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2010 ROTH IRA CONVERSIONS

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This white paper addresses financial planning issues that should be considered when determining whether to convert a qualified retirement account to a Roth IRA in 2010. It identifies opportunities and challenges, discusses issues, and offers solutions designed to help meet your needs.

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Introduction

All investors are exposed to the risks of change. Economic factors, individual circumstances, investment opportunities and tax laws, among other aspects of life, all change – elevating financial planning from a matter of convenience to a necessity.

Each investor's personal situation is unique. Therefore, every decision must be carefully considered in view of the investor's specific circumstances, goals and resources. This includes the decision to convert to a Roth IRA. For some, the conventional wisdom to defer, defer, defer the tax may not be the most financially advantageous.

As of January 1, 2010, Congress has enabled new groups of taxpayers to convert to Roth IRAs. All investors should consider the impact this decision could have on their financial well being. Younger investors should consider the impact eliminating income tax on investment earnings will have on their retirement accumulations. Their savings will grow that much faster. Older investors should also consider the non-tax benefits of conversion. Their ability to pull from different tax "buckets" can improve standards of living.

The popular media take one of two approaches to the conversion question. They are skewed either toward the old mantra of "pay no tax until absolutely required" or the more current "convert to hedge against future tax increases." Investors should be aware that the Roth conversion decision is not as simple as the mainstream media would make it seem. The obvious income tax issues are only a few of the many factors that must be considered. Rather than focus narrowly on these issues, a broader examination of the potential advantages and disadvantages of conversion is often more enlightening.

Removing variables such as an investor's personal priorities and uncertainty regarding potential changes in tax law simplifies the decision-making process. As we show in the following pages, when all elements of the decision are held constant over time, traditional and Roth IRAs generate the same after-tax results. Estate, tax and financial planning practitioners recognize this as the parity principle of IRA selection: That is, all things being equal, the choice between a traditional and a Roth IRA is a wash.

The particulars of an investor's situation will skew the decision. All investors considering a Roth conversion should be concerned about future tax laws. Wealthier investors should also consider wealth-transfer tax matters.

What other variables or factors should an individual consider? The primary purpose of this white paper is to provide information on multiple aspects of the Roth conversion decision and various planning opportunities. As with many financial planning decisions, the extraordinarily complex and fluid nature of the decision may require careful deliberation, consultation and coordination with tax, estate and financial advisors.

History

Year	Legislation	
1974	Employee Retirement Income Security Act ("ERISA")	Introduces the traditional IRA. Workers not covered by an employer-sponsored retirement plan may contribute up to $1,500 annually on a pre-tax basis.
1981	Economic Recovery Tax Act	Expands availability of traditional IRA to all workers under age 70½ even if covered by an employer-sponsored retirement plan, increases maximum annual contribution to $2,000 and permits a $250 contribution on behalf of a nonworking spouse.
1986	Tax Reform Act	Imposes a phase-out on deductibility of IRA contributions based on modified adjusted gross income (MAGI) and whether the individual or his/her spouse is covered by an employer-sponsored retirement plan.
1996	Small Business Job Protection Act	Raises the contribution limit for nonworking spouses from $250 to $2,000.
1997	Taxpayer Relief Act	Introduces the Roth IRA, creates a distinction between those covered by an employer-sponsored retirement plan and those not covered but whose spouse is covered, and raises the MAGI threshold on deductibility of IRA contributions.
2001	Economic Growth and Tax Relief Reconciliation Act ("EGTRRA")	Raised contribution limits, created the "catch-up" contribution for those age 50 and over, and introduced the low-income, non-refundable saver's credit for IRA contributions.
2005	Tax Increase Prevention and Reconciliation Act ("TIPRA")	Eliminates the MAGI and tax filing status restrictions on Roth conversion for all future years and allows 2010 conversion income to be recognized 50/50 over tax years 2011 and 2012.

