Rules and Risks of Roth Conversions

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Outline

- Traditional and Roth IRAs
- Risks of Conversion
- Practical Considerations
- Conclusions and Recommendations

THIS PRESENTATION MAY CONTAIN ERRORS.
DO NOT USE AS A PRIMARY TAX RESOURCE.

Traditional IRAs

- Contributions.
  - Contributions are generally pre-tax.

    Pre-tax contributions may be limited if taxpayer or spouse participates in an employer plan.
  - Limited to compensation of taxpayer plus spouse.
  - Traditional IRA plus Roth IRA ≤ $5,000 ($6,000).
  - No contributions on or after age 70½.

Roth IRA

- Contributions are after-tax.
  - Limited to compensation of taxpayer plus spouse.
  - Traditional IRA plus Roth IRA ≤ $5,000 ($6,000).
  - Contributions may be limited by AGI.
  - There is no age limit on contributions.

Taxation of Traditional IRAs

- Taxes on earnings are deferred.
- Distributions, less basis, are ordinary income.
- Aggregation

    IRA1: $100,000 with $15,000 basis

    IRA2: $50,000 with no basis

    10% of any distribution from either IRA is basis.
- California basis may be larger than federal basis.
- California basis must be computed for taxpayers who move into California.

Moving Between Pensions and IRAs

- Most pensions can be rolled over to a traditional IRA on separation from service. Basis moves *pro rata.*
- A traditional IRA can generally be rolled over to an employer plan (except nongovernmental 457 and SIMPLE plans). Basis cannot be rolled over.
- Strategy for tax-free conversion of basis:
  - Roll all traditional IRAs to a pension.
  - Convert the residual IRAs.

Taxation of Roth IRAs

- Taxes on earnings are deferred.
- Distributions are taken, in order,

Contributions	Tax-free
Conversions	Tax-free
Earnings	Tax-free after age 59½ and 5 years have elapsed since • Initial contribution to <u>any</u> Roth IRA; or • Initial contribution to the <u>specific</u> Roth designated pension account.

Early Withdrawal Penalties

Traditional IRAs and Pensions. Generally,

- 10% penalty plus 2½% California before age 59½.
- No penalty on early withdrawals from 457 plans.

Roth IRAs and Roth Designated Pensions.

- Contributions are recovered penalty-free.
- Conversions are penalty-free after the earlier of age 59½ or five years after the <u>specific</u> conversion.
- Earnings are penalized if distributed before age 59½.

Age 59½ Exceptions (not California)

Death, Disability and …

	Penalty: 401(a), 403(a) and 403(b)	Penalty: Traditional, SEP, SIMPLE and Roth IRAs	Tax: Earnings on Roth IRA
Substantially equal payments	Yes	Yes	
Separation from employment	Yes		
Certain ESOP dividends	Yes		
IRS levy	Yes	Yes	
Medical expense	Yes	Yes	
Transfers to spouse, ex-spouse	§72(t)(2)(C)	§408(d)(6)	
Unemployed health insurance		Yes	
First time homebuyer		Yes	Yes
Reservist	Elective deferrals	Yes	
Higher education		Yes	
Disaster-related (expired '09)	Yes	Yes	

SIMPLE Plans

Cannot move funds from an IRA to a SIMPLE plan.

During the first two years after the initial deposit to a SIMPLE plan,

- Early withdrawal penalty is 25% plus 6% California.
- Rollovers are only permitted to another SIMPLE plan.
- A prohibited rollover is treated as a taxable distribution followed by a contribution.
  - The distribution could be penalized before age 59½.
  - The contribution could be an excess contribution.
  - The contribution could be nondeductible.

Other Penalties and Taxes

6% annual federal penalty for excess contributions.

50% federal penalty for insufficient distributions.

Tax on Unrelated Business Income.

Disqualification (taxation of some or all of the IRA)

- Borrowing from, selling to, buying assets for personal use or unreasonable compensation.
- Pledge as security (margin accounts).
- Collectibles, except certain coins and bullion.

Recognizing Losses

- Aggregated basis exceeds aggregated value.
- To recognize a loss, <u>all</u> traditional IRAs or <u>all</u> Roth IRAs must be distributed.
- The loss is a miscellaneous itemized deduction subject to 2% of AGI.
- The loss is not allowed for AMT purposes.

An Alternative Paradigm

The traditional IRA is a joint venture.

- Governments' share is the unrealized tax.

The participant's share of the earnings on either IRA are tax-free.

- About 70% of the earnings on a traditional IRA.
- All of the earnings on a Roth IRA.

