

Roth IRA Conversion Opportunity

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With the benefit of income tax free distributions, Roth IRAs have become extremely popular savings vehicles since their introduction in 1998. Until now, most GenSpring clients have been unable to participate in Roth IRAs due to income based limitations on funding, either directly through annual contributions or conversions of an existing traditional IRA. The elimination of the income limitations for conversions beginning January 1, 2010 has created an exciting opportunity for many high income taxpayers.

Traditional IRA Rules

A Roth IRA is best explained by contrasting it to the “Traditional IRA” that has been around for many years. A traditional IRA is simply a personal savings plan that is granted certain tax benefits to encourage retirement savings. Contributions to traditional IRAs are either tax-deductible (the money goes into the IRA before tax) or nondeductible (you pay income tax on the money that goes into the IRA). Regardless of whether your contributions are tax-deductible, amounts contributed to a traditional IRA grow tax deferred inside the IRA.

Because the IRA is intended to be a retirement savings vehicle, any distributions made prior to reaching age 59 ½ are subject to a 10% penalty. The IRS requires that distributions from the IRA begin no later than age 70 ½, and specific rules govern the calculation of the minimum amount that must be withdrawn each year. Any distributions from the account that represent earnings or tax-deductible contributions are subject to ordinary income tax when withdrawn. Any non-deductible contributions made to the IRA are income tax free when withdrawn. If a traditional IRA is funded with both tax-deductible contributions and non-deductible contributions, each withdrawal is taxed according to the ratio of tax-deductible and non-deductible contributions.

Roth IRA Rules

Unlike a Traditional IRA that may be funded with tax-deductible contributions, a Roth IRA can only be funded with after-tax contributions. The upside to forgoing an income tax deduction when funding a Roth IRA is that all distributions from the IRA, including both contributions and earnings, are free from income tax. Additionally, unlike a traditional IRA, there is no requirement that minimum distributions begin at age 70 ½, allowing 100% of

the funds to continue to grow in an income-tax free environment potentially until death.

What has changed?

In 2006, President Bush signed the Tax Increase Prevention and Reconciliation Act (TIPRA) into law. Beginning in 2010, TIPRA repealed the \$100,000 income limitation for conversions of traditional IRAs to Roth IRAs, and for the first time allowed taxpayers who file their tax returns as ‘married filing separately’ to convert to a Roth IRA. As a result, taxpayers may now convert traditional IRAs to Roth IRAs regardless of their income or income tax filing status. Additionally, the IRS has recently clarified that certain employer sponsored retirement accounts such as 401(k)s and profit sharing plans can be converted directly into Roth IRAs.

A conversion of a traditional IRA to a Roth IRA is fully taxable (assuming the account was funded entirely by tax-deductible contributions) at ordinary income tax rates. For 2010 Roth IRA conversions, a special rule applies which automatically defers 50% of the resulting income tax liability until 2011 and the balance in 2012 unless you elect to pay the entire tax liability in 2010. Although deferral of income tax liability is generally advisable, this deferral must be considered in light of the expiration of current income tax rates at the end of 2010. Absent Congressional action (which appears unlikely), tax brackets above 15% will revert to the higher pre-2001 levels of 28%, 31%, 35% and 39.6%. We anticipate most taxpayers who decide to convert will forgo the opportunity to defer the tax liability to take advantage of lower rates. You should consult with your tax advisor to determine what course of action is best given your unique income tax situation.

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Why consider a Roth IRA Conversion?

While few people get excited about the prospect of accelerating income tax, there are a number of very compelling reasons to consider a conversion.

Potential income-tax free withdrawals

Unlike a traditional IRA or qualified plan, withdrawals from a Roth IRA are income-tax free if some relatively liberal conditions are satisfied. This could be tremendous advantage in a rising income tax rate environment.

No Required Minimum Distributions

As a general rule, all taxpayers must begin withdrawing money from a traditional IRA and paying income tax on the withdrawal beginning at age 70 ½. The rules require that funds be withdrawn based on the IRA owner's life expectancy, recalculated annually. For example, under these rules the life expectancy for a taxpayer age 70 is 27.4, and the RMD for a hypothetical \$1 million IRA would be \$36,496. This life expectancy is recalculated each year and requires larger withdrawals as the taxpayer ages. Even if the after tax proceeds of this distribution are re-invested outside of the IRA in taxable portfolio, the benefit of tax deferral has ended.

