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Understanding Roth IRA Conversions in 2010

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Advanced Roth IRA Conversion Strategies Overview


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- > ABCs of Roth IRAs
- > Reasons for converting to a Roth IRA
- > Mathematics of Roth IRA conversions
- > Recharacterizations
- > "Stretch" Roth IRAs
- > Using insurance to preserve post-death "stretch-out"
- > Integrating the estate tax
- > Integrating AMT
- > Integrating the new 3.8% health care surtax

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**Advanced Roth IRA Conversion Strategies
ABCs of Roth IRAs**


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- > Starting in 2010, the \$100,000 Modified Adjusted Gross Income (MAGI) limitation no longer applies
 - > The taxable income recognized on a Roth IRA conversion in 2010 may be spread over the following two tax years (i.e. 2011 and 2012)
- > Married Filing Separately taxpayers can convert to a Roth IRA

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Advanced Roth IRA Conversion Strategies
ABCs of Roth IRAs


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Convertible accounts


- > Traditional IRAs
- > 401(k) plans
- > Profit sharing plans
- > 403(b) annuity plans
- > 457 plans
- > "Inherited" 401(k) plans (see Notice 2008-30)

Non-convertible accounts

- > "Inherited" IRAs
- > Education IRAs

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Advanced Roth IRA Conversion Strategies
Reasons to Convert to a Roth IRA


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- 1) Taxpayers have special favorable tax attributes including charitable deduction carry-forwards, investment tax credits, net operating losses (NOLs), high basis non-deductible traditional IRAs, etc.
- 2) Suspension of the minimum distribution rules at age 70½ provides a considerable advantage to the Roth IRA holder.
- 3) Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax.

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Advanced Roth IRA Conversion Strategies
Reasons to Convert to a Roth IRA


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- 4) Taxpayers who can pay the income tax on the IRA from non IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields.
- 5) Taxpayers who need to use IRA assets to fund their Unified Credit bypass trust are well advised to consider making a Roth IRA election for that portion of their overall IRA funds.
- 6) Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, thereby lowering the effect of higher estate tax rates.

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Advanced Roth IRA Conversion Strategies
Reasons to Convert to a Roth IRA



- 7) Because federal tax brackets are more favorable for married couples filing joint returns than for single individuals, Roth IRA distributions won't cause an increase in tax rates for the surviving spouse when one spouse is deceased because the distributions are tax-free.
- 8) Post-death distributions to beneficiaries are tax- free.
- 9) Tax rates are expected to increase in the near future.
- 10) The new 3.8% Medicare surtax.

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Advanced Roth IRA Conversion Strategies
"Fading" IRC §691(c) Deduction – Example (cont.)



	No Planning	Roth IRA Conversion @ Death
IRA balance in 20 years	\$2,000,000	\$1,560,000
Less: IRC Section 691(c) deduction	- 450,000	0
Net taxable IRA distribution	\$1,550,000	\$1,560,000
Federal income tax @ 35%	\$542,500	
State income tax @ 5%	77,500	
Total income tax	\$620,000	
Net to beneficiaries in 20 years	<u>\$1,380,000</u>	<u>\$1,560,000</u>

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Advanced Roth IRA Conversion Strategies
Mathematics of Roth IRA Conversions



In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that:

- > The annual growth rates are the same
- > The tax rate in the conversion year is the same as the tax rate during the withdrawal years (i.e. $A \times B \times C = D$; $A \times C \times B = D$)

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Advanced Roth IRA Conversion Strategies
Mathematics of Roth IRA Conversions



	Traditional IRA	Roth IRA	Life Insurance
2010 Account Balance	\$ 1,000,000	\$ 1,000,000	\$ 1,000,000
Less: Income Taxes @ 40%	-	(400,000)	(400,000)
Net Balance	\$ 1,000,000	\$ 600,000	\$ 600,000
Growth Until Death	200.00%	200.00%	200.00%
Account Balance @ Death	\$ 3,000,000	\$ 1,800,000	\$ 1,800,000
Less: Income Taxes @ 40%	(1,200,000)	-	-
Net Account Balance to Family	\$ 1,800,000	\$ 1,800,000	\$ 1,800,000

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Advanced Roth IRA Conversion Strategies
Mathematics of Roth IRA Conversions



Critical decision factors

- > Tax rate differential (year of conversion vs. withdrawal years)
- > Use of "outside funds" to pay the income tax liability
- > Need for IRA funds to meet annual living expenses
- > Time horizon

