

# Memo

To: Clients and Friends  
From: Capital Enhancement LLC  
Date: October 21, 2009  
Re: Roth IRA Conversion

As you may be aware, starting in 2010, taxpayers with income above \$100,000 can convert IRA's and similar plans to Roth IRA's. Upon conversion, you would have to pay tax, but under certain conditions, your Roth IRA funds and all future earnings will be tax-free. The purpose of this memo is to educate you about the conversion rules and Roth IRA's, and to give you some guidance as to whether a conversion may be appropriate for you.

## Executive Summary

The Roth conversion deals with paying tax now to save substantially more tax in the future. The ideal candidate for a Roth IRA conversion is someone who:

- Does not need the IRA funds for his/her own retirement security.
- Has other financial resources besides IRA funds to pay the taxes due upon converting an IRA to a Roth.
- Does not anticipate the converted funds to be spent for at least 15 to 20 years and would consider leaving the Roth IRA to heirs after death.
- Is willing to invest the Roth IRA for growth after conversion to maximize the benefits of tax-free compounding.

## Roth Conversion Basics

- There is no income limit preventing you from converting in 2010 or future years. Previously, you could not convert IRA funds to a Roth IRA unless your income in a year was less than \$100,000.
- You can convert in 2010 or any future year, assuming the law does not change. For 2010 conversions, you can elect to pay the tax on your 2010 return, or you can elect to pay the tax evenly on your 2011 and 2012 returns. For conversions after 2010, you pay the tax on that year's return.
- If you made nondeductible contributions to an IRA, you do not pay tax on those contributions upon conversion. However, if you convert only part of your IRA balances, you determine the taxable amount of conversion by comparing the "basis" in all your IRA's to the value of all IRA's. The fraction resulting from the comparison represents the percentage of the conversion that is not taxable; the remainder is taxable.

- If you are under 59½ at conversion, there is no 10% early withdrawal penalty. However, if you withdraw those funds from the Roth less than 5 years after conversion or before 59½ (whichever period is longer), then the taxable amount is also subject to the 10% penalty. If you are under 59½ and withdraw funds to pay the tax on conversion, that withdrawal is subject to the 10% penalty.
- If your 401(k) allows you to take withdrawals, you can roll 401(k) funds to an IRA and then convert to a Roth. This can avoid mandatory 20% withholding from a 401(k) withdrawal.

## Roth IRA Basics

### Annual Contribution

- To make annual contributions to a Roth (maximum of \$5,000 in 2009 if under age 50 or \$6,000 if over age 50), you must have earned income of at least the amount of the contribution and your income must be less than \$120,000 if single and \$176,000 if married. The income limit prevented many from contributing to a Roth IRA in the past. You can contribute to a Roth after 70½ if you meet the above rules. Examples of earned income are wage income, consulting fees, and board fees.
- There is no current tax deduction for contributions. This gives you “basis” in a Roth.

### Tax Rules

- If you withdraw earnings in excess of your contributions (basis) before the later of 5 years or age 59½, the earnings are taxable and possibly subject to a 10% early withdrawal penalty. Regular 10% IRA penalty exceptions can apply. Earnings withdrawn after 5 years and 59½ are not taxable.
- Withdrawals from a Roth are considered to be first a return of your contributions (FIFO basis), and last, a return of the earnings on those contributions. This treatment is more favorable than the treatment of withdrawals from 401(k)'s and traditional IRA's, where the basis is recovered pro rata.
- Roth IRA's are not subject to the age 70½ minimum distribution rules, unlike other IRA's and 401(k)'s. You are not required to take any withdrawals from Roths prior to death. After your death, your beneficiary will be required to take withdrawals over his or her life expectancy over your death (for example, your child may have to withdraw the funds over a 30-year period after your death). Care must be taken in structuring the beneficiary designation to achieve the desired outcome. If you are concerned your children will cash in the IRA after your death, you could create trusts to be the beneficiary of your Roth.

## Breakeven Conversion Analysis

In this section, we will illustrate the number of years to break even from a Roth conversion, making assumptions regarding current and future tax rates, and investment returns. If you and/or your family can wait the specified number of years before spending the Roth money, you are better off converting to a Roth.

### Breakeven Number of Years before Roth Conversion Worthwhile

Income Tax at Conversion	Income Tax Later on IRA withdrawal	Annual Rate of Return			
		<u>4%</u>	<u>6%</u>	<u>8%</u>	<u>10%</u>
42%	35%	19	13	10	8
42%	28%	42	29	22	18
35%	28%	29	20	15	13
35%	20%	73	50	38	31
28%	25%	15	10	8	7
28%	20%	44	30	23	19

It is always better to convert if you anticipate that your future tax rate will be the same or higher than the rate at conversion given our assumptions.

### Assumptions

- 1) 42% bracket at conversion equates to a taxpayer in highest federal bracket living in a high tax state (e.g. NY, NJ)
- 2) 35% bracket equates to a taxpayer in the highest federal bracket living in a no tax state (e.g. Florida)
- 3) 28% bracket equates to an AMT taxpayer living in a no tax state (e.g. Florida)
- 4) Income tax paid on Roth conversion now is assumed to be invested at rate of return and investment earnings are taxed at capital gains rates (assumed to be 25% in 42% scenario and 20% in all others). Value of taxes paid is then deducted from value of Roth IRA.

### Other Considerations Regarding Conversion

This memo will not cover every technical aspect of a Roth conversion or every conceivable scenario. However, there are some other considerations for certain taxpayers in converting to a Roth.

If it is likely your estate will be subject to estate tax when you pass away, converting to a Roth could yield additional benefits, because your payment of income tax upon conversion reduces your estate, which in turn reduces the eventual estate taxes.

Additionally, if you have a Net Operating Loss Carryforward (NOL) or a charitable contribution carryforward, the cost of converting to a Roth may cost less than assumed, as some or all of the carryforwards could offset the tax on the additional income.

Please realize that a Roth conversion is not an “all or nothing” proposition. You could convert some of your IRA to a Roth and use your Traditional IRA to fund retirement expenses. Also, assuming the law does not change, conversion is not solely a 2010 decision. You could convert some IRA funds to a Roth each year in order to manage your marginal taxes upon conversion. For AMT taxpayers, a useful strategy could be to convert enough of your IRA funds each year until you are no longer in the AMT. In this way, the conversion would be taxed mostly at 28% (plus any state taxes) and would help to minimize the cost of conversion.

### Conclusion

Paying tax earlier than necessary is rarely wise but could be worthwhile if you and/or your family will not need to access the Roth funds for a long time and are willing to take some investment risk with the money, even if you will be in a lower future income tax bracket than in the year of conversion.

This memo is designed to help you think about converting; however, there is no substitute for discussing conversion in light of your personal circumstances, goals and objectives.