Effective January 1, 2010, and going forward, all investors – regardless of income level and tax filing status – may convert tax-qualified assets into a Roth IRA. For 2010 conversions, income from the taxable conversion may be spread equally over the 2011 and 2012 tax years.

Note, however, that the MAGI income phase-out on annual contributions to a Roth IRA remains intact. Only the conversion limitations have been lifted.

Prior to 2010, many working and retired investors were not permitted to convert because they either:

- Exceeded the $100,000 MAGI limitation (single or joint filers) or
- Were married filing separately.

Certainly, a Roth IRA conversion is currently attractive to many investors … investors who will need to educate themselves in order to answer the most basic of conversion questions: "Should I?"

Planning Tip: If you have triggered the MAGI phase-out on the ability to make a regular Roth IRA contribution, consider a non-deductible traditional IRA contribution followed by a conversion.

IRA Basics

An IRA may be established simply by opening an account at a bank or other financial institution. Features common to both the traditional and Roth IRAs include:

- Individuals with earned income – income subject to employment taxes – may contribute to the account annually.
- For 2010, the maximum annual contribution is $5,000 or 100% of earned income, whichever is less.
- Also in 2010, an additional catch-up contribution of $1,000 is permitted for individuals age 50 and over.
- Contributions must be cash.
- Contributions grow tax-deferred within the account.
- Investment restrictions prohibit holding life insurance or collectibles such as art, antiques and coins in the account.
- Taxable distributions prior to age 59½ are subject to a 10% premature distribution penalty, unless an exception applies.

Although the basics are the same, an appreciable difference exists between the traditional IRA and the Roth IRA. Key similarities and differences are discussed on the following page.

Phase-Out of Traditional IRA Deductibility

An investor is always allowed to make the maximum annual contribution to the traditional IRA. The task is to determine how much of the contribution is deductible and how much is non-deductible.

The deductibility of a traditional IRA contribution is based on whether the investor or the investor's spouse is covered for any part of the year by an employer-sponsored retirement plan, on what income (including Social Security benefits) is received and on the tax filing method used, as shown in the table below.

TRADITIONAL IRA DEDUCTIBILITY (2010)			
Filing Status	**Employer Plan Coverage**	**MAGI**	**Permitted Deduction**
Single or Head of Household	You are *not* covered	Any amount	A full deduction
	You *are* covered	$56,000 or less	A full deduction
		More than $56,000 but less than $66,000	A partial deduction
		$66,000 or more	No deduction
Married Filing Jointly	Neither you *nor* your spouse is covered	Any amount	A full deduction
	You *are* covered	$89,000 or less	A full deduction
		More than $89,000 but less than $109,000	A partial deduction
		$109,000 or more	No deduction
	You are *not* covered but your spouse *is*	$167,000 or less	A full deduction
		More than $167,000 but less than $177,000	A partial deduction
		$177,000 or more	No deduction

Planning Tip: Investors with sufficient earned income may always make the maximum annual IRA contribution – but contributions to traditional IRAs are not always fully deductible.

Example: A married investor filing jointly making $105,000 intends to make a $5,000 IRA contribution. Due to the phase-out, referenced above, $1,000 will not be deductible. The investor may wish to split the contribution: $4,000 to a traditional IRA and $1,000 to a Roth IRA.

Phase-Out of Roth IRA Availability

The ability to make a Roth IRA contribution is subject to phase-out based on modified adjusted gross income (MAGI) as shown below.

ROTH IRA MAXIMUM CONTRIBUTION PHASE-OUT (2010)		
Filing Status	**MAGI**	**Permitted Roth IRA Contribution**
Single or Head of Household	Less than $105,000	A full contribution
	More than $105,000 but less than $120,000	A partial contribution
	$120,000 or more	No contribution
Married Filing Jointly	Less than $166,000	A full contribution
	More than $166,000 but less than $176,000	A partial contribution
	$176,000 or more	No contribution

Planning Tip: Investors whose ability to contribute to a Roth IRA is limited by the phase-out may be able to make a traditional IRA contribution.

