

**Roth Conversions:
To Convert or Not to Convert?**


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"Of course you have a purpose in life. You pay taxes, don't you?"

Agenda

- Why consider conversion now?
- Refresher on Roth distribution rules
- Conversion rules
- The mechanics: running the numbers
- Roth conversions in employer plans
- Conversion factors and planning considerations
- Re-characterizations
- Closing



Roth IRA Conversion Planning Now?

- 2010 Repeal of \$100,000 modified adjusted gross income (MAGI) limitation
- Most of our clients could not consider this prior to 2010
- 2010 tax year has ended, is there any point in Roth IRA conversion planning now?
- Current relevance? **PLENTY**
- Even Warren Buffett's billionaire partner Charlie Munger told attendees at this year's Berkshire Hathaway meeting that he is converting his old IRA to a Roth IRA, and is planning to leave the account to his heirs, including his children and his grandchildren. His comment: "I think it just makes sense."

Roth IRA Conversion Planning Now?

- Some feel that conversion planning is dead (Nothing could be further from the truth)
- Thorough analysis and proper execution of Roth conversions may have incredible wealth building impact for your clients & heirs

Roth IRA Conversion Planning Now?

- Current tax avoidance should not be decision driver
- Conversions involve more than accounting and tax expertise, it's a collaborative effort of financial and legal advisor too
- Rules of thumb can lead us to faulty decisions
- Bottom line: run the numbers
 - Everyone's situation is different

Decision Drivers

- 3 main variables often mentioned:
 - current versus future tax rates
 - avoiding RMD requirements
 - source of cash to pay taxes
- While important, only a subset of planning factors that could come into play
- Depending upon family's financial planning situation, these may not be the most important factors to tip Roth IRA conversion decision one way or the other

Who Drives the Conversion Conversation?

- CPA?
- Lawyer?
- Financial Professional?
- All of us should be discussing this
- Arguably, we've not done an adequate job educating clients about their options—we can do better!

Fidelity Study: Investors Need Guidance!

- Less than 30% of investors who are eligible to complete a Roth IRA conversion are aware that they can "undo" that move
- 55% of newly eligible investors who have old 401(k)s with former employers are not certain whether their assets can be converted to Roth IRAs
- 34% of investors indicate they do not understand a Roth IRA conversion's tax implications (or the tax structure of a Roth IRA itself)
- 30% say their balances are too small for a conversion or they lack sufficient funds to cover the conversion tax costs
- 20% do not believe a Roth IRA fits their needs
- 44% said they would recharacterize if the additional taxable income from a Roth IRA conversion puts them into a higher federal income tax bracket

IRA Comparison

Traditional IRA	Roth IRA
Distributions taxed as ordinary income	Conversions (contributions) taxed as ordinary income
RMD – mandatory withdrawals at 70 ½	No mandatory withdrawals for original account owner (inherited Roth IRA must take RMD)
Tax deferred growth	Taxes for conversion can be paid from outside the IRA
	Distributions are not taxed (exceptions apply)
	Tax exempt growth

Who May Convert?

- Starting 2010
 - Modified Adjusted Gross Income (MAGI) limitation no longer applies
 - Anyone may convert, no income limits
 - Married Filing Separately taxpayers can now convert to Roth IRA

What Can You Convert?

Convertible Accounts

- Traditional IRAs
- 401(k) plans
 - In plan conversion
 - Out of plan conversion
- Profit sharing plans
- 403(b) plans
- 457 plans
- “Inherited” 401(k) plans (see Notice 2008-30)

Non-Convertible Accounts

- “Inherited” IRAs
- Education (Coverdell) IRA’s

When is it Beneficial to Convert?

More Beneficial to Convert	Less Beneficial to Convert
Future tax rates <u>higher</u>	Future tax rates <u>lower</u>
Participant has tax favorable attributes in year of conversion (charitable deduction carry-forwards, investment tax credits, etc.)	If the participant does not have tax favorable attributes, it's not necessarily a negative attribute when considering conversion
Use non-IRA assets to pay tax	Use IRA assets to pay tax
Do Not Need Roth Money to Live	Need Roth Money to Live
Subject to Estate Tax	Not subject to Estate Tax
Plan on leaving IRA to Non-Charitable Beneficiaries	Plan on leaving IRA to charity
Believe assets will appreciate	Believe assets will depreciate
Long life span post conversion	Short life span post conversion
Young at conversion	Older at conversion
Young beneficiaries	Older beneficiaries
Not concerned about asset protection	Concerned about asset protection (state law?)

