it could be beneficial, there will be a natural aversion to paying taxes sooner than needed. If you expect you will need every penny of your retirement money and think you will land in a much lower tax bracket than your current rate, it does not pay to convert.

What is the bottom-line benefit of a Roth conversion? The Roth conversion can put you in control of the tax liability for retirement funds and eliminates the worry about required distributions or future tax increases.

So now, we present a simple outline on a complicated subject.

### Conversion Candidates

- If you won't need the money in your pre-tax traditional IRA for a decade or more, you might be a candidate if your tax rate will be the same or higher in retirement.
- If you are a younger worker, not yet at peak earnings and expect your tax rate to be higher in withdrawal years.
- If you are retired and so well set financially that you can leave your IRAs to your children or grandchildren.
- If you have made mostly nondeductible (after-tax) contributions to a traditional IRA or 401(k), you may be a good candidate; there are rules to follow for calculating the taxability of converted assets.
- If you have made significant pre-tax contributions to a traditional IRA and/or 401(k) assets; the RMD required minimum distribution could place you in a higher tax bracket because distributions are realized income.

*Conversion calculators are available and will help to evaluate your personal scenario. Your tax preparer should be included in the conversion evaluation as tax consequences of a conversion can be significant.*

### Traditional IRA

- A traditional IRA is usually funded with earned income not yet taxed. Investments grow tax deferred and withdrawals are taxed at ordinary income rates. Current top federal rate is 35%, destined to go to 39.6% in 2011, possibly higher.
- RMD begins at age 70 ½.
- Under the new rules, high income taxpayers wanting to contribute to a Roth IRA are still subject to income limitations but, the rules allow high earners to convert traditional IRAs, resulting in a back-door way to fund a Roth on a continual basis.
- High earners subject to AGI limits can make nondeductible contributions (after-tax) to traditional IRAs and convert them to a Roth each year but, there is a special rule to consider, as converted assets must be drawn proportionately from your pretax and after-tax IRAs; taxes will be calculated proportionately.

### Roth IRA

- A Roth IRA provides the benefit of tax free future growth.
- Roths do not require account owners to withdraw any money, ever.
- A conversion can move more into a Roth IRA quickly.
- Rules of distribution for penalty free withdrawals from a Roth Conversion IRA:
  - Each conversion has its own 5 year clock.
  - IRS Publication 590 provides details for the exceptions.
  - If not qualified, you may have to pay the 10% additional tax on early distributions.
  - Qualified Distribution - You have to hold assets in a Roth for 5 years from the beginning of the year in which you first set up and contributed to the Roth and be at least age 59 ½, before contributions or earnings can be withdrawn without tax or penalty.
- In 2010, Roth contributions can be as follows:
  - Married taxpayers earning up to \$167,000 can make full \$5,000 contribution; this is \$6,000 for people over age 50.
  - Couples who earn up to \$177,000 can make partial contributions.
  - Single taxpayers who earn less than \$105,000 can make full contribution; it phases out above \$120,000.
- You may contribute to the Roth IRA after 70 ½ but, must have an earned income.

- Roth's benefits extend beyond tax advantages.
  - Unlike traditional IRAs, you are not required to make a minimum distribution once you turn 70 ½.
  - It is an effective way to leave money to heirs or save for emergency expenses later in life.
  - Roth withdrawals are not counted as income so dollars you take out will not affect taxability of Social Security benefits or income based Medicare premiums; then again, government Policy could change.

### **Distinct Difference in Contribution to an IRA versus Conversion of IRA**

- Will you still contribute to an IRA?
  - Now anyone willing to pay the income taxes due will be able to put retirement savings into a Roth even if it is through the back-door.
- Do you have a traditional IRA to convert?
  - In a conversion, you draw funds from a traditional IRA or 401(k), pay the ordinary taxes due on any pre-tax contributions and tax-deferred investment growth, then move the cash into a Roth IRA where future growth is tax-free.
  - The rules say the amount you convert must be drawn proportionately from your pretax and after-tax IRAs, so your savings depends on your mix of accounts.

### **Key Factors**

- **Taxes – General**
  - You may not want to convert if you will be in a lower tax bracket after retirement.
  - It's your combined federal and state taxes that matter; that could go down if you are moving to a state like Nevada or Florida and is a good reason not to rush a conversion.
  - Wisconsin residents are an exception to the calculations, as they face stiff penalties when converting their IRAs, unless changes are made to the State law during the year.
  - With a Roth IRA, you pay taxes now on contributions so you can withdraw tax-free later.
  - Experts generally do not recommend acting unless you have the money to pay the tax bill for the conversion without dipping into your Traditional IRA (if under 59 ½ you will face a 10% penalty).
  - Limit the tax pain from conversion; only convert an amount that would keep you from entering the next marginal tax bracket.

- Tax brackets are fairly wide in 2010. A married couple gets the 15% rate on taxable income up to \$68,000 while the next higher 25% rate goes up to \$137,000. For singles the 15% rate ends at \$34,000 and the 25% rate at \$82,400.
  - Unless an AGI restriction is put back in the tax code, always a possibility, Roth conversions are unlimited in future years.
  - The 2010 conversion is the only one that allows you to defer the taxes and spread it over multiple years. You can choose to report the amount converted on the 2010 tax return, or spread it equally across 2011 and 2012 returns. Given how tax tables are set today, the highest rate increases in 2011. You have until you file your 2010 return – April 15, 2011 or October 15, 2011 with extensions, to decide when to recognize conversion income.
- **Taxes – Estate**
  - Non-spouse beneficiaries who inherit both traditional and Roth IRAs must make annual withdrawals from those accounts (based on life expectancies).
    - The Roth IRA is included in the owner’s estate and is subject to estate tax, but
    - Roth beneficiaries owe no income tax on the money withdrawn.
  - Inherited non-spousal IRA accounts are not eligible for Roth IRA rollovers.
  - Inherited spousal IRAs can be rolled into the spouse’s own IRA and then converted to a Roth.
- **Government Policy**
  - The Roth IRA might be an important supplement for retirement income, in managing the taxability of Social Security benefits or income based Medicare premiums.
  - A ‘Tax Diversified’ retirement distribution strategy could be a benefit if you’re willing to bet that Congress won’t change the rules.
- **Cash flow needs / Distribution Requirements**
  - If you need the funds within 10 years, converting probably is not worth it.
  - The longer the Roth is untouched, the more advantageous the conversion.
  - Income needs may not go down in retirement.
    - Most retirement calculators estimate the need for 70% to 80% of preretirement income.
  - If you underestimate the minimum needed to maintain a given standard of living, your tax rates may not be lower in retirement.
- **Time and Age**
  - Time and age are critical factors when working with retirement calculators which analyze conversion benefits.

## Special Strategies

- **Recharacterization (Do Over Rule)**
  - You have the ability to undo the conversion all the way until October 15, 2011.
  - If your IRA assets drop in value after you pay the tax, you may want to undo the conversion and get a refund of the tax.
  - This generous do-over rule may mean you want to open a separate Roth for each conversion or for separate asset classes.
  - Only keep those separate Roths until the time to recharacterize has expired; then transfer the accounts into one master Roth IRA.
- **Estate Planning**
  - The no lifetime required minimum distribution for the owner and spousal-beneficiary makes the Roth ideal for estate planning.
  - Converting to a Roth will reduce the size of the estate because of the taxes paid up front at conversion, after which it would then provide the benefit of an income free gift to beneficiaries.
- **Partial Conversion**
  - The Roth conversion isn't all or nothing.
  - You can convert part of a Traditional IRA to a Roth.