The planning aspect lies in determining how those contribution dollars may be best divided among traditional and Roth IRAs.

Traditional vs. Roth IRAs

	Traditional IRA	Roth IRA
Eligibility Requirement	Investors under 70½ with: • Earned income or • A spouse who earns income	Investors of any age with: • Earned income or • A spouse who earns income
2010 Contribution Limit	$5,000 ($6,000 if 50 or older on 12/31/10) or up to 100% of earned income, whichever is less	$5,000 ($6,000 if 50 or older on 12/31/10) or up to 100% of earned income, whichever is less; ability to contribute the maximum is subject to phase-out (discussed on page 7)
Deductibility	Pre-tax and after-tax contributions allowed; deductibility subject to phase-out (discussed on page 6).	After-tax contributions only
Deadline to Establish and Fund	On or before tax filing deadline, not including extensions (for most individuals, this is April 15)	On or before tax filing deadline, not including extensions (for most individuals, this is April 15)
Distributions	Taxed as ordinary income, unless rolled over or represent a return of after-tax contributions	Tax-free if made <u>*five years*</u> after account established <u>*and*</u> holder: • Attained age 59½, • Has died, • Has been disabled or • Is a first-time homebuyer ** Converted amounts subject to their own five-year periods*
Premature Distribution Taxation	A 10% premature distribution penalty applies to taxable portion of distributions made prior to age 59½, unless one of the following exceptions applies: • Death • Disability • Divorce • Medical bills (above certain thresholds) • Certain health insurance premiums • Qualified education expenses • First-time homebuyer • Series of substantially equal payments	If the distribution is made <u>*before*</u> the end of the five-year period and no exception to the left applies – earnings are subject to both ordinary income tax and 10% penalty If the distribution is made <u>*after*</u> the end of the five-year period and no exception above applies but an exception to the left applies – earnings are subject to ordinary income tax but no 10% penalty
Required Minimum Distributions (RMDs)	RMDs required to begin in the year in which the individual attains age 70½	No RMDs
Beneficiary RMDs	Beneficiaries must begin taking RMDs in the year following the year of original holder's death	Beneficiaries must begin taking RMDs in the year following the year of original holder's death
Distribution Hierarchy	Pro-Rata: Each distribution carries with it a pro-rata portion of pre-tax and after-tax dollars	FIFO – In the following order: 1. Contributions 2. Conversions of taxable amounts 3. Conversions of after-tax amounts 4. Earnings

Roth IRA Conversion

Strategic Roth IRA conversion has been included in every savvy advisor's planning arsenal since 1997. Yet only recently has the Roth IRA conversion become table talk among investors – doubtless the result of the inordinate amount of attention it received in 2009 and 2010 from both financial and mainstream media.

Given the Roth IRA's distinctive benefits, most investors should at least evaluate the conversion opportunity in the context of their specific circumstances. Granted, that task is more challenging today than in years past given the current flux and uncertainty surrounding taxes, healthcare and welfare benefits. Still, there has never been a simple "yes" or "no" answer to the conversion question. The many variables in the equation require evaluation on an individual situational basis.

Clearly, an investor's retirement account strategy should be coordinated with his or her overall financial and estate plans to achieve the best possible result – whether the goal is retirement income or wealth-transfer maximization. Guidance from a financial advisor can be instrumental in this decision-making process.

Though the Roth IRA's promise of tax-free income is certainly a siren's song, the conversion decision requires careful economic analysis and identification of any special considerations. This section reviews conversion basics and provides examples and strategies for managing:

- Conversion taxation and
- Special situations.

Conversion Basics

A Roth IRA conversion simply entails taking a distribution from a qualified retirement account and moving it into a Roth IRA within 60 days. But completing a conversion can be confusing. Conversion, for example, is not an all-or-nothing decision. Partial conversions are permitted. Determining the optimum conversion amount – as opposed to the maximum conversion amount – can become somewhat complex.