Roth Distributions (Refresher)

- **Qualified Distributions** are tax free if they meet two requirements:
 - Five Years after first contribution
 - § 408A(d)(2)(B)
 - Exception: surviving spouse may treat inherited Roth IRA as one of her own for purposes of 5 year rule
 - And one (or more) requirements of § 408A(d)(2)(A) are met:
 - After Age 59.5
 - After Participants death
 - Attributable to Participant being disabled
- If fail to meet this test, then non-qualified and the distributions subject to income tax*

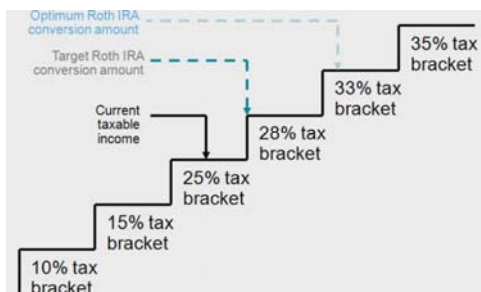
Roth Distributions (Refresher)

- 5 year rule applies separately for each Roth conversion that has occurred
- Basis can be withdrawn tax-free (FIFO Method), no pro-rata
- Distributions not subject to income tax if they do not exceed aggregate contributions and/or conversions to Roth IRA
- Any distributions of investment gains taken from your Roth IRA prior to age 59 1/2 are considered early withdrawals
- Early withdrawals are subject to income taxes as well as the Roth IRA early withdrawal penalty* (exceptions follow)

Information Needed for Analysis

- Date of birth of participant; spouse; beneficiaries
- Amount of retirement assets
- Amount of non-retirement assets (“outside assets”)
- Amount of other estate assets
- Health of participant and spouse – life expectancy (time horizon)
- Expected growth rate of investments
- Amount of retirement income needed
- Estimated tax rates today and in the future
- Charitable intent
- State law – creditor protection rules

Think in Terms of “Brackets” not Dollars



Mathematics of a Conversion

- Example
 - Janie Smith has \$1,000,000 IRA growing at 8%
 - \$350,000 of non-qualified liquid assets growing at 5.2%
 - Difference in growth rates used to reflect lack of income taxes affecting IRA growth
 - Does not need IRA to live on during retirement
 - Age 50
 - Convert or don't convert???



Roth Conversions Within Employer Plans

- Small Business Jobs Act of 2010 (“SBJA”) allows for “in plan Roth rollover/conversion”
- As of 9/27/10, employees with 401k/403b accounts can convert to designated Roth (within plan)
- Starting in 2011
 - Governmental 457 (b)
 - Note- these plans will be permitted for the first time to contain a Designated Roth Account in 2011

Roth Conversions Within Employer Plans

What are they?

- In Plan Roth Rollover is an eligible distribution from individual account (401k, 403b, 457b) other than from a Designated Roth Account to a Designated Roth Account in the same Employer plan
- Means you don’t have to transfer money out of the plan to a Roth IRA to do a conversion
- Can be:
 - Direct rollover (no withholding)
 - 60 day rollover (60 day rollover, withholding applies)

Roth Conversions Within Employer Plans

What amounts are eligible?

Any vested amount:

- Pre-tax elective deferrals
- Safe harbor match
- Safe harbor non-elective
- Qualified match
- Qualified non-elective match

Roth Conversions Within Employer Plans

- Can be desirable if:
 - you aren't in a position to take a distribution from the plan, or
 - you prefer not to do so, perhaps because:
 - you like the investment opportunities offered by the plan, or
 - you want to keep your money in a plan that's covered by ERISA protections.

Roth Conversions Within Employer Plans

- Same tax consequence as Roth IRA conversion
- Pay tax on the amount converted (reduced by any after-tax dollars included in that amount)
- Need to come up with money from a source outside your 401k account to pay the tax
- Distributions from the account will be tax-free, including all the investment earnings that accumulate after you do the conversion, pursuant to distribution rules discussed
- Subject to same 5 year period (for distributions) as when converting to Roth IRA

Roth Conversions Within Employer Plans

What does the employer have to do? (new IRS guidance released 11/2010)

- **Plan amendment**
 - Employer doesn't have to adopt a formal plan amendment before implementing this option.
 - IRS notice provides an extension of time in which the required amendment can be adopted retroactively
- **Roth contribution program required**
 - Employers can't offer the in-plan conversion option unless they also allow plan for Designated Roth Accounts
- **Amounts eligible for distribution and rollover**
 - In-plan Roth conversions available only for amounts that are eligible for distributions
 - Employer that does not otherwise permit in-service withdrawals can allow (for eligible participants) solely for the purpose of in-plan Roth conversions

