

Taking Advantage of a Roth IRA

Introduction

The Roth IRA was created in 1997 to serve as a retirement savings alternative to the traditional IRA. While contributions to a Roth IRA are made with after-tax dollars, qualified distributions from the account are free of income tax. Since inception, contributions to Roth IRA's have been subject to a Modified Adjusted Gross Income (MAGI) limitation. This limitation precluded many wealthy taxpayers from enjoying the benefits of the Roth IRA. Additionally, the conversion of a traditional IRA or other qualified retirement plan to a Roth IRA account has been prohibited for taxpayers with MAGI above \$100,000. However, effective January 1, 2010, a new door of opportunity has been opened for all taxpayers interested in taking advantage of the Roth IRA. While the MAGI limitation for contributions to a Roth IRA remains in effect, the \$100,000 MAGI limitation for conversions has been repealed. Converting to a Roth IRA will not make sense for everyone, but this new legislation creates an opportunity that should be explored because of the potential retirement, income tax, and estate planning benefits that it creates.

Traditional IRA vs. Roth IRA

Depending on income levels and participation in an employer sponsored retirement plan, contributions to a traditional IRA may or may not be tax deductible. Dollars invested in a traditional IRA accumulate tax-deferred until the account holder begins taking distributions in retirement. With a traditional IRA, required minimum distributions (RMD) must be taken at least annually once the individual reaches age 70.5. These distributions are taxed at ordinary income rates. While the taxpayer enjoys tax-free growth until retirement, this growth will ultimately be taxed.

Alternatively, contributions to a Roth IRA are not deductible and are made with after-tax dollars. Roth IRA assets then grow tax-free rather than tax-deferred because qualified distributions from the Roth IRA are free from income tax. A qualified distribution is any distribution that occurs after five years from the first contribution to the Roth IRA or five years after a Roth IRA conversion and meets one of the following criteria:

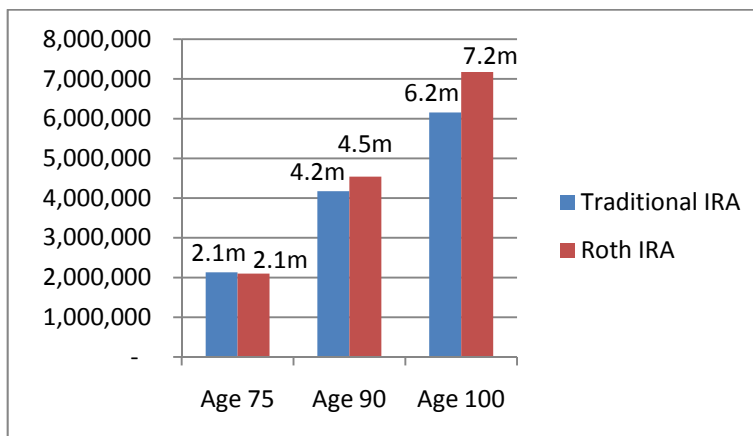
1. A distribution on or after the day on which the taxpayer reaches age 59.5
2. A distribution after the death of the original Roth IRA owner
3. A distribution due to the original account owner's disability
4. A distribution up to \$10,000 to acquire a first time home

While a traditional IRA owner is required to begin drawing on the account at age 70.5, there is no such requirement for the Roth IRA. If the taxpayer does not need to draw on the Roth IRA, the account continues to grow free of tax. The differences between a traditional IRA and a Roth IRA continue after the death of the IRA owner. At death, funds from both IRA's will be distributed to the beneficiaries of the account. If the beneficiary is the spouse of the decedent, the surviving spouse can treat the IRA as their own. All other individual beneficiaries will generally be required to take annual distributions over their life expectancies. In any event, qualified distributions from a Roth IRA will maintain their tax-free status.

