

Solving the Roth IRA Conversion Conundrum

Post-Election Musings

Following this November's election it seems a virtual certainty that Federal ordinary income and capital gains tax rates will rise; the only question will be by how much? Congress will most likely modify the "Bush tax cut" legislation currently on the books, raising the question about potential 2010 tax law changes.

How can one soften the blow should tax rates be increased? That is the question on the minds of many investors, tax advisors and wealth managers. One possibility for consideration is conversion to a Roth IRA.

Why? Because starting in January 2010, unless Congress changes the law, the \$100,000 modified adjusted gross income (MAGI) limitation for Roth IRAs will vanish. As a result, individuals who previously were ineligible will be able to convert assets held in Traditional or Rollover IRAs, or qualified retirement plans, to a Roth IRA, regardless of how much they earn. Clients who expect their marginal tax rates next year or in retirement to be higher than current rates may benefit by converting to a Roth IRA.

Of course, what the government gives with one hand it often takes back with the other. Thus,

WHAT IS A ROTH IRA CONVERSION? A Roth IRA conversion takes place when an IRA (Traditional, Rollover, SEP, or SIMPLE) or qualified retirement plan (e.g., 401(k), 403(b)) is transferred (i.e., converted) to a Roth IRA. Income tax is due on the conversion amount by April 15th following the year of conversion. Unlike pre-tax IRAs and qualified retirement plans, qualified distributions from Roth IRAs are not taxed upon distribution.

investors will be obligated to pay ordinary income tax on deductible IRA or 401(k) contributions that are converted to a Roth IRA. Under current law, to ease the pain, investors who convert in 2010 are allowed to spread the tax bill over the ensuing two years. Converting in 2008 (i.e., prior to the anticipated escalated ordinary income tax rates for 2009) will fix the Roth conversion tax liability at the investor's 2008 marginal tax rate.

The idea of paying taxes sooner rather than later may seem counterintuitive, but in some cases it may be the right move. "The biggest misconception many wealth managers have is that paying tax early is a bad thing," says Robert S. Keebler, a certified public accountant and partner at Virchow, Krause, & Company LLP in Green Bay, Wisconsin. "I believe that Roth IRA conversions cannot be summarily dismissed. They have to be analyzed as part of every financial and estate plan."

Potential Roth IRA Tax-Savings Features

Keebler shared these views, as well as several innovative Roth IRA conversion strategies, at a seminar held at TFC Financial Management's Boston headquarters this past June. In his presentation, Keebler outlined several factors that bolster the case for converting to a Roth IRA:

1. Taxpayers who have special, favorable income tax attributes, such as large charitable deductions or carry-forwards, or investment tax credits, can benefit by converting to a Roth IRA.
2. Roth IRAs do not have required minimum distributions beginning at age 70½. Therefore, there is more time for assets to grow tax-free for future generations.
3. Those who are subject to the federal estate tax benefit from paying income tax at ordinary rates before estate tax, rather than taking the income tax deduction when a Traditional IRA is subject to estate tax.
4. Taxpayers who can pay the Roth conversion-generated income tax with non-IRA funds benefit greatly from the ability to enjoy greater long-term, tax-deferred growth potential.

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5. Taxpayers who need to use IRA assets to fund a unified credit trust/bypass trust may want to consider making a Roth IRA election for that portion of their IRA funds.
6. Because the federal tax brackets favor married couples who file jointly over single filers, tax-free Roth IRA distributions will not increase a surviving spouse's tax rates.

Roth Conversion Strategies

The key to a successful Roth IRA conversion is to keep as much of the conversion taxable income as possible in the investor's current marginal tax rate. In some cases, as Keebler points out, it makes sense to convert a larger amount and pay the current ordinary income tax rate on the conversion amount.

Conversions must occur on a pro-rata basis, meaning that investors cannot escape paying income tax by converting only the portion on which they have already paid taxes. The IRS treats the Roth conversion-generated income as if it came from both the taxable and non-taxable sources, based on the percentages of each to the total balance of the IRA. When rolling assets from a qualified plan, such as a 401(k), to a Traditional IRA, clients should consider *not* rolling over after-tax contributions. Rather, they should consider using these assets to fund a Roth IRA conversion.

The Ideal Candidate

The ideal candidate for a Roth IRA conversion is an investor who:

- Has outside funds available to pay the income tax due;
- Will not immediately need the Roth IRA to meet annual retirement living expenses;
- Wants to leave an income tax-free asset to heirs;
- Expects to be in the same or a higher tax bracket in the future;
- Lives in a state which imposes a state death tax.

Keebler noted that each individual's situation is unique, and thus there are several tactical considerations that should be analyzed prior to converting to a Roth IRA. These include the investor's current marginal tax rate versus projected tax bracket, current and future cash flow needs, the availability of outside funds to pay the income tax liability, and the client's investment time horizon, as well as their estate planning objectives. Investors should also weigh the differences in the bankruptcy protections provided by IRAs and qualified plans.

Subtle Strategy Considerations

If the value of an investor's Traditional IRA or qualified plan portfolio has recently experienced a sharp decline, converting to a Roth sooner rather than later may result in a lower tax bill. Conversely, if initially carefully structured, there are times when it may make sense to reverse—or "recharacterize"—all or a portion of a Roth conversion. Keebler suggests that investors consider what he calls a "hedge-your-bets strategy," whereby they selectively take advantage of the ability to recharacterize Roth IRA assets.

For example, an investor could open separate Traditional IRAs to hold different asset classes, such as domestic and/or international mutual funds, and then convert those assets to separate Roth IRAs. If the value of the international funds was to drop significantly, that conversion could be recharacterized (i.e., Roth conversion reversed), while the domestic segment of fund assets could remain in the Roth IRA. The IRA owner has until October 15 of the calendar year following conversion to consider and close out the recharacterization equation before finalizing the conversion. This segregation strategy could result in optimal tax savings.

The wild card in all of these strategies is the chance that a new administration and Congressional line-up in Washington could change the rules that govern Roth IRA conversions. The changing rules are an ever-present possibility in the field of both income tax and estate planning that requires constant vigilance. One possibility is that rules could change regarding the taxation and distribution rules for Roth IRAs (e.g., subject to required minimum distributions, earnings subject to taxation). We should also be aware that the rules could change regarding Traditional IRAs (e.g., accelerated required minimum distributions, loss of stretch IRA rules for beneficiaries versus more favorable required distribution rules for beneficiaries).

As with most financial planning issues, the solution for an investor depends on their family's unique circumstances and objectives. TFC can assist in this planning, working along with each family's estate planning attorney, who in the end, will draft the necessary documents assuring coordination with each family's estate objectives.