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Advanced Roth IRA Conversion Strategies
Mathematics of Roth IRA Conversions



The key to successful Roth IRA conversions is to keep as much of the conversion income as possible in the current marginal tax bracket

- > However, there are times when it may make sense to convert more and go into higher tax brackets
- > Need to take into consideration the new 3.8% Medicare "surtax"
- > Need to take into consideration the impact of AMT

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Advanced Roth IRA Conversion Strategies
Mathematics of Roth IRA Conversions

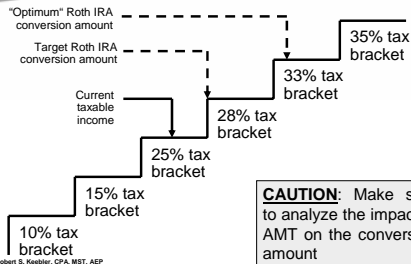


2010 Tax Brackets

	Single	Married Filing Jointly	Head of Household
10%	\$8,375	\$16,750	\$11,950
15%	\$34,000	\$68,000	\$45,500
25%	\$82,400	\$137,300	\$117,650
28%	\$171,850	\$209,250	\$190,550
33%	\$373,650	\$373,650	\$373,650
35%	> \$373,650	> \$373,650	> \$373,650

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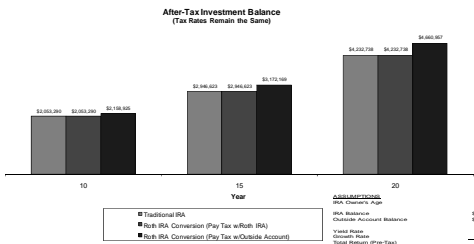
Advanced Roth IRA Conversion Strategies
Mathematics of Roth IRA Conversions



CAUTION: Make sure to analyze the impact of AMT on the conversion amount

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Advanced Roth IRA Conversion Strategies
Mathematics of Roth IRA Conversions
Example #1 – 50-Year-Old IRA Owner

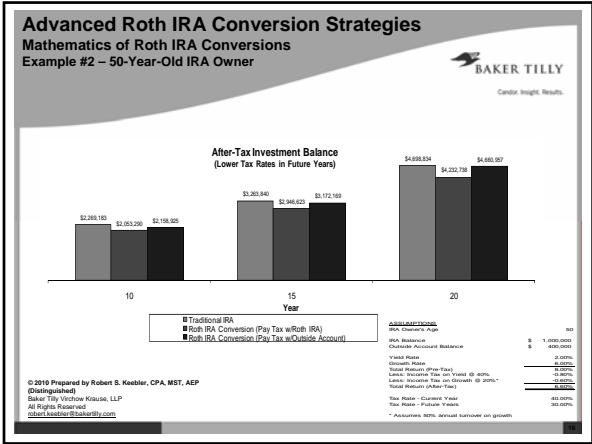


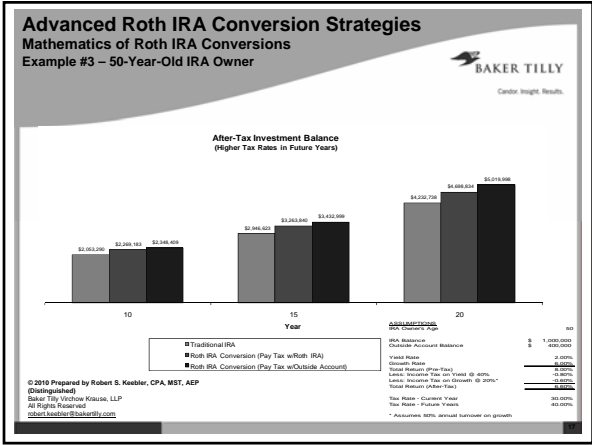
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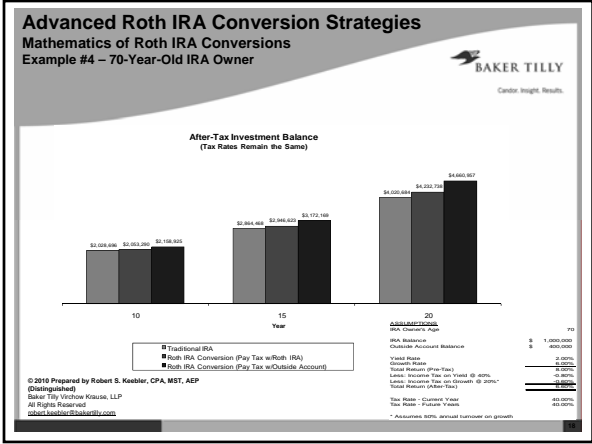
ASSUMPTIONS