The Mechanics of the Roth IRA Conversion

In a Roth IRA conversion, funds from a traditional IRA (or some other qualified retirement plans) are transferred into a Roth IRA account. After the conversion, the account will operate under the rules of a Roth IRA explained above. Upon the conversion, however, there are immediate income tax consequences to consider. Taxpayers converting to a Roth IRA will generate taxable income on the conversion. While accelerating taxable income is contrary to traditional income tax planning, the Roth IRA conversion is a unique situation in which a taxpayer may benefit from paying income tax on all or a portion of their retirement accounts now rather than in the future. Many expect higher tax rates in the future such that paying tax now on retirement account balances may result in less overall tax than if the tax were paid when funds are distributed from the accounts in the future. Additionally, taxpayers converting to a Roth IRA in 2010 have the option of spreading the taxable income from the conversion over the 2011 and 2012 tax years. Unfortunately, there is no simple formula to determine whether an individual should convert to a Roth IRA. Every taxpayer is subject to their own unique circumstances and there are many variables that factor into the decision to convert or not.

The following example compares the growth of a traditional IRA account to a Roth IRA. Consider a taxpayer, age 60, converting a \$500,000 traditional IRA to a Roth IRA with a 7% growth rate. The taxpayer has a taxable investment account worth \$450,000 with a basis in the account of \$400,000 yielding 3% (reinvested) and growing at 4%. The taxpayer's tax rate (35%) will remain constant. The example also assumes an estate tax rate of 45% with a \$3,500,000 exemption. The taxpayer in this example pays the income tax on conversion with funds from his taxable account.



Over a 40 year period, the Roth IRA account value is approximately 17% higher than the traditional IRA. The lack of a required minimum distribution in the Roth IRA account creates this disparity.

Who is the Roth IRA Conversion for?

There are many factors to consider that effect a taxpayer's decision to convert to a Roth IRA or not. The table below provides a summary of some of these variables and their impact on a taxpayer's decision. While this summary acts as a general guideline for a taxpayer considering a conversion, each taxpayer's personal situation is unique and should be thoroughly evaluated before the decision is made.

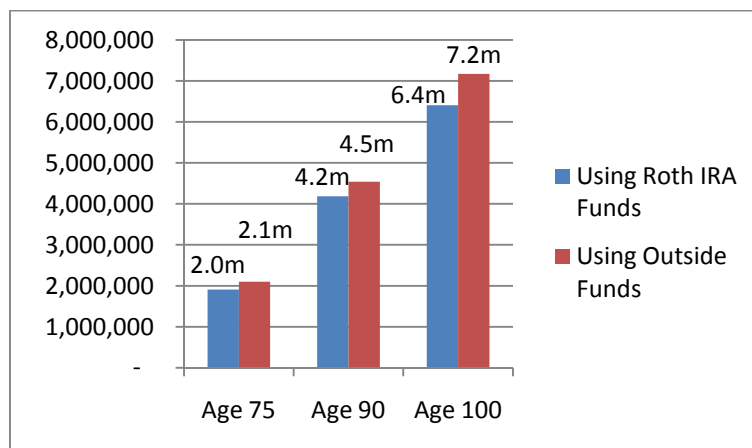
Taxpayer	Taxable Assets to Pay Tax?	Expected Future Tax Rate	When will IRA funds be needed?	Rate of Spending from IRA	Convert or Not
Multigenerational Family	Yes	Same	Never	Zero	Yes
Soon to Retire	Yes	Lower	Soon	Medium	No
Retired	Yes	Same	Probably Never	Low	Yes
Young Professional	Yes	Higher	Later	Unknown	Yes

Ability to Pay Income Tax with Taxable Assets

The first variable for an individual to evaluate in making the decision to convert to a Roth IRA is whether the taxpayer can afford to pay the income tax on conversion from their taxable assets. If an individual must withdraw conversion funds to pay the tax, then the benefits of a Roth IRA conversion are significantly reduced or eliminated. One of the significant advantages of the conversion is the ability to shift assets into a tax-free account. By using conversion funds to pay the tax, the Roth IRA account balance is reduced. Additionally, if the taxpayer is younger than 59.5, then any use of the conversion funds will result in a 10% premature distribution penalty.