The Case for Converting

Many articles have been written about Roth IRA conversion. They typically describe situations where a variable pertinent to the decision clearly favors a Roth IRA conversion. Such examples are perfectly fine – except every investor's situation is different.

Several factors exist that could make a conversion favorable.

Consider conversion if ...	Because ...
Tax due on the converted amount can be paid from other sources.	Paying the conversion tax from non-qualified funds significantly increases post-conversion, tax-qualified accumulation.
The time horizon is long.	The longer the converted amount remains in the Roth IRA, the greater the conversion benefit.
Assets to be converted are currently depressed or are expected to appreciate significantly.	Converting before affected assets increase in value results in a lower conversion tax. If those assets do not increase in value, investors may select an appropriate time to unwind ("recharacterize") and recover any conversion taxes paid (see page 15).
Flexibility in controlling your taxable income is desired.	Controlling your level of taxable income in retirement can help you avoid higher income tax brackets, taxation of Social Security benefits and more.
Estate planning goal is efficiency.	Roth IRAs may be used to provide tax-free income to heirs, even if the Roth IRA is used to fund a trust for the heirs' benefit.

The Case for Not Converting

In the past, a number of investors simply could not bring them themselves to accelerate the tax payment required by conversion. The bottom line is that the “tax tail will wag” the conversion decision for certain investors even after they have thoroughly evaluated the strategy. The important point here is that they have indeed thoroughly evaluated their options.

Some factors indicate conversion should be disregarded.

Disregard conversion if ...	Because ...
Tax due on the converted amount must be paid from the qualified retirement account to be converted.	Paying the conversion tax from qualified funds significantly decreases post-conversion, tax-qualified accumulation.
Converted amounts may need to be accessed in the near future.	Converted amounts withdrawn within five years are non-qualified distributions subject to the 10% premature distribution penalty unless some other exception applies, such as attainment of age 59½.
Retirement assets to be converted include inherited IRAs, RMDs, 72(t) payments and hardship distributions.	Not all retirement assets are eligible for conversion.
The future is expected to bring a lower tax bracket.	Although high income investors foresee higher marginal rates in their future, most investors expect lower tax brackets in retirement.
Another goal would be compromised.	Conversion can have an unintended financial impact on education funding plans and near-term Medicare Part B premiums.

Why Bother? – or – the Parity Principle

One important aspect of conversion planning is the "parity principle." When two things are equal in amount, or have the same net result, they are said to be *in parity*.

The parity principle, as applied to traditional and Roth IRA accumulation, means that – if all factors pertaining to both IRAs are the same – traditional and Roth IRAs will generate the same net spendable lump-sum distribution amounts.

If All Else Is Equal, Net Spendable Results Will Be Equal As Well.

	Traditional IRA	Roth IRA
Converted Amount	**$100,000**	**$100,000**
Tax Due on Conversion @ 25%	N/A	$25,000
Beginning Account Balance	$100,000	$75,000
Account Balance @ Distribution	**$466,096**	**$349,572**
Tax Due on Distribution @ 25%	$116,524	N/A
Spendable @ Distribution (after-tax)	$349,572	$349,572

Illustration assumes 20-year holding period with 8% annual growth rate.

All things are rarely equal, however. And therein resides the planning opportunity for the informed. The ability to stop taking RMDs by converting to a Roth IRA may be the determining factor for certain investors. For others, the estate planning benefits may tip the scales. Regardless, objectively assessing the specifics of the individual planning situation will uncover the determining factor(s).

Example: Lew holds ABC stock in his traditional IRA. Because Lew believes that ABC stock will become very valuable, he should convert to a Roth now. If he converts after ABC has appreciated, he will ultimately pay a higher conversion tax.

