

## **The Do's and Don'ts of Roth Conversions**

Roth conversions are one of the hot topics for 2010. Although the concept of a Roth conversion is not a new one, the ability for virtually anyone to execute a conversion, regardless of income levels, has made them the subject of numerous articles and seminars. Although most of these articles approach the decision from a tax viewpoint, a Roth conversion can also affect your current cash flow, retirement income options and estate planning. Additionally, because of the perfect storm of expiring tax law, newly enacted tax law and in some cases, a total void of tax law, a few additional items need to be brought to your attention for both consideration and clarification. Therefore, you should always take a comprehensive approach when considering whether a Roth conversion is right for you.

### The Rules:

- Since the beginning of 2010, the income limits regarding conversion eligibility have been eliminated. Bear in mind that this is just the first year that the income limits are eliminated, not the only year.
- The unique consideration for 2010 is that it offers the one-time opportunity to spread conversion-related income across the 2011 and 2012 tax years. This option is available at the time you file your tax return. At first glance, it may seem obvious to spread the income tax hit across two future tax years, yet for many tax filers this might not be the best choice. Once considerations of future income tax rates, current income levels and other financial situations are taken into account, taking the entire conversion into current income for the 2010 tax year might result in the lowest overall taxation for certain individuals.
- In years after 2010, if you decide to execute a Roth conversion the tax impact of the entire conversion will be taken into income for that same tax year.
- As is the case with any conversion, you have until the time you file your taxes (due date plus extensions) to “recharacterize,” or undo, your conversion. In the past, people primarily recharacterized when they discovered that they were ineligible to execute a conversion due to income restrictions. Although this purpose no longer applies, there are still good uses to recharacterization. Recharacterizations can be used as a means to protect against paying higher taxes if a converted account has declined in value since the time of conversion. They also can be employed to undo a taxable transaction if your financial situation has changed and you need to preserve assets for current use, such as if you are laid off or are facing a large unforeseen expense.
- Tax rates for 2011 and 2012 are as yet unknown, which just adds to the uncertainty. Remember that the decision to take all the conversion income as 2010 income or to spread it over the 2011-12 tax years is one that does not need to be made until you file your taxes. With any luck Congress will have addressed income taxation laws by then to eliminate some of the unknowns.
- Roth conversions initiated in 2013 and beyond might affect whether or not your investment income is subject to the newly enacted 3.8% Medicare surtax. Although your conversion income is not directly subject to this additional tax, a conversion in 2013 would increase your modified adjusted gross income (MAGI) and could bump you into surtax territory on your net investment income.

### Do consider a Roth conversion if:

- You expect to be in a higher tax bracket in retirement than you are today.
- You have significant wealth tied up in your IRAs and 401(k)s but you are still working and will not need any of this money in the foreseeable future. A Roth conversion will serve as an opportunity for you to create more income tax flexibility in retirement by effectively reducing the size of the asset bucket which will be subject to required minimum distributions.

- You have a small rollover IRA from a previous employer and see value in having those assets be able to grow tax-free in the future.
- You have more than sufficient assets for your lifetime and want your family to be able to inherit assets that will not be subject to income taxation.
- Your *only* tax-deferred account outside your employer plan is an IRA which consists of non-deductible (after-tax) contributions. Converting an account with mostly after-tax contributions will result in little taxation as a result of the conversion, since only earnings in excess of basis would be subject to taxation.
- You have accumulated substantial assets within your employer plan, but your employer just recently allowed the Roth option inside the plan. You see benefit in being able to convert some of your employer plan assets to the Roth, but because you are still employed, the assets need to stay within the plan itself. The recently enacted Small Business Act allows this type of conversion beginning in 2010 under a specific set of circumstances and would follow the same taxation choices for 2010 as is available for other conversions.