Conversion Increases Tax-free Earnings

Before Conversion

- $1MM traditional IRA plus $300,000 non IRA assets.
- Participant receives earnings on $1MM.
- About 70% of earnings are tax-free.

After Conversion

- $1MM Roth IRA.
- Participant receives earnings on $1MM, as before.
- All earnings are tax-free.

Other Conversion Considerations

- Roth IRAs are exempt from RMDs before death. For those with surplus resources,
  1. There is more time to accrue tax-free earnings.
  2. Larger inherited IRAs.
- For those with surplus resources,
  1. Estate tax may be reduced.
  2. Roth IRAs are better for funding bypass trust.
- ERISA provides better asset protection.

On the Other Hand,

Converting Generally Costs More

"Conversion Premium"

- 32% Costs (taxes, Medicare surcharges, other) if the IRA were converted today.
- 29% Costs (taxes, Medicare, other) if the IRA were distributed over the lives of owner and beneficiary.

It may be possible to reduce the conversion premium by converting gradually, by converting less and by converting in years of low income or high deductions.

Medicare Premium Surcharge

(AGI is based on the tax return from two years before)

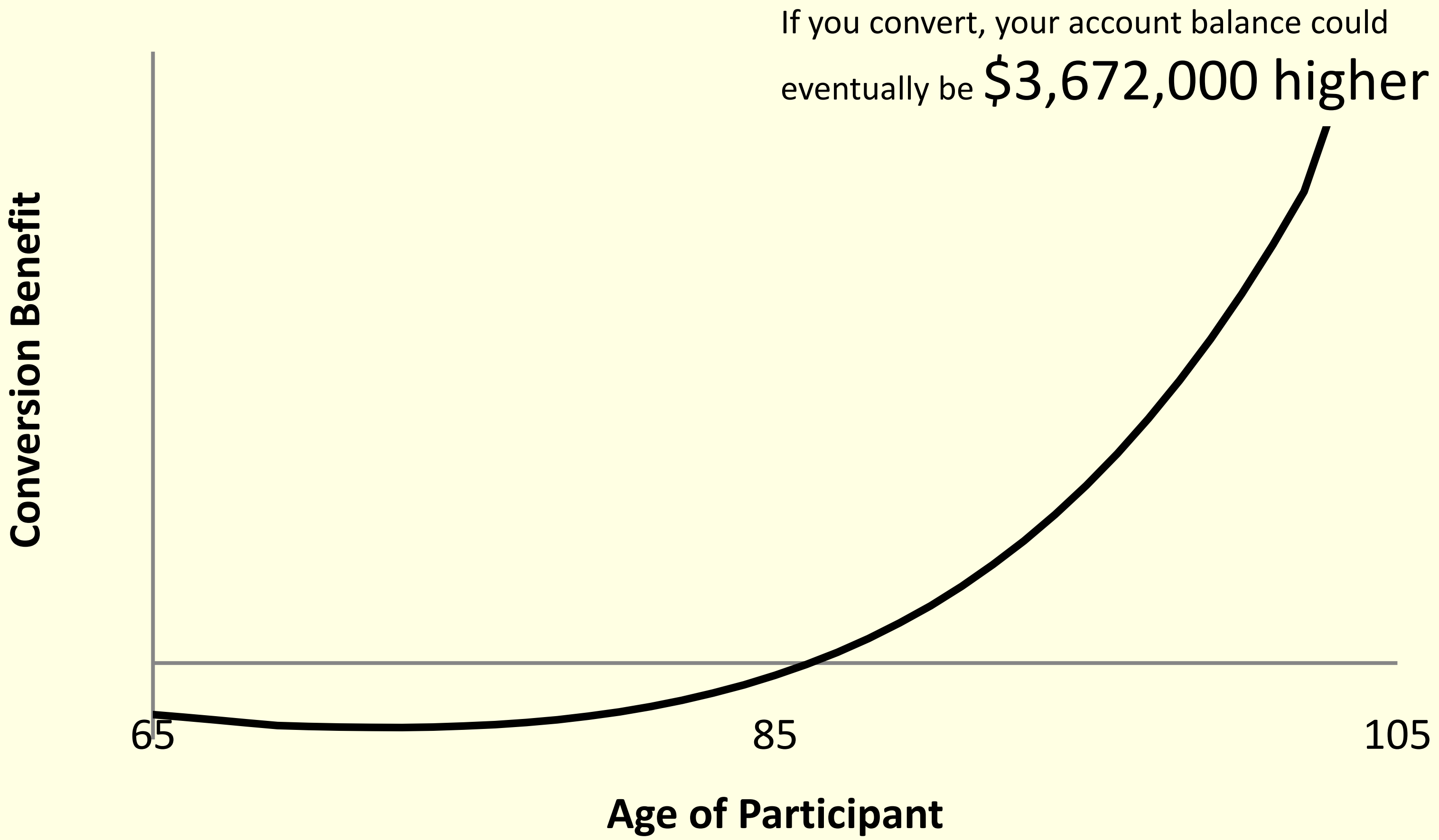
2008 AGI , per person	2010 Surcharge
$85,000 or less	none
$85,001 to $107,000	$700
$107,000 to $160,000	$1,495
$161,000 to $214,000	$2,291
More than $214,000	$3,086

