

Planning Ideas—Conversion to a Roth IRA

We're not finished with 2009 yet, but top advisors are already focusing on 2010. The reason is that tax law changes with potentially significant implications loom in the not-so-distant future. One of those changes concerns rollovers to Roth IRAs.

Consider this an opportunity to be proactive. Take the discussion to your clients instead of waiting until they ask, "is a Roth IRA right for me?"

2010: A year of Change

Since Congress enacted legislation creating Roth IRAs several years ago, the rule has been that only individuals with modified adjusted gross income (MAGI) of less than \$100,000 were permitted to rollover traditional IRAs or qualified retirement plan (QRP) funds to a Roth IRA. This income limitation prevented many affluent and high net worth (HNW) individuals from enjoying the benefits of a rollover Roth IRA. However, beginning in 2010, the income limitation will be removed. In addition, although the rollover funds are includable in income, the income need not be reported in 2010; instead it can be reported ratably over years 2011 and 2012.

An important question many advisors and clients will face is whether or not to convert.

Key Differences Between Traditional and Roth IRAs

The starting place for answering this question is to have a firm grasp on the differences between a traditional and Roth IRA. The following table highlights the key differences.

	IRA	Roth IRA
Amount of Contributions	<p>\$5,000 (\$6,000) for individuals 50 or older). 2009 amounts are subject to indexing.</p> <p>Taxpayers must have earned income in order to contribute, except in the case of a spousal</p>	<p>\$5,000 (\$6,000) for individuals 50 or older). 2009 amounts are subject to indexing.</p> <p>Contributions for joint filers are phased out for MAGI between \$166,000 and</p>

	IRA	Roth IRA
	IRA.	\$176,000. 2009 amounts are subject to indexing. Different dollar amounts apply to taxpayers with different filing statuses. Taxpayers must have earned income in order to contribute, except in the case of a spousal IRA.
Deductibility of Contributions	Deductibility depends on filing status, income, and whether or not the taxpayer or his or her spouse participates in an employer-sponsored QRP. For individuals filing jointly and participating in an employer-sponsored QRP, the deduction phases out for MAGI between \$89,000 to \$109,000. 2009 amounts are subject to indexing. For individuals filing jointly and <i>not</i> participating in an employer-sponsored QRP, the deduction phases out for MAGI between \$166,000 to \$176,000. 2009 amounts are subject to indexing.	Non-deductible.
Age Limit for Contributions	Age limit for both rollover and annual contributions is 70 ½.	No age limit on rollover or annual contributions.
Distributions	Distributions are generally includible in income.	Distributions of <i>contributions</i> are always tax-free.

	IRA	Roth IRA
	Distributions prior to age 59 ½ are generally subject to a 10% penalty tax, but several exceptions apply.	Distributions of <i>earnings</i> are tax-free if made more than five years after a taxpayer made his first contribution to any Roth IRA and are made after the IRA owner attains age 59 ½, becomes disabled, or dies.
Required Minimum Distributions During Life	Required minimum distributions (RMDs) must be made after April 1 following the year that the individual attains age 70 ½.	No required minimum distributions required during life.
Required Distributions following Death	Assuming there is a designated beneficiary, the benefits may “stretch out” over the beneficiary’s remaining lifetime.	Assuming there is a designated beneficiary, the benefits may “stretch out” over the beneficiary’s remaining lifetime.

Planning Considerations—Income Taxes

Although Roth IRA distributions are, generally, income tax free, that benefit will be diminished if taxpayers are in a lower tax bracket at the time distributions are received than they were in the year of rollover. On the other hand, because most HNW individuals will always be in the highest tax bracket, a rollover to a tax-free Roth IRA probably makes sense. Also, with the federal deficit at an all-time high, few expect tax rates to drop anytime soon; if anything, rates are likely to increase.

Keep in mind, however, that there are no lifetime required distributions from a Roth IRA and distributions may ultimately be made, not to the IRA owner, but to beneficiaries. If the beneficiaries are heirs who are likely to be in a lower tax bracket than the IRA owner, or if the beneficiary is a tax-exempt charity, this may swing the calculation in the opposite direction. It hardly makes sense to pay taxes on the rollover amount today at a high rate, when the benefit of tax-free distributions will ultimately be lost or minimized.

Another consideration relates to the value of the rollover assets today as compared to how they are expected to perform in the future. It is likely that given the recent economic downturn, many IRA balances will be relatively undervalued in 2010. This suggests taking the tax hit in 2010 rather than in a year when values may be more in line with expectations.

Yet another consideration is that although contributions to a traditional IRA are not allowed after age 70 1/2, affluent and HNW individuals whose income does not exceed the MAGI limits and who have earned income can continue to make contributions to a Roth IRA even after age 70 1/2. Although the contributions are not deductible, earnings thereon are, generally, income tax free.

Planning Considerations—Transfer Taxes

Transfer taxes also come into play in the decision-making process. Income taxes paid on a rollover to a Roth IRA reduce the taxpayer's taxable estate. Given that the maximum current income tax rate of 35 percent is less than the current maximum estate tax rate of 45 percent, wealthy clients are better off paying income taxes than estate taxes on IRA balances. For every dollar of income tax paid at 35 percent, there's an estate tax savings of 45 percent.

Furthermore, in some instances, the income tax paid at 35 percent may be sufficient to reduce an individual's taxable estate below the current exemption of \$3.5 million, thus eliminating estate taxes altogether. For example, a client on his or her death bed with an estate of \$3.6 million may be well-advised to take a \$300,000 rollover distribution, pay income taxes of \$100,000 plus, and thereby lower the taxable estate below the \$3.5 million exemption.

Bottom Line

Clients will be looking to their advisors to help them decide whether to rollover their IRA and QRP benefits to Roth IRAs in 2010. Take this opportunity to distinguish yourself from the crowd. Know the basic rules concerning contributions, deductions, and distributions. Think through how you'll frame decision points for clients and practice the conversation you'll have with them about the decisions they face. Consider the tools your firm makes available and specialist resources you have access to. Remember, it's not learning the technical details that make a difference, it's executing on what you know that counts.

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