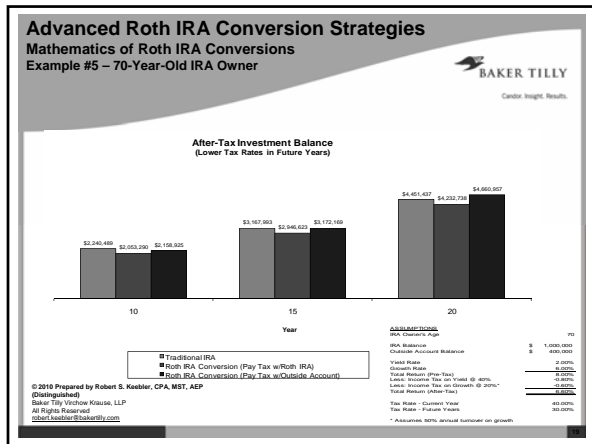
IRA Owner's Age	50
IRA Balance	\$ 1,000,000
Outside Account Balance	\$ 400,000
Yield Rate	7.00%
Conversion Rate	5.00%
Total Return (Pre-Tax)	10.00%
Leads Income Tax on Withdrawal @ 25%	10.00%
Leads Income Tax on Withdrawal @ 20%*	10.00%
Total Return (After Tax)	10.00%
Tax Rate - Current Year	40.00%
Tax Rate - Future Years	40.00%

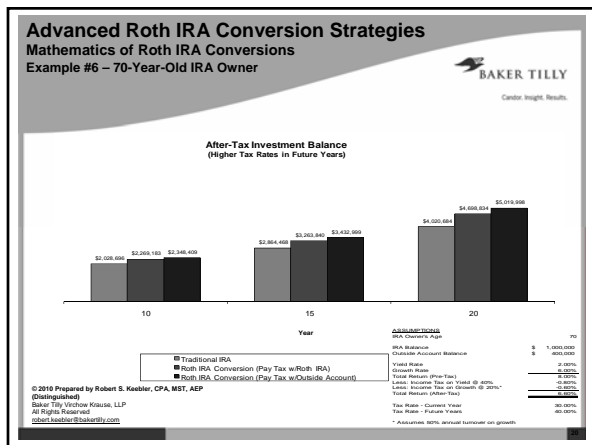
* Assumes 60% overall turnover on growth











Advanced Roth IRA Conversion Strategies

Recharacterizations

Taxpayers may "recharacterize" (i.e. undo) the Roth IRA conversion in current year or by the filing date of the current year's tax return

- > Recharacterization can take place as late as 10/15 in the year following the year of conversion

Taxpayers may choose to "reconvert" their recharacterization

- > Reconversion may only take place at the later of the following two dates:
 - (1) The tax year following the original conversion OR
 - (2) 30 days after the recharacterization

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Advanced Roth IRA Conversion Strategies Recharacterizations

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Conversion Period **Recharacterization Period** **Tax Payment Period**

2010 **2011** **2012** **2013**

1/1/2010: First day a 2010 conversion can take place

12/31/2010: Last day a 2010 conversion can take place

4/15/2011: Normal filing date for 2010 tax return

10/15/2011: Latest filing date for 2010 tax return / last day to recharacterize 2010 Roth IRA conversion

4/15/2012: Normal filing date for 2011 tax return / date of first tax payment on 2010 conversion

4/15/2013: Normal filing date for 2012 tax return / date of last tax payment on 2010 conversion

CAVEAT: Because of adverse market conditions that could occur from the end of the "recharacterization period" to the end of the "tax payment period" (i.e. 10/15/2011 – 4/15/2013), serious consideration should be given to investing in highly-secure liquid investments (e.g. certificates of deposit) to reserve for the tax liability due on the 2010 Roth IRA conversion.