Risks of Roth Conversion

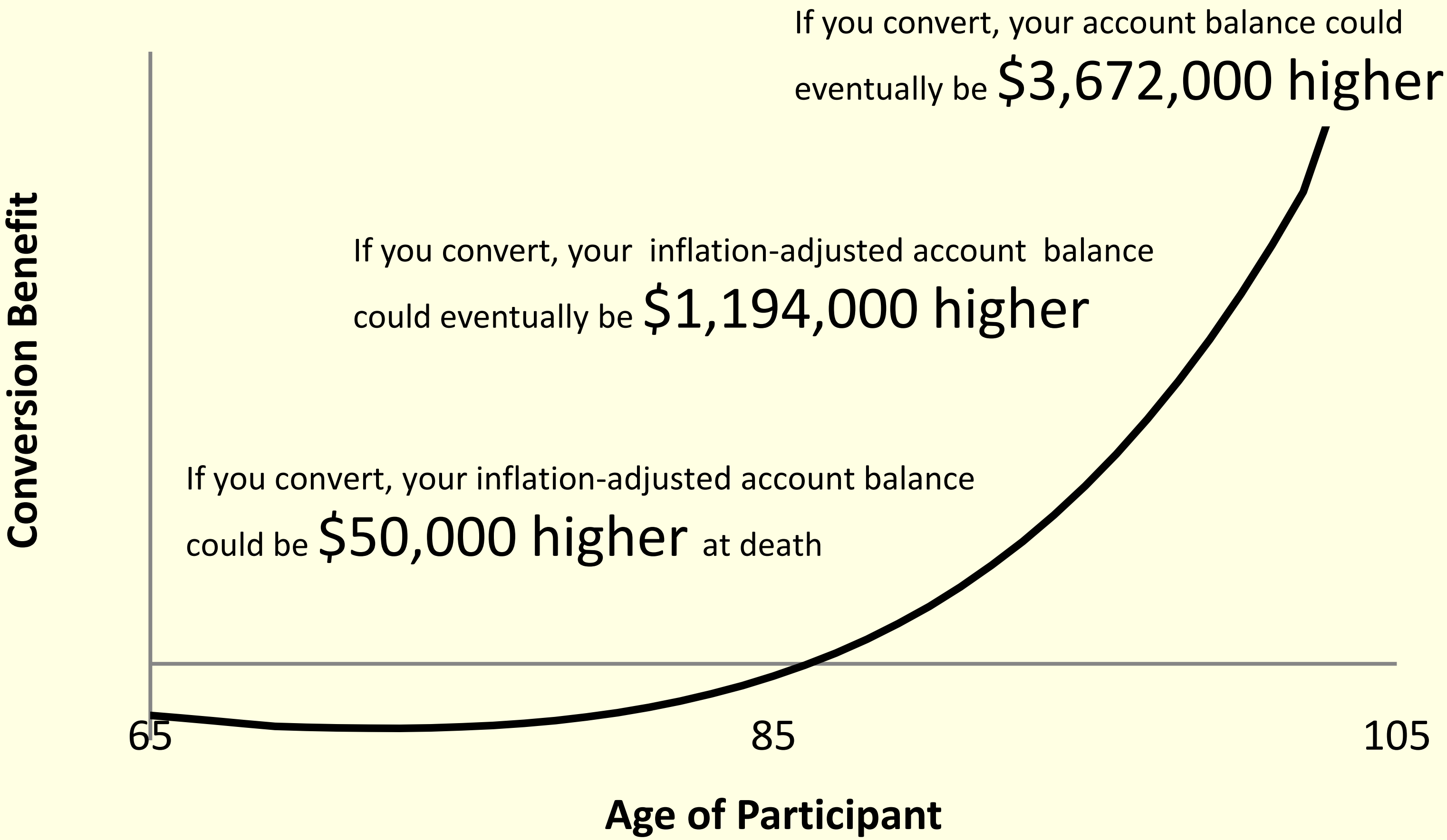
- Modeling Risks
  - Neglecting mortality and inflation overstates benefits.
  - Assuming an effective tax rate misstates benefits.
  - Neglecting surplus resources understates benefits.
- Return Variation Risk
- Policy Risks
  - Repeal of RMD, Social Security and Medicare exemptions
  - Require rapid distribution of inherited IRAs