The RMD rules do not apply to Roth IRAs during the account owner's lifetime. This avoids the 'leakage' that occurs with the traditional IRA and allows more value to compound free from income tax. This can be a tremendous advantage for clients who do not need to access the fund in the IRA.

Estate Tax Considerations

Another potentially powerful benefit of the Roth IRA involves the estate tax. Both traditional IRAs and Roth IRAs are included in the owner's taxable estate and subject to estate tax at the applicable rate. In addition to being subject to estate tax, any withdrawals that occur after the owner's death are subject to income tax. In effect, the estate tax is calculated on dollars that will be used to pay income tax.

When you convert to a Roth IRA and pay the income tax with non-IRA assets, you remove those funds from your taxable estate. This has the effect of lowering the combined tax rates compared to paying estate tax on the traditional IRA and then paying income tax on withdrawals.

This benefit is obviously very dependent on estate tax rates and may be difficult to quantify for younger IRA owners because of the uncertainty surrounding future estate tax rates. Also do not overlook the possibility that a Roth Conversion might be an effective "death-bed" planning opportunity for the wealthy taxpayer with a large traditional IRA.

Who Can Convert?

The elimination of the income limits on conversion has greatly expanded the number of taxpayers eligible to convert. Anyone with a traditional IRA or qualified retirement plan (i.e., 401k) is now eligible.

The rules are slightly more restrictive for inherited retirement account. Spousal beneficiaries of inherited IRAs are eligible to convert to Roth IRAs, while non-spousal beneficiaries are not. Both spousal and non-spousal beneficiaries of inherited qualified retirement plans are eligible to rollover qualified plan balance into a Roth IRA.

Example:

Linda's mother died in 2005 with Linda designated as sole beneficiary of her traditional IRA. The IRA is now an inherited IRA, and Linda is taking the annual required minimum distributions as required by the IRS. Because Linda is a non-spousal beneficiary of the inherited IRA, she is not eligible to convert the IRA to a Roth IRA.

If Linda was the beneficiary of a 401k plan rather than an IRA, she could rollover the 401k plan into a Roth IRA.

Should I Convert?

Much has been written about whether or not to convert a traditional IRA or Qualified Plan to a Roth IRA. Some argue it is a "no-brainer" and everyone should convert now that they have the opportunity. Other commentators cite multiple factors and considerations that must first be evaluated. Much of the guidance is geared towards the 'mass-affluent' client, where in most cases it will depend largely how soon and to what extent the IRA will be needed to fund retirement, and how the income tax liability from the conversion will be funded. Do the same rules and principles apply to the high net worth client? The following are the key considerations.

When, if at all, will you need to access the IRA funds?

If you will need access to the funds within the next five years, it may be difficult to justify accelerating the income tax by converting to a Roth. Also keep in mind that the converted amount must be kept inside of the Roth IRA for at least five years to avoid a 10% early withdrawal penalty. Think of the five years as a minimum – the longer you can defer drawing funds from the Roth IRA post conversion, the better.

Those who may need access to some portion of the IRA within the foreseeable future might consider a partial conversion

Most high net worth clients will not look to their IRA as their sole source of income during retirement. If there is no need or plan to access the funds, the analysis is simplified. Those who may need to access some portion of the IRA within the foreseeable future might

consider using a capital sufficiency financial model to determine the timing and extent of the need. This may lead to consideration of a partial conversion.

Source of Funding Income Tax Liability

To maximize the potential benefit of a Roth conversion, it is preferable to use non-IRA assets to pay the income tax liability resulting from the conversion. This allows for greater tax free growth within the Roth IRA. In addition, taxpayers who are under 59 ½ incur a 10% penalty if they withdraw IRA funds to pay the income tax on the conversion.

High net worth clients contemplating a Roth IRA conversion should look to non-IRA funds to pay the associated income tax liability. Depending on the size of the income tax liability, this may require some cash flow modeling to ensure that the depletion of non-IRA assets will not impact your ability to maintain your lifestyle or meet other financial goals.

Views on Future Income Tax Rates

If you think that going forward you will be in the same or a higher income tax bracket than you are in today, paying income tax in today's lower income tax rate environment is generally beneficial.

Keep in mind that your tax bracket could increase due to unforeseeable circumstances such as higher levels of income or changes in income tax rates.

Estate Planning Objectives

For clients who intend to pass the bulk of their wealth to their heirs, a Roth IRA conversion allows them to prepay for their heirs the income tax on the funds in a traditional IRA. Not only will this allow your heirs to withdraw funds free from income tax, the money used to pay the income tax liability will avoid taxation in your estate. Additionally, it eliminates the requirement to take minimum distributions from the account each year upon reaching age 70 ½.