Roth Conversions Within Employer Plans

What does the employer have to do? (new IRS guidance released 11/2010)

- **Withholding not required**
 - Withholding doesn't apply to a direct in-plan Roth conversion
- **Recharacterizations not permitted**
 - Serious drawback to an in-plan Roth conversion compared with other types: you can't use a recharacterization to undo the conversion if you change your mind later
- **Plan loans are not a problem**
 - Participant who has taken a loan from account can do an in-plan conversion that moves loan from the regular to Roth account, unpaid balance of the loan being treated as the amount transferred



Planning Considerations (Taxes, Estate, Financial)

Conversion Considerations

- Contrary to traditional tax wisdom – paying the tax today may be more beneficial to the client
- Can result in an increase in overall retirement assets available
- Can result in larger inheritance to beneficiaries
- Can provide a tax-free source of income in future
- Time horizon in context of conversion not solely a function of age of account owner, but instead the period of time the assets will be consumed or distribution (ie. stretch over heirs lifetimes)
- Some traditional IRA's may have basis – check for Form 8606

Conversion Factors

- Current and future cash flow needs
- Estate planning goals
- Life expectancy and current health of IRA owner
- Taxpayer's current and estimated marginal federal and state rates
- Basis in traditional IRA, charitable contribution carryovers, & other tax attributes that will affect the ultimate tax paid on conversion
- Estimated federal and state estate tax liability
- Anticipated rates of return on all assets (both IRA and non-IRA assets)
- Income needs during retirement years – more or less than traditional RMD's
- Life expectancy of the beneficiaries
- State law for liability protection
- Taxpayer's belief on where Congress will go with income, estate, and gift tax legislation

Conversions and Estate Planning

Given existence of estate tax, there are three general "rules" to keep in mind when evaluating the estate planning opportunities available under new Roth conversion rules:

Rule 1

- It's more advantageous for decedent to leave assets that do not have attached income liability
 - IRA's potentially face double taxation (estate and income taxes)

Conversions and Estate Planning

Rule 2

- The estate tax is *tax-inclusive*
 - assets that will be used to pay the estate tax may be the same assets that are taxed

Rule 3

- The income tax on assets converted from a traditional IRA to a Roth may be either tax-exclusive or tax-inclusive
 - investor can use another source, making the conversion tax exclusive

Conversions and Estate Planning

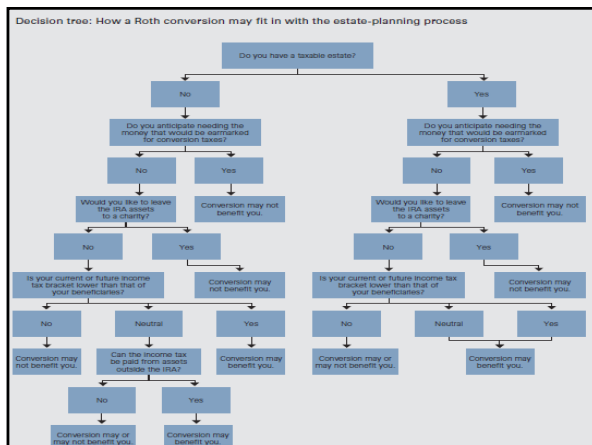
- Taxpayers may benefit from paying income tax before estate tax (when Roth election is made) vs. income tax deduction received (IRD) when traditional IRA is subject to estate tax (§691c)
- Clients making Roth IRA election during lifetime reduce their overall estate, thereby reducing effect of higher estate taxes **OR**
- Roth conversion may result in payment of more estate taxes to the extent it helps family's wealth grow faster over time, the bigger the estate, the bigger the tax

Conversions and Estate Planning

- Roth IRA distributions to beneficiaries (post death) are tax free
- Consider Roth IRA to fund Unified Credit bypass trust or GST exempt trust (exemption is funded on after tax basis)
- Consider using charitable split interest trust as tool in reducing income tax in year of Roth conversion
- Ensure documents allow executors or POAs to make Roth election/recharacterization decisions for clients

Conversions and Asset Protection

- Roth conversion from a traditional IRA *should* have no impact on creditor protection, *however*.
- Conversion of money in a qualified plan would remove the extensive protection afforded qualified plans and place the account under the rules for IRAs
- Bankruptcy rules that provide substantial protection of IRAs, this only applies to a debtor in bankruptcy
- If concerned with potential liability, seek legal counsel re: impact of the conversion of a qualified plan account to a Roth IRA (under **state law**)
- Florida: barring fraudulent transfer, F.S. §222.20 generally provides that both traditional IRAs and Roth IRAs are exempt from the creditor claims of an owner of such an IRA.

