

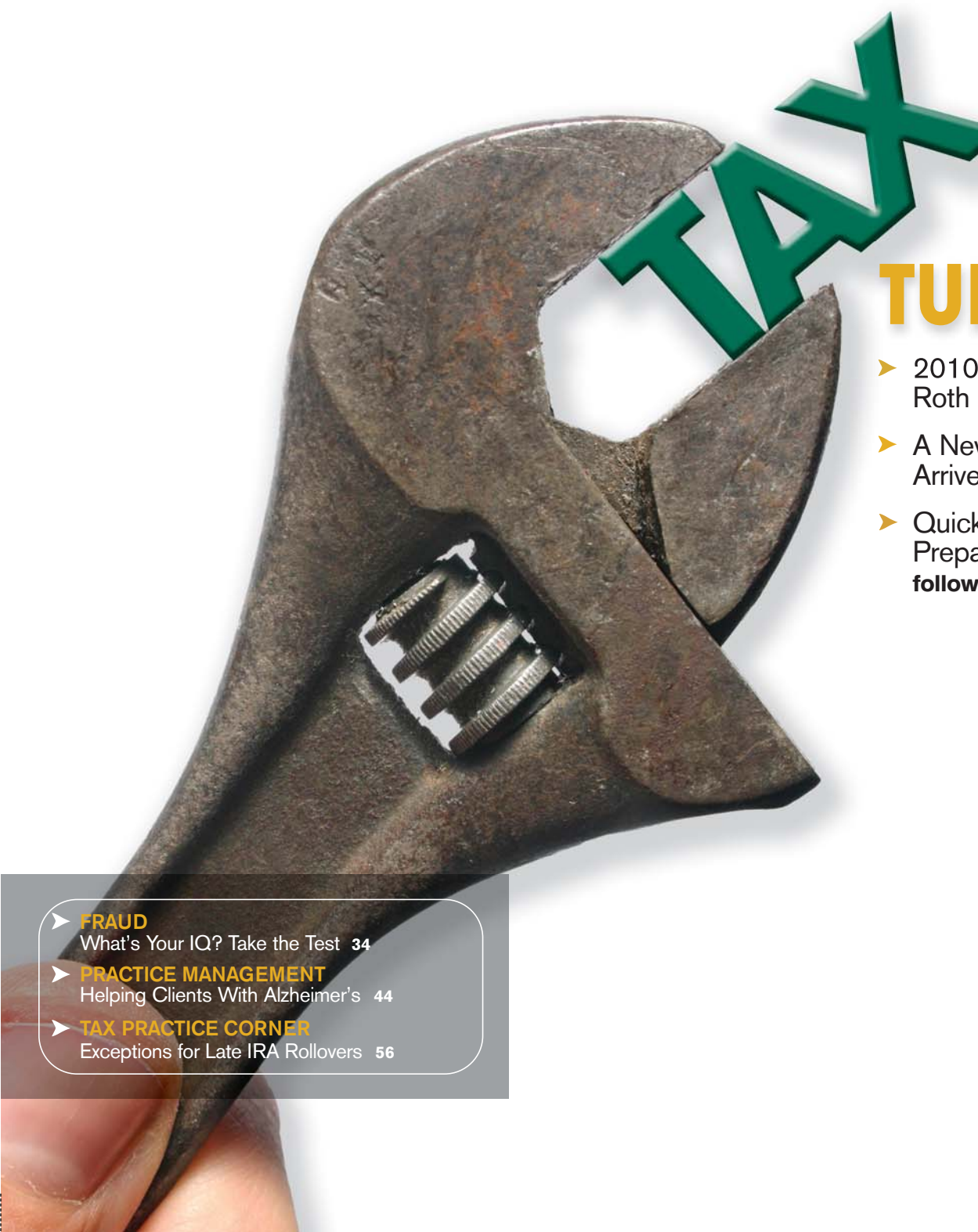
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2010: The Year of the Roth Conversion?

by Rich Arzaga

This year will be the Year of the Tiger, according to Chinese custom, but it also could be remembered by investors as the Year of the Roth Conversion, a decision that can have a large impact on investors' ability to build wealth during their lifetime and preserve wealth for beneficiaries.