What May Be Converted

Not all distributions are eligible for conversion – which is essentially a rollover (distribution and recontribution). Only distributions that are eligible for rollovers may be converted. RMDs are generally not eligible for rollover and so may not be converted.

Individual investors may convert eligible rollover distributions from their:

- Traditional IRAs;
- Employer-sponsored retirement plans, including
  - Profit sharing,
  - 401(k)s,
  - 403(b)s,
  - 457(b)s and
  - Stock bonus plans;
- SEP IRAs;
- SIMPLE IRAs.

A surviving spouse beneficiary may convert an inherited IRA or employer-sponsored qualified retirement plan account by rolling the deceased's account(s) into his or her own traditional IRA then converting that traditional IRA to a Roth IRA.

Non-spouse beneficiaries may convert inherited employer-sponsored qualified retirement plan accounts.

> **Example:** Jason is a non-spouse beneficiary of a 401(k) plan account. He is an excellent candidate for a Roth conversion, and consults with the 401(k) plan administrator. He learns that the 401(k) plan document allows a non-spouse beneficiary to move directly from the inherited 401(k) account to an inherited IRA. Jason instructs the 401(k) plan administrator to make a *direct transfer* into his newly established *inherited Roth IRA*.

Conversion Taxation

To the extent the conversion amount is taxable, it is included in ordinary income for the year of conversion.

> **Planning Tip:** Conversion can push an individual into a higher tax bracket. Consider partial conversions to "run the brackets."

Below are a few additional conversion tax considerations.

No 10% Penalty

Even if the investor is under age 59½, the 10% premature distribution penalty does not apply to a properly executed conversion.

2010 Tax Hit Split

Investors who make a Roth IRA conversion in 2010 have two options for paying the income tax due on the converted amount. Investors may either:

- Pay 100% of the income tax due on the taxable conversion amount with the 2010 tax filing, or
- Defer payment of the tax due and pay in two installments over 2011 and 2012.

> **Example:** Darby wants to defer income tax as long as possible. She elects deferral by simply including one-half of the taxable conversion amount in income on each of her 2011 and 2012 tax filings.

> **Planning Tip:** Ordinary income tax rates are scheduled to rise in 2011 and will if Congress allows EGTRRA to sunset. The 10% income tax rate will be eliminated; the 33% rate will rise to 36% and the top rate of 35% will rise to 39.6%.

SIMPLE IRA

A SIMPLE IRA may only be converted to a Roth IRA after the SIMPLE IRA is two years old. The two-year aging period starts from the date on which the investor first participated in the SIMPLE IRA.

After-Tax Dollars

If the investor has both pre- and after-tax contributions in an IRA, every dollar distributed contains some of each. Any distribution from a traditional, SEP or SIMPLE IRA is considered to be a pro-rata percentage of the pre- and after-tax dollars.

Investors who have multiple traditional, SEP and/or SIMPLE IRAs must aggregate all IRAs to determine what percentage of each dollar distributed from any one of those IRAs is taxable.

Example: Casey has two IRAs and a 401(k):

- $6,000 traditional IRA of which $5,000 is after-tax,
- $26,000 SEP IRA that is 100% pre-tax and an
- $80,000 401(k) that is 100% pre-tax dollars.

Casey converts only the traditional IRA because he believes he will only be taxed on $1,000 of the converted amount.

At tax time, Casey discovers he must aggregate both of his IRAs to determine the taxable portion of the conversion. He dutifully completes IRS Form 8606 and discovers that 84.37% of his aggregate IRA dollars are pre-tax. $5,062.50 of the $6,000 converted is taxable.

Planning Tip: It may be possible to isolate the cost basis for conversion. Casey could have asked his 401(k) plan administrator if the plan would accept a rollover. If the 401(k) plan accepts rollovers, Casey could have rolled some or all of the pre-tax traditional and SEP IRA dollars to the 401(k) plan. A 401(k) may not accept a rollover of after-tax monies so they would be left behind in the IRA. Then, Casey could have controlled or eliminated the conversion tax consequence.