It is important to note that the Roth IRA conversion is not a one-time opportunity and there is no requirement that an individual convert all or none of their tax-deferred retirement accounts to a Roth IRA. A taxpayer may convert any portion of their traditional IRA to a Roth IRA. Further, a traditional IRA owner can convert to a Roth IRA over a period of years, rather than all at once. By spreading the conversion over a period of time, a taxpayer can control the amount of taxable income resulting from each conversion. Once the taxpayer has determined their ability to cover the income tax that a Roth IRA conversion would generate, there are several other variables that must be considered before converting. A taxpayer contemplating a Roth IRA conversion should also consider expected future tax rates, their need to use Roth IRA funds during retirement, their time horizon until retirement, as well as estate planning considerations with their retirement accounts.

The following example illustrates the growth of a Roth IRA conversion account using outside funds compared to a Roth IRA conversion account using Roth IRA funds to pay the income tax on the conversion. Using the same assumptions as the previous example, the table below shows the impact that paying income tax on conversion with taxable amounts has on a Roth IRA account.



The Roth IRA account accumulates faster by using taxable investments to cover the income tax created by the conversion. At age 100, the Roth IRA account created using outside investments to pay the income tax on conversion is 12% greater than the Roth IRA account that used funds from within the account to pay the tax. There are other variables that factor into the decision to convert to a Roth IRA.

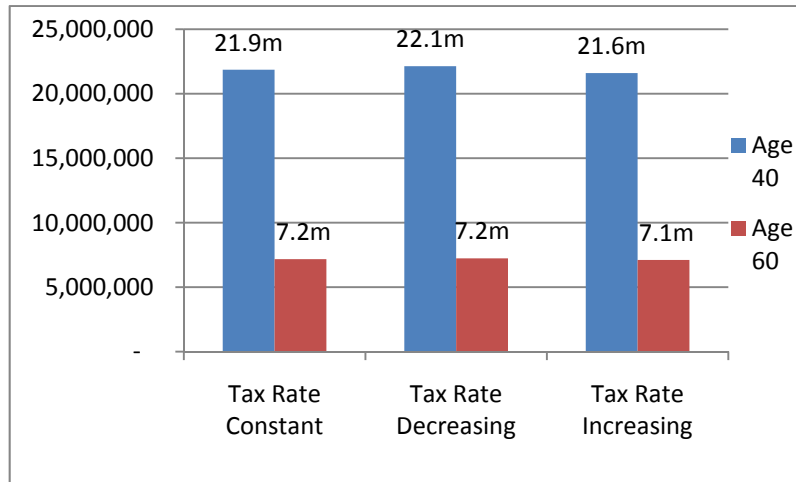
Expected Tax Rate in Retirement

Once a taxpayer determines if the income tax on conversion can be paid using outside funds, it may appear that the decision to convert would depend solely on the taxpayer's expected future tax rates. Converting to a Roth IRA is more attractive for a taxpayer anticipating higher future tax rates when the funds are expected to be withdrawn. By converting, an individual accelerates the income tax due on future distributions from a traditional IRA to today's expected lower income tax rates. Once the tax is paid at conversion, the Roth IRA will generally enjoy future tax-free status. While tax rates do factor into the decision to convert, there are other factors that have a more significant impact on the growth of a Roth IRA.

Spending Needs in Retirement and Time Horizon

If a taxpayer will not need to withdraw funds from their Roth IRA in retirement, then the argument for a Roth IRA conversion becomes more compelling. Roth IRA's are not subject to required minimum distributions like the traditional IRA. An individual with a traditional IRA who does not need funds from their IRA must still take taxable RMD's each year after reaching age 70.5. Since a Roth IRA owner is not required to take RMD's, the Roth IRA account balance continues to compound in a tax-free environment. Even if an individual eventually needs to access Roth IRA funds in retirement, the longer the taxpayer can delay distributions, the more attractive the Roth IRA conversion becomes.

Using the same assumptions as the examples above, the following illustration reveals the significant impact that a taxpayer's time horizon plays in the growth of a Roth IRA account. The table below shows the Roth IRA account value at age 100 for each scenario.