Brokerage Firm Calculator 5/28/2010

$1MM Conversion, age 65 female, 30% tax

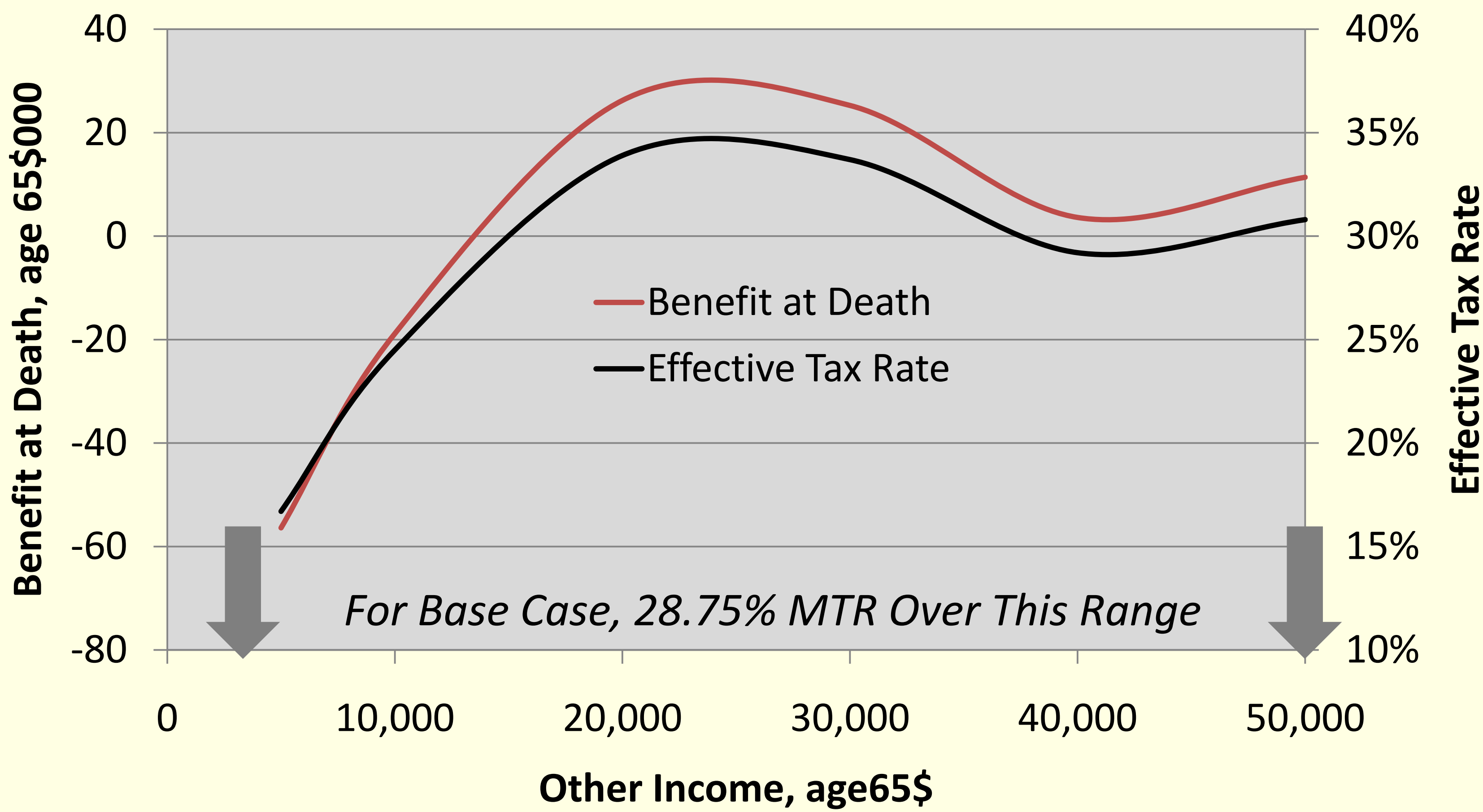


Inflation Discounting, Mortality Weighting