Caution: Casey would not have been able to roll the pre-tax dollars back out of the 401(k) plan until the year following the year of conversion and then only if the 401(k) plan document permitted in-service distribution. Casey would have wanted to ask the plan administrator about that, too.

Offset Conversion Income

Investors may be able to minimize ordinary income to make conversion more affordable. Use one or more of the following strategies to defer income and accelerate Schedule A itemized deductions as appropriate.

- Make a charitable contribution to a donor-advised fund. In-kind contributions of appreciated property, such as stocks, bonds and mutual funds, avoid capital gains tax and generate income tax deductions.
- Defer bonus payments, the sale of capital gains property and other income into future tax years. Higher income investors should exercise caution here because, as previously discussed, the top two tax rates are scheduled to increase in 2011.
- Implement a defined benefit plan – it shelters significantly more income than a 401(k).
- Absorb unused charitable contribution carryforwards.

2010 Charitable Kicker

The phase-out of Schedule A itemized deductions has been eliminated for one year – 2010. For this one year, high-income investors may be able to write off all of their itemized deductions.

Example: Neal's 2010 Schedule A itemized deductions include real property taxes, state and local income taxes, and charitable contributions for a total of $50,000. For 2010, Neal can write off 100% of his $50,000 in itemized deductions. In previous years his itemized deductions would have been subject to phase-out.

Action Item: Include the tax advisor early in the conversion decision process.

The tax implications of conversion can be difficult to discern, even for a tax professional. Consult with a tax advisor or CPA early in the decision making process to avoid any unpleasant surprises come tax time.

Planning Tip: High-income investors can use a 2010 charitable contribution deduction to efficiently offset 2010 conversion income. Caution is advised as all charitable contributions are not created equally.

Other Considerations

Investors considering converting to a Roth IRA should also consider the many non-conversion tax aspects involved. The decision to convert to a Roth IRA requires a lot of analysis. Yet, conversion is not a firm commitment. It comes with a "free look" period. Investors who convert early in the tax year may have up to 18 months from the date of conversion to change their minds. If their assumptions regarding future income tax rates, asset appreciation or some other decision factor fail to materialize, they may simply recharacterize to reverse the conversion. The mechanics of recharacterization and some other non-tax related decision factors are covered later in this paper.

Educational Financial Aid

An investor's Roth IRA conversion can significantly affect a dependent child's ability to qualify for needs-based financial aid. Three variables generally determine how much and what type of needs-based financial aid is available to the student. These are the cost of attending the school, the student's available resources and the expected family contribution ("EFC").

The EFC is the amount the student's family is expected to pay. The EFC calculation takes into account not only the students' assets and income but also the parents' assets and income. However, not all assets are counted. Securities held in retirement accounts such as 401(k)s and IRAs are not generally counted, unless they are withdrawn while a conversion is taking place.

A conversion in Year 1 will count as income on Year 2's financial aid application. Investors whose child will apply for financial aid in the near future should carefully consider the timing of a Roth IRA conversion. If the child is young, there may be plenty of time to convert without affecting financial aid income eligibility requirements. If the child is already attending college, consider delaying conversion until after the child's junior year.

Action Item: Include a dependent student's financial aid officer early in the conversion decision process.

Conversion tends to increase income, which can drive financial aid awards down. Spreading income from a 2010 conversion over 2011 and 2012 may impact financial aid awards for multiple years.

Different educational institutions calculate awards differently. To help ensure the advice you receive is accurate, consult the applicable college's financial aid officer early in the Roth IRA conversion decision process.

Insurance Alternatives

Conversion viability often depends on how well the assumptions underlying the decision hold true. Certain assumptions, including future income tax rates and investment performance, involve elements beyond the investor's control. For this reason, many investors may be more comfortable considering alternative strategies such as wealth preservation and replacement.