Clearly, a taxpayer's time horizon has a much more significant impact on the future value of the Roth IRA account than the expected future tax rate.

Taxpayers with Favorable Tax Attributes

Since a Roth IRA conversion creates immediate taxable income, many taxpayers may be discouraged from converting. Taxpayers may, however, have tax attributes that could be used to offset the taxable income created by a Roth IRA conversion. The economic struggles of the last two years left many taxpayers with net operating losses, charitable contribution carryforwards, and other favorable tax attributes that have not been used. Most of these attributes cannot be carried forward indefinitely. If a taxpayer does not expect to take advantage of these attributes before they expire, then they should consider a Roth IRA conversion to take advantage of these tax benefits.

Estate Planning Considerations

All of the discussion thus far has been centered on retirement planning for the investor, but there are also estate planning considerations to take into account in deciding to convert to a Roth IRA. The payment of income tax on conversion to a Roth IRA has the potential to provide an immediate estate tax benefit since the taxable estate has been depleted by the income taxes paid. In essence, conversion eliminates the estate taxation of the deferred income tax liability associated with traditional IRA accounts. Thus, most taxpayers expecting a taxable estate will benefit from converting to a Roth IRA. Furthermore, the value of the assets passing to heirs is enhanced – they inherit an account providing tax-free income rather than an account taxed at ordinary income upon distribution.

Recharacterization

Of course, the benefits of a Roth IRA conversion will not be known for some time since there are so many variables that factor into the ultimate success of the conversion. The benefit of converting to a Roth IRA might not be realized due to circumstances occurring after the conversion. For example, even if Roth IRA assets plummet in value after conversion, income tax is payable on the amount converted rather than the reduced account value making conversion disadvantageous.

Fortunately, the new Roth IRA conversion rules include a recharacterization provision that allows taxpayers to reverse course. An individual can recharacterize their Roth IRA conversion up until the due date of their 2010 tax return including extensions (as late as October 15, 2011). An individual deciding to recharacterize the conversion simply instructs the trustee of the Roth IRA to make a trustee-to-trustee transfer of the converted amounts, plus the net income earned while in the Roth IRA, to the trustee of a new traditional IRA. On the individual's tax return, the original conversion amount will be reported as having been transferred to a traditional IRA rather than a Roth IRA. It is as if the Roth IRA conversion never happened. The ability to recharacterize a Roth IRA conversion creates yet another unique opportunity for taxpayers.

It is unusual for a well-diversified portfolio to experience a significant drop in value over the course of one year, but as 2008 showed, it can happen. To mitigate the potential for a significant loss in value after a conversion, a traditional IRA owner could convert a fully diversified IRA into a number of different Roth IRA accounts, each holding one asset class or investment type. Creating multiple Roth IRA accounts with a single type of investment makes tracking the performance of each asset class easier. If one of the newly created Roth IRA's performs poorly, then the account owner can recharacterize the conversion to that specific Roth IRA as if it never happened. Once a taxpayer has recharacterized a Roth IRA conversion, there still remains the opportunity to convert back to a Roth IRA. An individual taxpayer is only allowed to convert funds to a Roth IRA one time per year. Therefore, a taxpayer who recharacterizes a Roth IRA in October of 2011 can "reconvert" the IRA to a Roth IRA at its reduced value.

Conclusion

For many individuals, a Roth IRA conversion in 2010 offers a wonderful planning opportunity that has never before been available. The ability to undo a Roth IRA conversion with a recharacterization provides remarkable flexibility if circumstances change. While a Roth IRA conversion will not make sense for all taxpayers, it is definitely an opportunity that should be thoroughly evaluated. Each individual, with the help of a tax professional, should examine their unique financial circumstances to determine whether the advantages of conversion are expected to outweigh the disadvantages.

Jeff Call	678-302-1456
Jeff Eischeid	770-790-3714
Jonathan Swartz	678-302-1477
Chris Benner	678-302-1413
Carolyn Arnold	678-990-2275



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