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Advanced Roth IRA Conversion Strategies Comparison of Using Roth IRA vs. Traditional IRA to Fund a Bypass Trust

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Year 01 Year 02 Year 03 Year 04

Traditional IRA Traditional Investment Account Roth IRA

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Advanced Roth IRA Conversion Strategies "Missing" IRC §691(c) Deduction - Example


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	Traditional IRA	Roth IRA
Gross estate	\$1,000,000	\$1,000,000
Less: Federal income tax on Roth IRA conversion @ 35%	-	- 350,000
Less: State income tax on Roth IRA conversion @ 5%	-	- 50,000
Taxable estate	\$1,000,000	\$600,000
Federal estate tax @ 45%	\$450,000	\$270,000
State estate tax @ 10%	100,000	60,000
Total estate taxes	\$550,000	\$330,000
Traditional IRA balance	\$1,000,000	
Less: IRC Section 691(c) deduction	- 450,000	
Net taxable IRA balance	\$550,000	
Federal income tax IRA withdrawals @ 35%	\$192,500	
State income tax on IRA withdrawals @ 5%	27,500	
Total income taxes on IRA withdrawals	\$220,000	
Net after-tax IRA balance to beneficiaries	\$230,000	\$270,000

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Advanced Roth IRA Conversion Strategies
 "Fading" IRC §691(c) Deduction – Example


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	No Planning	Roth IRA Conversion @ Death
IRA balance @ death	\$1,000,000	\$1,000,000
Less: IRC Section 691(c) deduction	- 450,000	- 450,000
Net taxable Roth IRA conversion	\$550,000	\$550,000
Federal income tax @ 35%	\$192,500	\$192,500
State income tax @ 5%	27,500	27,500
Total income tax	\$220,000	\$220,000
Net to beneficiaries @ death	\$780,000	\$780,000

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Advanced Roth IRA Conversion Strategies
 "Stretch" Roth IRAs


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Objective: Prolong IRA payments over longest possible period of time, thus increasing wealth to future generations

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Advanced Roth IRA Conversion Strategies
 "Stretch" Roth IRAs


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Scenarios

- > Immediate distribution
- > Roth IRA payable to non-qualified beneficiary (five-year rule)
- > Roth IRA payable to surviving spouse (spousal rollover)
- > Roth IRA payable to child

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Advanced Roth IRA Conversion Strategies
"Stretch" Roth IRAs
Comprehensive Example



Assumptions

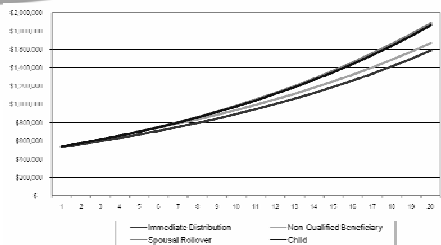
- > IRA owner's age - 68
- > Spouse's age - 62
- > Child's age - 35

- > Roth IRA balance - \$500,000
- > Taxable investment account balance - \$0

- > Pre-tax growth rate - 7%
- > After-tax growth rate - 6%

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Advanced Roth IRA Conversion Strategies
"Stretch" Roth IRAs
Comprehensive Example



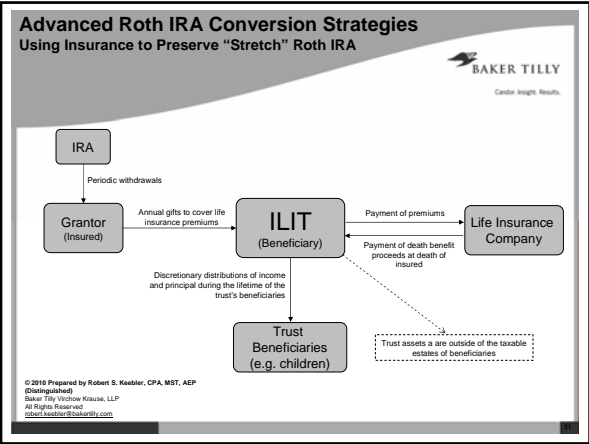
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Advanced Roth IRA Conversion Strategies
Using Insurance to Preserve "Stretch" Roth IRA

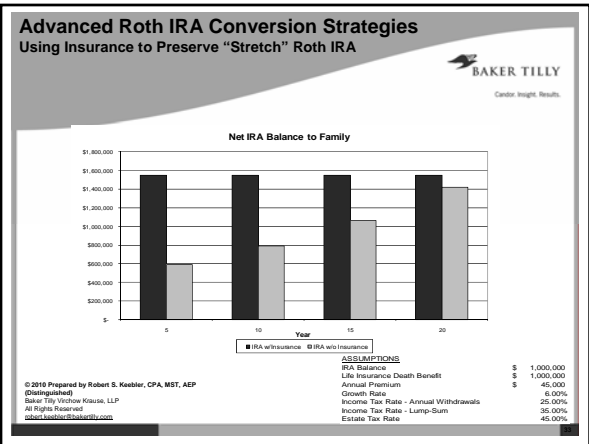


In situations where IRAs and/or other qualified retirement plans make up the majority of a decedent's taxable estate, approximately 60% to 80% of the value of these assets could be lost to taxes.