One simple strategy is wealth replacement insurance. For an approximation of the funds needed, calculate the income tax that would have been incurred by the heirs inheriting the retirement asset. Then purchase life insurance sufficient to pay the heirs' income tax obligation. This strategy often appeals to investors who would like to provide tax-free income to heirs.

Example: Henry, age 65, has $500,000 in a traditional IRA. Assuming that sum has not appreciated and that his heirs are in the 30% effective income tax bracket, their income tax obligation on the inherited IRA is $150,000. Instead of converting, Henry – a non-smoker in good health – purchases a $150,000 life insurance policy with an annual premium of $3,155.

Henry's heirs will receive his traditional IRA, subject to income tax, and $150,000 of tax-free life insurance proceeds. The life insurance proceeds may be used to pay the income taxes on the inherited traditional IRA.

Planning Tip: Henry could take penalty-free distributions from his traditional IRA to pay the life insurance premiums so he is not "out-of-pocket." In the 30% effective income tax bracket, an annual distribution of $4,507 would be sufficient to pay both the $1,352 income tax due on the distribution and his $3,155 annual premium payment.

Another simple strategy works in reverse and may actually be more effective than conversion in transferring wealth to heirs. This approach requires two steps:

- Calculating the income tax that would have been due on the converted amount and
- Making a single life insurance premium payment in that amount.

Example: Kimberly, age 67, has a $500,000 traditional IRA. In the 30% effective income tax bracket, the income tax generated by conversion will be $150,000. Instead of converting, Kimberly – a non-smoker in good health – makes a single premium payment of $150,000 and purchases approximately $570,000 of life insurance coverage, guaranteed for the remainder of her life, with the balance going to her heirs.

Kimberly's heirs will receive her traditional IRA, subject to income tax, and $570,000 of tax-free life insurance proceeds. The life insurance proceeds may be used to pay the income taxes on the inherited IRA and still provide a legacy for Kimberly's heirs.

Medicare and the "High-Income" Individual

Wealthier investors are well aware that they will pay higher Medicare Part B premiums. Part B premiums are based on prior years' taxable income – a figure which, all else being equal, will grow annually once RMDs begin. These income-sensitive premiums are only one of two important Medicare planning points.

Effective January 1, 2013, a new 3.8% Medicare surtax on "excess" investment income will affect single investors with MAGI in excess of $85,000 ($250,000 for married individuals filing jointly). And, again, tax-free Roth IRA distributions do not affect excess investment income calculations.

Roth IRA conversion facilitates planning for Medicare Part B premiums as well as for the new tax on excess investment income. However, there is a two-year window of particular concern. Converting up to one year before, or one year after, applying for Medicare Part B, benefits may result in higher premiums for the year following the year of conversion. Conversion income recognized after 2010 will similarly increase MAGI for purposes of calculating the Medicare surtax. Plan for the long term. Shoulder the short-term consequences of conversion today to reap multiple years of lower Medicare Part B premiums and lower Medicare surtaxes.

Recharacterization

Conversions occasionally go wrong: Assets decline in value post-conversion, expected tax increases get shelved or estate plans change. Whatever the reason, an investor may want to "unwind" a conversion.

Generally investors have until the April 15 tax filing deadline, or, if properly extended, until October 15 of the year following conversion to unwind or recharacterize the conversion and eliminate the associated income tax due.

Planning Tip: Remember Lew, who expected his ABC stock to appreciate wildly? If ABC does not perform as he expects, Lew may have until as late as October 15 of the year following the conversion year to unwind the conversion without a tax consequence.

Planning Tip: ABC stock also has the potential to lose a significant portion of its value. Knowing this, Lew converts the ABC stock into Roth IRA 1 and all other assets into Roth IRA 2. If ABC does not perform, Lew can unwind only the ABC portion of his conversion – Roth IRA 1 – and recover what could be considered an unnecessary conversion tax payment on the original ABC conversion.