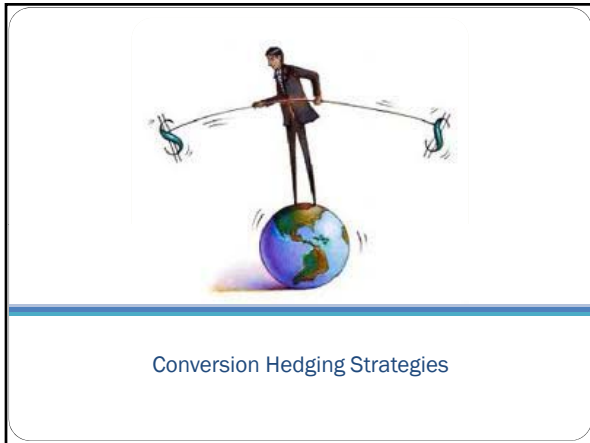


Conversions and Tax Planning

- If death of married taxpayer is imminent, might make sense to convert to Roth while taxpayer is still alive in order to utilize lower "married filing jointly" tax rate
- Consider series of partial conversions to control effect on tax rates
- Monitor AMT impact on conversion
- Monitor taxation of Social Security benefits upon conversion
- Be aware of IRA values after conversion to see if recharacterization makes sense

Conversions and Tax Planning

- Starting 2013, Patient Protection and Affordable Care Act, as modified by Health Care and Education Reconciliation Act of 2010 (Health Care Reform):
 - Adds new 3.8% Medicare tax on unearned income for certain taxpayers (\$200k AGI single, \$250k AGI joint)
 - Increased AGI due to conversion could make this new tax apply
- Withdrawals from Roth IRAs don't raise Medicare premiums or taxes on Social Security income, whereas regular IRA withdrawals do.
- Review net unrealized appreciation (NUA) opportunity for company stock in corporate plans before you convert



Roth Conversion Hedging Strategies

- Partial conversion
 - Roth conversion isn't all or nothing
 - Can convert part of an IRA or plan to a Roth
- Undo the Roth conversion via recharacterization
- Break up IRA into various IRAs then convert to Roth
 - Hold different asset classes in each

Unwinding a Conversion

- “Re-characterization rule” allows the IRA owner to take a second look/change their mind on conversion decision when he/she files tax return (includes extensions to Oct. 15)
- May be warranted if stock market plunges after conversion
- Cannot re-characterize a portion of Roth conversion by “cherry picking” only stocks that declined
- All gains and losses to entire Roth IRA, regardless of actual stock/fund re-characterized, must be pro-rated
- Use a new Roth IRA account to permit re-characterization

Unwinding a Conversion

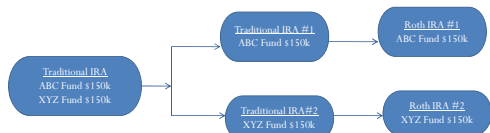
- What happens if the market tanks after your client converted? Reverse ill-fated conversions
- Recharacterization
 - allows an investor to reverse amounts converted from a Traditional IRA to a Roth IRA and recover any taxes paid. But, this conversion must be completed by Oct. 15
 - All/portion of the amount an investor converted can be recharacterized, and traditional IRA balances can be reconverted back to a Roth IRA in the next tax year or 30 days after the recharacterization, whichever is later

Unwinding a Conversion



Break Up IRA

- Consider creating separate IRAs for each asset/fund you plan to convert, that way you can more easily unwind funds that decrease in value after conversion
- Keep winners and throw back losers
- Keep separate Roths until the time to recharacterize has expired, then transfer the accounts into one master Roth IRA



Bottom Line on Roth Conversions

- New Roth era offers great chance to work with high income clients
- Can help clients control tax liabilities for retirement, estate planning
- Roth conversion planning is a complex issue
- Planning should be approached holistically, that is, considering the transfer of wealth either during one's lifetime or after death, based on clients specific goals
- Roth conversions present a prime example of why the client should work with the financial team (attorney, CPA, and financial advisor) to ensure the achievement of the client's planning objectives

Planning Tools

- Software:
 - CCH software – Roth IRA Conversion Expert™ (*most robust)
 - Brentmark Retirement Plan Analyzer
 - MoneyGuidePro™
- Online basic tools:
 - www.fidelity.com/rothevaluator
 - <http://www.dinkytown.net/java/RothConversion.html>

Questions? Comments?



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Send us all of your money and we'll send back
whatever we don't use."

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