Prior to 2010, anyone (except married taxpayers filing separately) with an annual adjusted gross income (AGI) of no greater than \$100,000 could convert a traditional IRA to a Roth IRA. The AGI cap has prevented higher-income earners, a class of savers that might have benefited most from this strategy, from participating. However, under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) these previously ineligible taxpayers will be eligible to participate starting this year (including married but separate filers). In fact, there is an incentive to take action in 2010: Everyone who converts this year may defer and spread income recognition

from the conversion over tax years 2011 and 2012. A conversion in 2010 thus could reduce the marginal tax rate and total taxes due on what otherwise would be a larger single-year distribution. The 10% penalty tax otherwise imposed on early or excess distributions from an IRA does not apply. A conversion could be an attractive retirement income and estate planning strategy for wealthy individuals and high-income earners who seek to reduce taxes later in life and transfer more wealth to beneficiaries tax-free. But like any other approach to income and taxes, this decision is eventually based on a set of sustainable assumptions and specific objectives of the taxpayer.

ADVANTAGES OF A ROTH ACCOUNT

A chief advantage of a Roth IRA is that it has more flexible rules concerning distributions. Also, taxpayers who are otherwise unable to contribute to a traditional IRA can take advantage of a Roth IRA's appreciation free from tax on gains. Other advantages of a Roth IRA include:

- In most instances, contributions can be withdrawn at any time without penalty. Earnings may be withdrawn without tax or penalty if the taxpayer is at least age 59½ and has held the Roth account for at least five years. Similar strategies that provide for tax-free growth and withdrawal are the IRC § 529 plans for college education and cash-value life insurance policies. Each has its strengths and limitations.
- With a Roth IRA, there are no required minimum distributions (RMDs) like those that apply to traditional IRAs when the taxpayer reaches age 70½. For

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affluent families with sufficient resources for retirement income, the RMD can seem an unnecessary expense with a confusing formula. From a client's perspective, eliminating RMDs can provide a great sense of relief from the annual hassle of calculating and managing these distributions.

- Unlike with traditional IRA accounts, taxpayers can continue to contribute to a Roth IRA after reaching age 70½—also an attractive feature as Americans redefine retirement and continue to be industrious into later years. Starting in 2010, a retired couple can contribute \$12,000 each year (including the “over-50 make-up” amount) into Roth accounts. The AGI limits on regular contributions to a Roth IRA still apply, but it is possible to make nondeductible contributions to a traditional IRA and convert them to a Roth, regardless of AGI. These contributions grow free of income tax indefinitely, creating significant value for taxpayers as well as their beneficiaries.
- A tax-diversified retirement distribution strategy also helps with Social Security planning. Up to 85% of Social Security benefits are taxable. When calculating modified adjusted gross income (MAGI) for Social Security purposes, taxpayers must include all taxable and tax-exempt income and 50% of their Social Security

benefits, but not Roth IRA distributions. Having a Roth IRA to supplement retirement income can be very important in managing the taxability of Social Security benefits.

IDEAL CONVERSION CANDIDATES

Some taxpayers may benefit more than others from converting to a Roth IRA. Assuming there are no cash flow issues, risk management gaps, other tax planning considerations that need to be weighed against the benefit of a conversion, advance tax issues at play, or adverse legislative changes, taxpayers who stand to benefit the most are those who:

- Are wealthy.
- Seek to reduce estate settlement costs.
- Won't need to draw income from converted retirement accounts.
- Are young, high-income earners.
- Believe their tax bracket will be the same or higher in retirement, or more specifically, when they draw income from their qualified retirement accounts. The attractiveness of traditional IRAs and qualified retirement

plans depends on the assumption that taxpayers will have a lower effective tax rate after retirement, when the deferred taxes on the savings will come due. Conversely, taxpayers whose tax rate seems more likely to be the same or higher in retirement might just as soon pay taxes on income now and accumulate tax-free gains. Consider the conversion comparison in Exhibit 1.

The difference between columns C and D in Exhibit 1 is that income taxes were paid from within the \$100,000 account in column C, whereas income taxes

were paid from sources outside the account in column D. This difference in earnings (or tax savings) will not be subject to income tax when withdrawn or transferred to beneficiaries and is a compelling reason to pay taxes from outside sources if possible. Column B shows how a higher tax rate in retirement than at conversion favors conversion.

WILL TAX RATES BE LOWER IN RETIREMENT?

Many advisers note that retirees generally have less income than when they worked ➤



EXECUTIVE SUMMARY

■ **Converting a traditional IRA to a Roth IRA** may be an attractive option at any time, but it is especially likely to result in tax advantages if done in 2010, since recognition of income resulting from the conversion may be deferred and spread over tax years 2011 and 2012.