To properly recharacterize:

1. Transfer the converted amount, adding earnings or subtracting losses, back to a traditional IRA by the recharacterization deadline,
2. Amend the conversion year tax return by filing IRS Form 1040X, and
3. Request a refund, plus interest, of any conversion tax paid.

Example: Ajay converts to a Roth IRA on January 1 in Year 1. By April 15 of Year 2, he files his tax return and pays the taxes due on the converted amount. Immediately after, the market drops.

Ajay has until October 15 of Year 2 to recharacterize. He will need to transfer the converted amount plus earnings back to a traditional IRA. As he has already filed his return and paid the tax due, he must file an amended 1040X clearly marked "Filed pursuant to section 301.9200-2" in order to receive a tax refund, plus interest.

Planning Tip: Ajay may later reconvert into a Roth IRA. And, if the asset values are still depressed, the tax due on the reconversion will be lower than the tax due on the original conversion, resulting in a tax savings.

Caution: The earliest Ajay may reconvert is:

- The beginning of the year following the year in which he originally converted to a Roth IRA, or *if later…*
- The end of the 30-day period beginning on the day of his recharacterization to a traditional IRA.

Social Security Taxation

Up to 85% of Social Security (SS) benefits are exposed to federal income tax. Higher income leads to higher exposure. It only made sense to Congress that higher income individuals should pay more tax. The congressional challenge was that higher income SS recipients typically arrange their affairs so that they receive significant amounts of tax-free income. The legislators' solution was simply to carefully define the criteria for tax-free income. The definition of income, for purposes of SS taxation, currently includes tax-free income from municipal bonds, Series EE bonds and certain other vehicles. It does not include Roth IRA income.

Planning Tip: Conversion may expose SS benefits to higher income taxes in the year of conversion; however, tax-free Roth distributions do not impact SS taxation. Traditional IRA distributions can carry a double tax impact: They are taxable and they may result in reduced SS benefits.

Wealth Transfer

Facilitating wealth transfer is an important reason to consider a Roth IRA conversion. The ideal candidate here has a long time horizon (20 years or more), heirs in the same or higher tax bracket, heirs with special planning needs (asset protection or welfare benefits planning), or an estate tax obligation on those conversion dollars that exceeds the income tax due on conversion. Often, it only takes one of these elements to justify conversion.

Example: Toni's situation mandates leaving significant IRA assets in trust for her daughter, Taylor. The trustee has the power to turn off Taylor's distributions, enabling income to accumulate within the trust. Unfortunately, trusts generally have higher income tax rates than individuals, so the trust will pay more in taxes. To avoid this anticipated income tax problem, Toni converts to a Roth IRA and pays the taxes up front at her personal – likely lower – income tax rate.

Action Item: Include the estate planning advisor early in the conversion decision process.

The estate planning implications of conversion can be difficult to discern, even for an estate planning professional. Consult with an estate planning advisor or attorney early in the decision-making process to avoid any unpleasant surprises for your heirs.

Planning Tip: Review qualified retirement account beneficiary designation forms whenever a significant change in tax law occurs, you are contemplating converting to a Roth IRA or your financial or familial situation changes.

Summary

Now that we have explored the Roth IRA conversion question in some depth, it should be clear that the decision is much more complex than it first appears. There are many more variables to consider than have been broached in this white paper. State and local income tax laws, for example, vary and may not conform to the federal rules discussed herein.

As individual investors educate themselves on, and understand many of the implications of, converting to a Roth or staying with a traditional IRA, the more appropriate course of action may appear to emerge. Even so, consultation with a financial advisor is highly recommended.

Action Items

1. Consult with your financial advisor about the income tax and non-tax considerations of Roth IRA conversion.
2. Coordinate the income tax aspects of any decision to convert with a tax advisor.
3. Tell your estate planning advisor that you have implemented a Roth IRA conversion and provide him or her with your new beneficiary designation information.

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