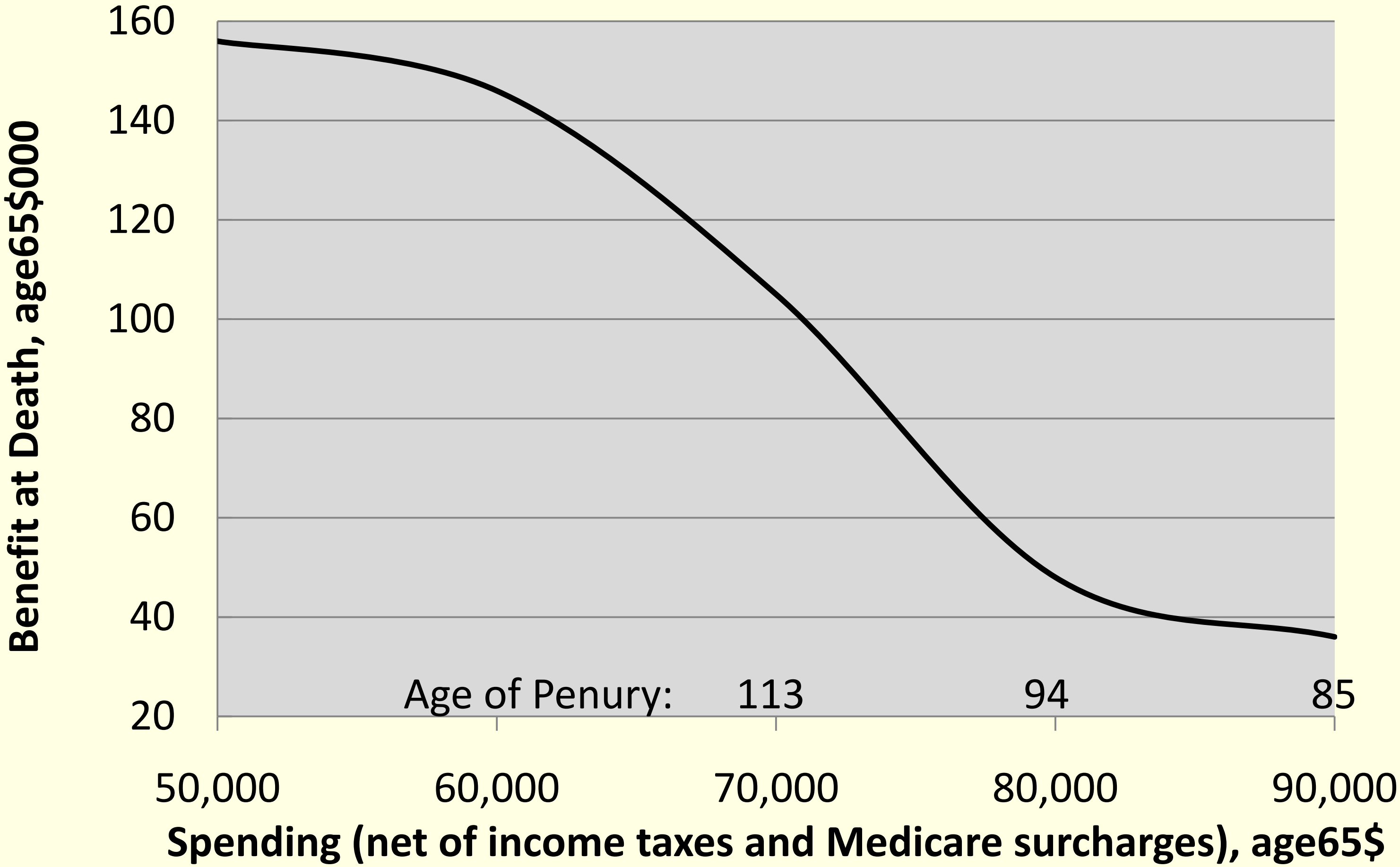
Estimate Taxes from Income Forecast

$400,000 IRA, age 65 female, $20,000 Social Security



Benefit Depends on Spending