■ **The likeliest candidates for tax savings** from a Roth IRA conversion are high-income taxpayers, who can best benefit from the account's tax-free inheritability and the removal of adjusted gross income restric-

tions on conversion for 2010. The advantage of tax-deferred plans presupposes retirees will have a lower tax rate than when working; however, this assumption is questionable, given the prevalence of retirees who report needing greater income in retirement than they expected.

■ **The use of the strategy can be a gateway** to other planning and investment strategies for taxpayers and beneficiaries.

■ **A Roth IRA generally offers advantages** of greater taxpayer control over distributions. Con-

tributions may be withdrawn at any time without tax or penalty, and earnings may be withdrawn without tax or penalty if the taxpayer is at least age 59½ and has held the Roth account for at least five years. Also, unlike a traditional IRA, a Roth IRA has no required minimum distributions, and taxpayers may contribute to it after age 70½.

■ **Other, less-apparent features of Roth IRAs** that could make conversion a more attractive option include that 401(k) and 403(b) plans may now be

converted and that their tax-free status can be inherited.

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and therefore will have a lower tax rate. But that's far from certain, first because it assumes the brackets will remain unchanged except for inflation adjustments, and second because it's far from clear most taxpayers' income goes down enough in retirement to change their tax bracket. Tax rates are subject to change over times as long as the retirement investing horizon. Notably, all federal income tax brackets are scheduled to revert in 2011 to their higher pre-Economic Growth and Tax Relief Reconciliation Act rates. President Barack Obama's fiscal 2010 budget plan proposes letting only the top two brackets, currently 33% and 35%, revert to the prior rates of 36% and 39.6%.

One reason retirees' tax rates may not be lower than before retirement is that they often find—contrary to conventional thought—their income needs don't go down, so they wind up tapping additional



sources of income beyond what they had planned. Most advisers and retirement calculators estimate the need for 70% to 80% of pre-retirement income. But according to a survey by Cogent Research in 2007 for Sun Life Financial (see

Exhibit 2), many retirees underestimate the income needed to maintain their standard of living. The older the retiree, the greater the underestimation of needs. Also not calculated is the impact of risk, such as the considerable cost of long-term care. Also, younger taxpayers don't necessarily have higher tax rates than later in life, because they generally don't earn as much as in middle age.

LESS-APPARENT BENEFITS OF A ROTH CONVERSION

Besides the lack of an AGI ceiling and deferral and spreading of distribution recognition of a Roth conversion in 2010, other, less-well-known attractive features include:

Any retirement account is eligible.

Under provisions introduced by the Pension Protection Act of 2006, rollovers and transfers to a Roth account may be made from any qualified retirement account, including 401(k) and 403(b) plans. Previously, only transfers from IRA accounts were permitted.

Self-directed, higher-growth investments. Some investment strategies involve

It's Reversible

IRC § 408A(d)(6) allows taxpayers to recharacterize within six months of the tax year's return due date (without extensions) a contribution to a traditional or Roth IRA, including "reversing" a traditional-to-Roth conversion. In golfing terms, the IRS allows the taxpayer to "take a Mulligan." Why, after all this effort, would someone wish to recharacterize a conversion? A typical reason would be a decline in the value of the Roth account, making the tax bill more, relative to that value, than the client wants to pay. For example, a calendar-year taxpayer converted a \$100,000 IRA to a Roth IRA before April 15. A year later, the Roth IRA was worth only \$25,000. Without a recharacterization, the client will pay income tax on \$75,000 of value that no longer exists. If the conversion is recharacterized before the Oct. 15 deadline (assuming an April 15 return due date), the tax bill on the \$100,000 conversion is erased. The recharacterization must be done as a trustee-to-trustee transfer, which the taxpayer must elect by notifying the trustees of both IRAs of the amount and type of contribution being recharacterized. It's worth noting that recharacterization of a contribution—or conversion to a Roth IRA, for that matter—is not an all-or-nothing proposition.

Exhibit 1 Conversion Comparison

A	B	C	D
Effective Federal Income Tax Rate at Retirement	Traditional IRA	Roth Conversion (taxes paid in 2012 and 2013 from account)	Roth Conversion (taxes paid outside account)
20%	\$339,828	\$342,283	\$424,785
25%	\$318,589		
30%	\$297,349		
35%	\$276,110		
40%	\$254,871		

This example assumes an IRA account with a present value of \$100,000 generating a 7.5% annualized rate of return during a 20-year investment period and a current federal income tax rate of 25%. Calculations for a traditional IRA assume a lump-sum payment at the end of the 20-year period. Actual after-tax returns depend on factors that include the schedule of distributions. These calculations do not factor in state income taxes, if applicable, which would strengthen the position for a Roth conversion, as long as the tax rate at distribution is higher than in the year of contribution. However, note that not all state tax codes incorporate federal law on conversion to a Roth account (see "Timing the Roth IRA Conversion," *JofA*, July 99, page 73).