Don't consider a Roth conversion if:

- You expect to be in a significantly lower tax bracket in your retirement than you are today.
- You will need to begin taking distributions from a newly converted Roth account in the next few years, thereby not allowing adequate time to benefit from the tax-free growth of the account.
- You are already in need of IRA distributions in order to meet regular expenses.
- You do not have adequate available cash to pay the due taxes from savings or cash flow. The ideal situation is to be able to convert the IRA using outside assets to meet the income tax obligation.
- You will not have need of the money in your lifetime and you plan to leave your assets to charity upon your death. Charitable beneficiaries already receive IRA assets tax-free so a conversion would result in unnecessary taxation.
- You have a mix of pre-tax and post-tax IRAs and are considering converting just the post-tax IRAs since this should hypothetically result in only earnings being taxed at conversion. Because of this combination of pre- and post-tax contributions, an IRA proration rule would apply which mandates that any existing basis gets prorated across the total of *all* your IRAs as of year-end. This same proration issue would occur if you owned only non-deductible IRAs, converted them to Roths, but then transferred a prior employer plan to a rollover IRA before year-end. This "gotcha" is currently before the IRS for clarification but they have not ruled on it as of yet.
- You currently have students in college and you have been receiving financial aid by filing the FAFSA form each year. A Roth conversion will increase the Expected Family Contribution and will typically decrease the aid you are awarded for the year. This also would apply if you have a student entering college in 2011-12 and you hope to receive federal aid via the FAFSA filing.

Examples of Roth conversion opportunities:

1. Joe is retired at age 60 and has assets totaling \$7 million, including \$2 million in a rollover IRA. Comprehensive planning has indicated that Joe is unlikely to have need of his IRA assets during his lifetime and he desires that the IRA go to his children at his death. He would also prefer that any inheritance not be subject to income taxation. *Recommendation:* Because Joe will not need the IRA for his own purposes and has adequate savings to pay the income tax, he should consider converting the IRA to a Roth. Although this represents significant taxation today, it eliminates the necessity for Joe to take required distributions at age 70.5 and it provides a tax-free inheritance for his children.
2. Susie is 52, has a \$3 million IRA and plans to continue working for another 10+ years at a high salary. By the time she is required to begin distributions from the IRA at age 70.5, the expected distributions could keep her in a high tax bracket throughout retirement. She currently has additional assets in taxable accounts which she has accumulated from free cash flow. *Recommendation:* Susie should consider a Roth conversion of a substantial portion of her IRA and

should evaluate the option of paying all conversion related taxes in 2010 since she expects to remain in high tax brackets for the foreseeable future. This will expand her choices in retirement regarding taxation of income for meeting annual expense needs.

3. George is 35 and changed jobs last year. While he was awaiting eligibility to participate in his new employer's 401(k), he was able to save significant sums to his taxable accounts, as well as transfer his prior employer's plan assets to a rollover IRA. His new job is at a significantly higher salary and he anticipates being able to save at much higher levels in the future. He is now eligible to begin deferring current income to his new employer's 401(k). *Recommendation:* George could convert his rollover IRA to a Roth IRA, using some of his taxable savings to pay the conversion taxes. His deferrals to his new 401(k), coupled with taxable and Roth savings, would give him a high level of flexibility in meeting eventual retirement expense needs.
4. Janice is currently employed and has accumulated \$1 million in her employer 401(k) plan. Her company recently added a Roth 401(k) option to the plan. Ideally, she would like to find a way to move her assets to the Roth side of the 401(k) while she is still employed. *Recommendation:* Janice should investigate if her employer intends on amending the plan document to allow these types of conversions, as recently legalized by the Small Business Act of 2010. If the plan also allows in-service withdrawals, she could consider converting a portion of the pre-tax deferral to the Roth 401(k) portion of the plan. The assets would remain in the employer plan and Janice could either recognize all income from the conversion in 2010 or split the conversion income over 2011 and 2012.

Roth conversions are not something that should be executed just because everyone else is doing it. A conversion decision involves not just income tax planning, but long term financial planning decisions that encompass many different areas of your life. If you are wondering if this opportunity is right for your situation, contact your financial advisor to initiate a discussion. A comprehensive examination of your circumstances will help to decide if a Roth conversion is a wise move for you.

Regards,

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*Cheryl Sherrard was quoted in Jilian Mincer's Wall Street Journal article, "Roth-to-IRA Reversal Opens up Options." The article can be found in the Personal Finance section of the October 26 issue, page C11.*

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