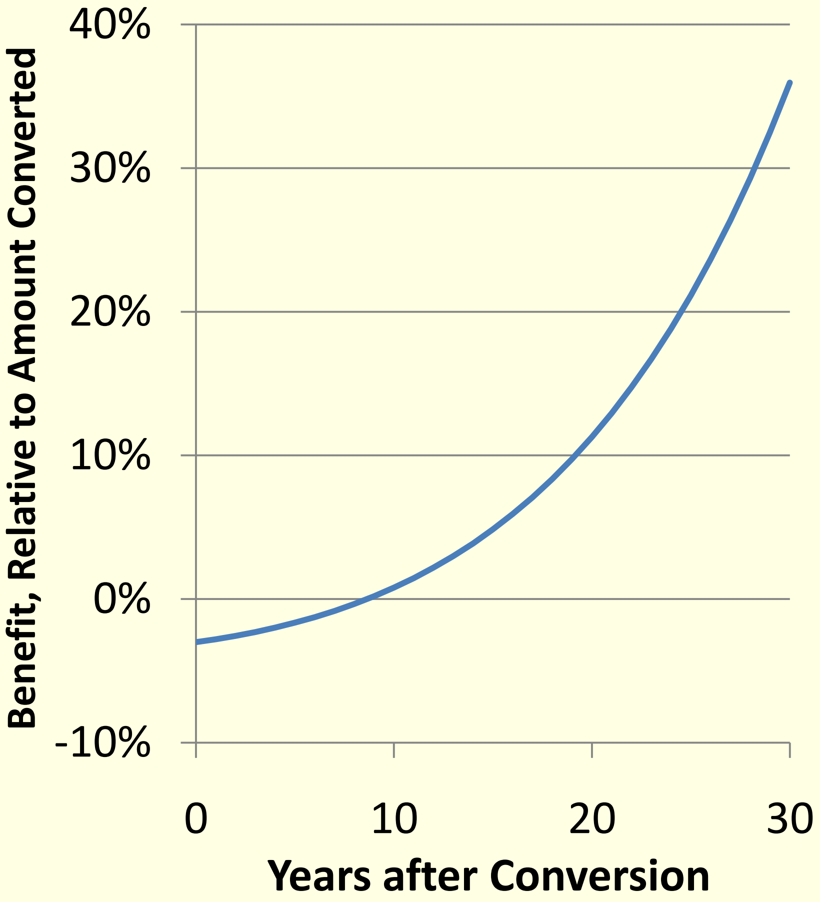
$400,000 Conversion, age 65 female



Conversion Benefit Without Distributions

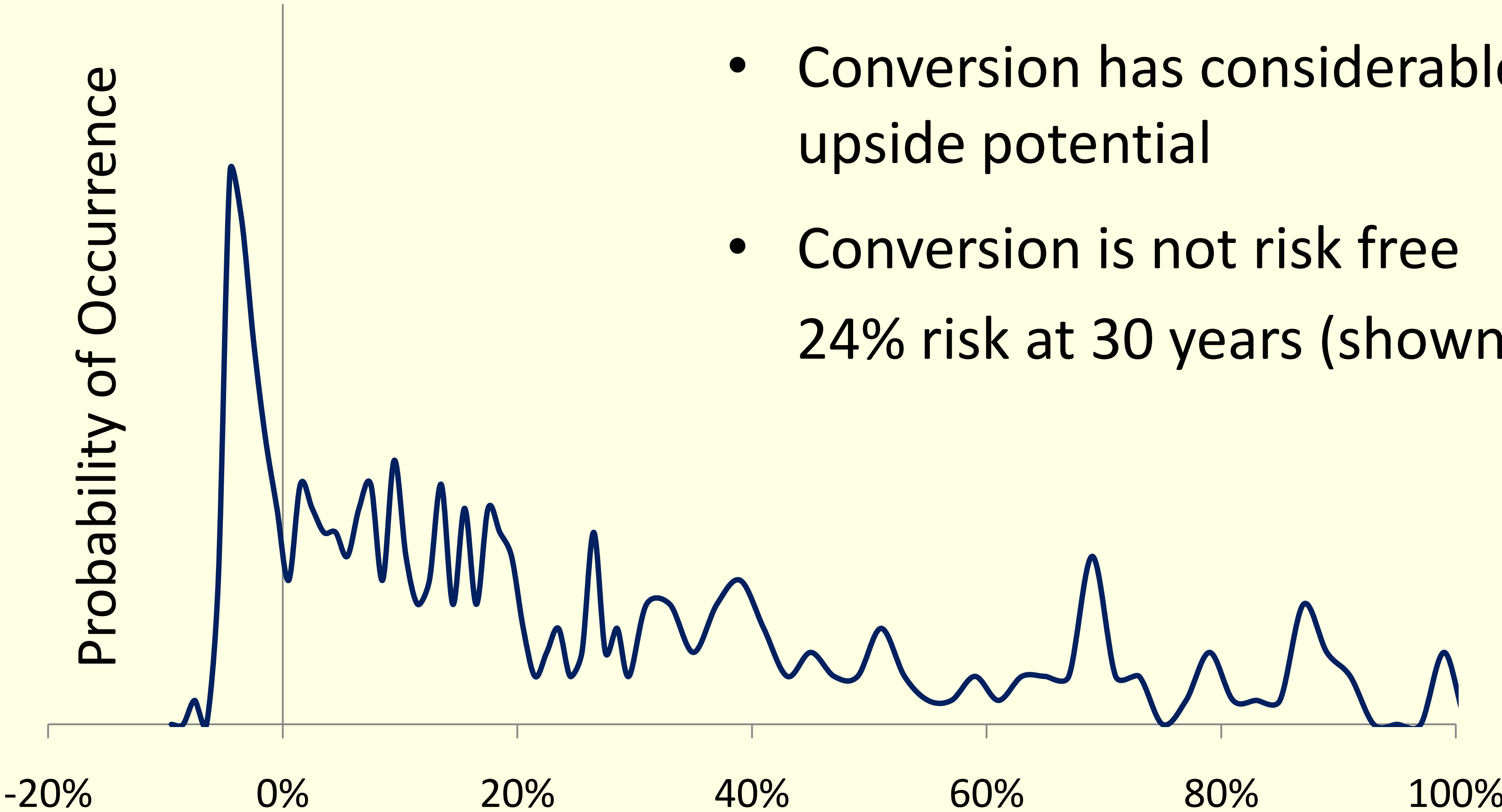
Illustration:

- 6% return net of inflation & expenses
- 32% Conversion Costs
- 29% Tax in Retirement
- 4.8% after-tax return on Conversion Costs
- Benefit is inflation-adjusted and after-tax



Modeling Return Variation

No Distributions, 6% return, 16% standard deviation



- Conversion has considerable upside potential
- Conversion is not risk free

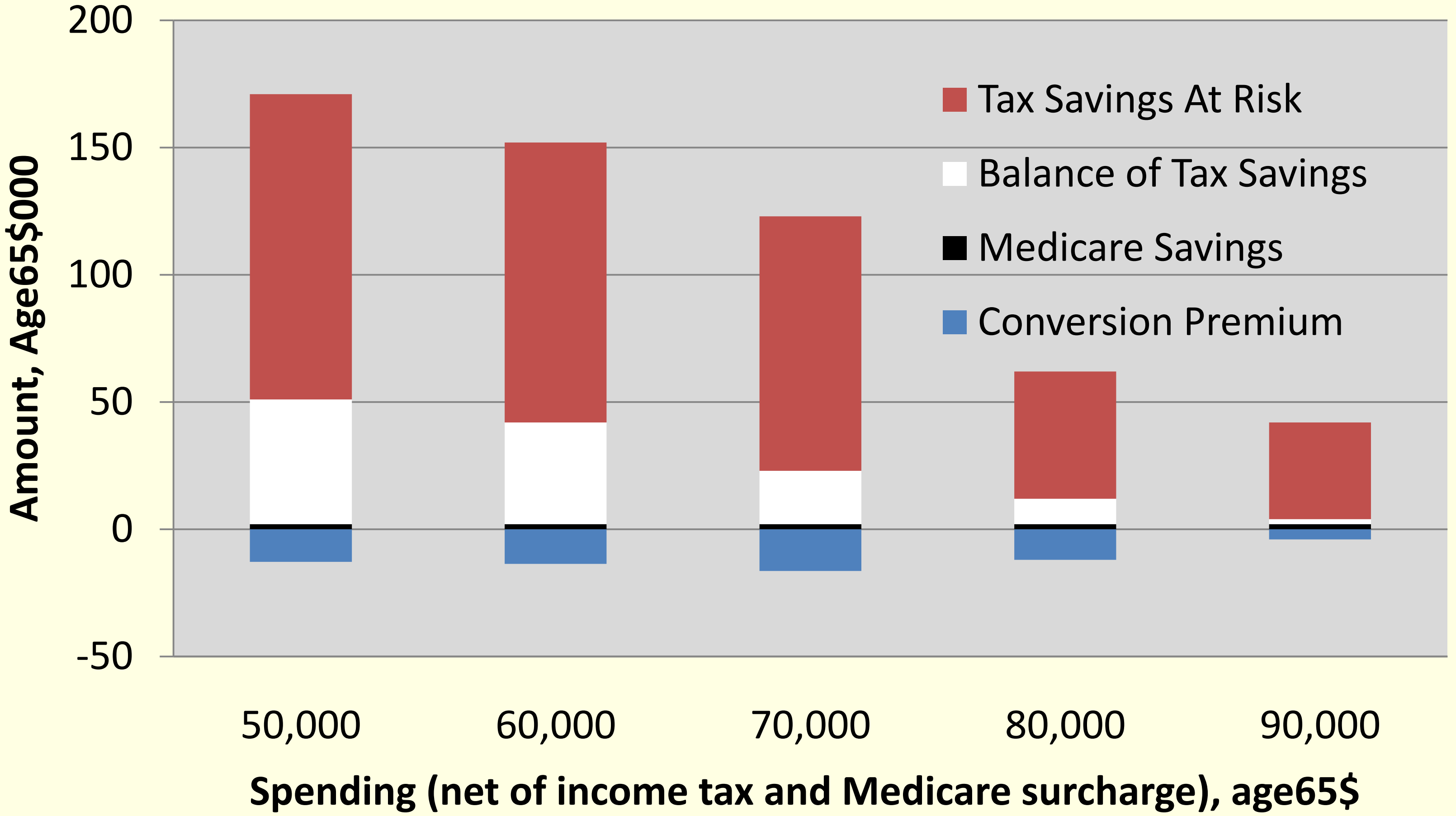
  24% risk at 30 years (shown)