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the placement of capital with no or low dividends in exchange for high future growth. Private equities and nontraded growth and developmental or value-added real estate trusts fit this strategy. The opportunity to invest capital that, while it is after-tax, can seek higher, tax-free growth is the Holy Grail for moderately aggressive to aggressive investors. Again, younger taxpayers with a longer time horizon who currently pay a lower marginal tax rate are good candidates for this strategy, as are wealthy families seeking to grow the estate for heirs or charity.

Leaving a tax-free legacy. Many taxpayers hate paying income tax—even after they're dead. The tax-free status of a Roth IRA can extend far into the future if the surviving spouse names a young grandchild or great-grandchild as the beneficiary.

Getting children involved. Tucked inside the list of ideal conversion candidates

are those who don't need to draw income from retirement accounts and have a lower marginal tax rate than their grown children. In this instance, it is in the best interest of the children to help their parents pay the income tax on the conversion. Since the children will receive the Roth proceeds income tax-free at the death of their parents, they are thus able in effect to pay a lower tax rate today for a larger tax-free benefit in the future. Gifting rules and proper beneficiary designation should be considered.

For many taxpayers, 2010 may indeed be the Year of the Roth Conversion. CPAs and financial planners can balance the decision-making process with clients' current financial condition and tolerance and capacity for risk, financial planning objectives and time horizon. Now that 2010 has arrived, most clients have heard about this opportunity, but many are still unsure whether it is suitable for their circumstances. Certainly, the strategy is worth a thoughtful exploration. ♦

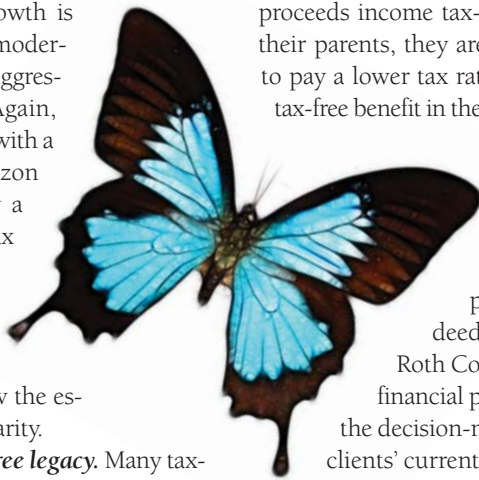
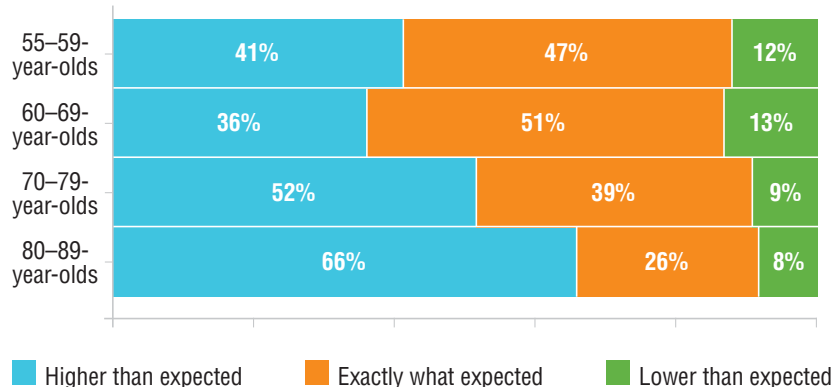


Exhibit 2 Expenses in Retirement: Expected vs. Actual

"Would you say the expenses that you've had and expect to have in your retirement are: Much higher than expected, exactly what expected, or much lower than expected?"



Source: *Perspectives: Retirement Lifestyles*, "The Expense Reality," 2007, Sun Life Financial.

AICPA RESOURCES

JofA articles

- "Taxes in Troubled Times," April 09, page 36
- "To Roth or Not to Roth?" Feb. 07, page 64
- "Investment Tax Planning for Retirement," Aug. 03, page 63

The Tax Adviser article

"Tax Clinic: Roth IRA Conversions in 2010," Oct. 09, page 664

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