Many clients with charitable inclinations have named charities as beneficiaries of their traditional IRAs to minimize the adverse income and estate tax consequences. A Roth Conversion would require a re-examination of any charitable bequests made via IRA beneficiary designation since it would not make sense to prepay tax on assets destined for tax exempt charities.

Likelihood of future change in the law

One of the main reasons for converting to a Roth IRA is that qualified distributions from a Roth IRA are completely tax free. This is clearly the result under current law. Some commentators question whether this will always be the tax treatment of Roth IRAs as Congress looks for additional ways to raise revenue. A change in the tax treatment of distributions would certainly impact the expected results from a conversion and could potentially eliminate any benefit of a Roth conversion. While there are currently no proposals being considered that would change the tax treatment of Roth distributions or that would impose other types of tax on these accounts, you should be aware that this possibility exists.

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Roth Conversion Timeline

January 1, 2010	December 31, 2010	October 15, 2011	April 16, 2012	April 15, 2013
The first day conversion possible regardless of income or filing status	The last day that conversions can take place and have two years to pay tax on conversion	The last day to re-characterize 2010 conversions (includes extensions)	50% of the resulting tax due for 2010 conversions	50% of the resulting tax due for 2010 conversions

Re-characterization Possibilities

A re-characterization is an election to change the nature of an IRA contribution or conversion. It is often used by taxpayers who change their minds or are ineligible for one type of IRA contribution or conversion and want to switch to another. When a taxpayer re-characterizes a Roth IRA conversion, the conversion is effectively ignored and the funds are treated as having never left the traditional IRA.

A Roth Conversion may turn out to be an unwise decision due to facts and circumstances unknown at the time of the conversion. For example, if the value of the IRA drops after the conversion, the income tax liability would be disproportionate to the amount converted, since the income tax liability is determined based on the value at the date of conversion. Future changes in income tax rates could also cause a taxpayer to second guess the decision to convert. The ability to re-characterize a Roth conversion provides a limited 'look-back' period to re-evaluate the decision to convert.

The rules for re-conversion are very specific. In most situations it can be accomplished by instructing the trustee of the Roth IRA to make a trustee to trustee transfer of the converted amount (plus any net income earned while in the Roth IRA) to a newly established traditional IRA. This must be completed before the due date (including extensions) of the taxpayer's federal income tax return. For most taxpayers converting in 2010, this will give them until October 15, 2011 to re-characterize the conversion.

If you re-characterize, you must wait until the later of the first day of the following taxable year or 30 days from the re-characterization to convert again.

In very few situations will a Roth Conversion be a “no brainer,” even where financial modeling illustrates a fabulous benefit. As you consider the opportunity, keep in mind that diversification of tax strategies, such as a partial conversion, may help mitigate some of the uncertainties. Also remember that although this opportunity is new for 2010, the elimination of the income limitations on the Roth Conversion is permanent so the opportunity may be around for some time.

The rules allow for a partial re-characterization. The question then arises whether a taxpayer can “cherry-pick” assets to re-characterize in situations where certain assets inside the IRA have appreciated while others have depreciated. Anticipating this type of strategy, the IRS issued a set of rules referred to as the “anti-cherry picking rules.” These rules thwart this strategy by requiring pro-ration of all gains and losses over the entire Roth IRA rather than on an asset by asset basis.

Despite these rules, it may still be possible to segregate appreciation and depreciation with careful planning at the time of conversion. Instead of converting to a single Roth IRA, consider converting into separate IRAs based on asset classes or investment strategy. If one or more investment strategies perform poorly, then consider re-characterizing that IRA back to a traditional IRA to avoid paying income tax on the value that has disappeared. If other Roth IRAs with different strategies or investment classes have appreciated, maintain the Roth IRA and take comfort in the fact that that the income tax liability is based on the value at the time of conversion.

Everyone with a Traditional IRA or a Roth IRA should give some thought to a Roth Conversion. If the considerations above support a conversion, the next step should be financial modeling to determine to what extent the IRA funds will be needed to fund lifestyle expenses, and whether you can afford to pay the income tax liability triggered by the conversion with non-IRA funds. We can also help compare balances and wealth transferred to heirs under a 'no conversion' vs. a 'roth conversion' scenario. Although the financial modeling will in no way help predict the future, it will help in understanding how the different variables such as rates of return, income tax rates and estate tax rates impact the results.

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