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- ### Advanced Roth IRA Conversion Strategies Using Insurance to Preserve "Stretch" Roth IRA
- > Use of second-to-die to avoid having to liquidate a large IRA or Roth IRA
 - > Use of insurance to facilitate spousal post-mortem Roth IRA conversions
 - > Use of insurance to facilitate non-spousal post-mortem Roth IRA conversions
 - > Only applies to post-mortem conversions from qualified retirement plans (e.g. 401(k) plans)
 - > Purchase of annuity within IRA to pay life insurance premiums
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Advanced Roth IRA Conversion Strategies
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Robert S. Keebler, CPA, MST: The Roth IRA Conversion Decision

Should a client convert to a Roth IRA?

Bob's Roth Conversion Observations

- After determining the "optimal" conversion amount, additional amounts converted may be detrimental in that they increase the effective tax rate on the conversions.
- Always convert more than the initial numbers suggest and recharacterize if warranted.
- Recharacterize dispersed accounts in November of the year of conversion and reconvert in January.
- The Roth IRA is the most powerful asset with which to fund a GST exempt trust. There is no bright line rule or "optimal" conversion amount for all individuals, considering that each individual's financial, income tax, and wealth situations are different, if several of the ten reasons are met, it is likely the individual is a good candidate for a Roth IRA conversion.
- Partial conversions generally provide a better qualitative result than 100% conversions.

11 Reasons to Convert to a Roth IRA™

1. Taxpayers have special favorable tax attributes, including, a high basic rate, charitable deduction carry-forward, investment tax credits, net operating losses (NOLs), etc. This is because these attributes reduce the effective income tax rate.
2. Suspension of the minimum distribution rules at age 70½ provides a considerable advantage to the Roth IRA holder.
3. Taxpayers benefit from paying income tax before estate tax (but a Roth IRA election is rarely compared to the income tax deduction obtained when a traditional IRA is subject to estate tax).
4. Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields.
5. Taxpayers who need to use IRA assets to fund their Unified Credit bypass trust are well advised to consider making a Roth IRA election for that portion of their overall IRA funds.
6. Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, thereby lowering the effect of higher estate tax rates.
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8. Post-death distributions to beneficiaries are tax-free.
9. Tax rates are expected to increase in the very near future.
10. The ability to recharacterize allows the taxpayer 2020 "thinkout", effectively allowing them to "undo" conversions that were not advantageous.
11. 1.8% Surtax. A conversion will be beneficial for taxpayers.



Important Tax Law Considerations	Important Financial Considerations	Important Estate Planning and Asset Protection Considerations																					
<h4>CPA's Checklist</h4> <p>Client's Situation</p> <p>Retirement Accounts</p> <p>Trusts</p> <p>Charitable Contributions</p> <p>Gifts</p> <p>Unified Credit</p> <p>Charitable Deductions</p> <p>State Tax</p> <p>Income Tax</p> <p>Capital Gains</p> <p>Real Estate</p> <p>Other</p>	<h4>Financial Advisor's Checklist</h4> <p>Conversion Period</p> <p>Recharacterization Period</p> <table border="1" style="width: 100%;"> <thead> <tr> <th>Year</th> <th>Conversion</th> <th>Rechar.</th> <th>Income</th> <th>Capital Gain</th> <th>Loss</th> <th>Other</th> </tr> </thead> <tbody> <tr> <td>2010</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>2011</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table>	Year	Conversion	Rechar.	Income	Capital Gain	Loss	Other	2010							2011							<h4>Lawyer's Checklist</h4> <p>Estate Planning Considerations</p> <p>Asset Protection</p> <p>Credit Shelter Trust</p> <p>Charitable Deduction</p> <p>Charitable Contribution</p> <p>Charitable Deduction</p> <p>Charitable Contribution</p> <p>Charitable Deduction</p> <p>Charitable Contribution</p> <p>Charitable Deduction</p> <p>Charitable Contribution</p>
Year	Conversion	Rechar.	Income	Capital Gain	Loss	Other																	
2010																							
2011																							



CPA's Checklist

Client's Situation

Retirement Accounts

Trusts

Charitable Contributions

Gifts

Unified Credit

Charitable Deductions

State Tax

Income Tax

Capital Gains

Real Estate

Other

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