Conversion by Younger Participants

- Considerable upside potential and some downside risk.
- Opportunity costs.
- Event risks.
- It is better to enhance returns; can do both!
- Delaying conversion may be the better choice.

What is at Risk if RMD Policy Changes?

$400,000 Conversion, age 65 female



Available Calculators Have Limitations

	Brokerage Firm - free	CCH Roth IRA Conversion Evaluator $595	Brentmark Retirement Plan Analyzer $595
Deflate cash flows	No	No?	No
Mortality weighting	No	No	No
Estimate tax from income	No	No	No
Spending and income	Yes	Yes	No
Return variation	No	No	No
Policy changes	No	No	No
Capabilities determined	5/28/2010	Review	Demo version

Higher Priorities

- Is your customer sacrificing his standard of living to make his children rich or *alma mater* proud?

  Might it be better to gift surplus assets to family or to charity during life?

- Rooting out unnecessary investment expenses and optimizing asset allocations will provide comparable benefits with lower risk.

- Confirm IRA beneficiary designations and estate planning documents.

Practical Considerations

2010 is Special

- AGI limit, which had prevented conversion by higher income taxpayers, have been repealed.
- Taxes are probably going to increase; conversion costs are probably higher in the future.
- Can defer half of conversion income to 2011 and half to 2012 or can elect to report all income in 2010.

  Determine what is best for your customer.

  Delay decision to October 2011.

Practical Considerations
Recharacterization

- A Roth conversion can be undone for any reason.
- Trustee-to-trustee and must recharacterize earnings.
- Cannot reconvert before the later of thirty days or the beginning of the next tax year.
- The deadline is October of the year after the conversion, assuming a timely filed return.

  An extension request must include a bona fide and reasonable estimate of the tax liability based on all information available at the time of the request.

Practical Considerations
Timing of Federal Tax Payments

First Conversion Year

- Avoid interest on underpayment by paying 100/110% of the prior year's tax in equal quarterly estimates.
- Delaying full tax payment to October costs about 5% in interest and penalties, absent recharacterization.

  Penalties are avoided by paying at least 90% of the tax liability by April 15th.

Year After Conversion

- Avoid interest on underpayment by paying 90% of the current year's tax in equal quarterly estimates.

Practical Considerations
Inherited IRAs

- A beneficiary must distribute a traditional or Roth IRA within five years of death; or

  Begin distributions within one year of death. Annual required distribution are usually based on the beneficiary's life expectancy.

- A beneficiary cannot convert an inherited traditional IRA to an inherited Roth IRA.

- A spouse can finesse these rules by electing to be treated as the owner rather than as the beneficiary.

Practical Considerations

Mechanics of Conversion

- Converting to a Roth IRA with the same custodian has the least risk.
- Converting to a Roth IRA with a new custodian should be satisfactory.
- Rolling a distribution from a traditional IRA over to a Roth IRA within 60 days is not recommended.
- Do not consolidate accounts or close the traditional IRA until after the recharacterization deadline.
- Consider separate conversions of each asset class.

Conclusions and Recommendations

Guidelines

- It is better to pay conversion costs from non IRA assets.
- It can be advantageous to reduce the conversion premium.
- Early conversions may be advantageous.
- Benefits can be attractive for those with surplus resources.

Conclusions and Recommendations

Provide Competent Advice

- Estimate taxes from income; discount for inflation and incorporate mortality risk.
- Evaluate policy and investment risks.

Priorities

- Comparable financial benefits can likely be achieved in other ways with lower risk.

For More Information

- Publication 590 “Individual Retirement Arrangements,” www.irs.gov.
- “Life and Death Planning for Retirement Benefits,” Natalie Choate, www.ataxplan.com.
- For further discussion, see www.lingane.com/tax/rothconversions.pdf.