



## The Roth Conversion Opportunity

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### *A significant change in the tax law in 2010*

In 2010 owners of traditional IRAs and eligible retirement plans may convert all or a portion of their IRA or plan into a Roth IRA. In prior years only owners with incomes under \$100,000 were eligible. Income tax is generally payable on the amount converted in the year of conversion. We recommend that you consult with your tax advisor to determine if paying taxes up front is worth the benefits provided by the Roth IRA, and we welcome the opportunity to help you in the process. The following is a general guide to introduce you to the concept and is not a substitute for the personal advice of your tax professional.

### **Does it make sense for you?**

The first step is to answer the following questions:

**1. Do you have an eligible IRA or retirement plan?**

Only IRAs and certain plans can be converted. Most qualified retirement plans do not allow a conversion to an IRA until you retire or leave the company.

**2. Do you have sufficient cash savings outside of your Traditional IRA to pay the income tax on the conversion?**

If you need to use the funds within the IRA to pay the income tax on the conversion, you may not want to convert.

**3. If you convert, will you need to draw from the Roth IRA for living expenses, and if so, when?**

A Roth IRA is a powerful savings vehicle that is more compelling the longer it compounds tax free.

If you are concerned about running out of money in retirement, you probably do not want to accelerate the payment of income taxes.

**4. Do you expect to be in a higher or lower tax bracket in your retirement years?**

With the ever changing tax laws, this question may be difficult to answer. If your income tax bracket in retirement is likely to be lower than today, you may want to maintain the status quo, keep your traditional IRA, and take payments as required over your life expectancy starting at age 70½.

### **Who Should Convert?**

#### **The Most Compelling Case: Future Generation Strategy**

If you have significant assets outside of your IRA and think it unlikely that you will ever need to draw on the Roth IRA, you are a good candidate for conversion. The Roth IRA can be a home run if you are interested in maximizing the wealth passing to future generations. Since you are not required to withdraw funds from the Roth during your life and your beneficiaries can extend payments over their life expectancy, the tax free compounding benefit can be staggering. Paying the income tax now has the added benefit of reducing your estate if you are subject to estate tax.

#### **What is a “traditional” IRA?**

For most people, an account funded with pre-tax contributions or a rollover of a pre-tax account, like a 401k. The concept is to set aside some compensation income to accumulate tax free and avoid paying income tax in your earning years. When you withdraw funds in your retirement years, you pay the income tax on those earnings when presumably you are in a lower tax bracket. You have to start withdrawing from your IRA at age 70 ½.

#### **What is a Roth IRA?**

An account funded with dollars on which you have already paid income taxes. The Roth IRA also accumulates tax free, but in a significant difference, all “qualified distributions” are not taxable. In addition, with the Roth IRA the owner (wage earner) does not have to take any withdrawals during life. The Roth IRA can stay intact, grow through the power of compounding, and has a minimum distribution requirement only for the beneficiaries after the owner is deceased.

Traditional (or rollover) IRA	Roth IRA
Defer income tax until you withdraw funds	Pay tax up front: funded with after tax dollars
Income earned within the IRA is tax deferred until withdrawn	Same but not taxable upon withdrawal either
Have to take it out gradually starting at age 70 1/2	Wage earner not required to make withdrawals
Incur 10% penalty if take money out before age 59 1/2 with some exceptions	Same but fewer exceptions. Must have a Roth for 5 years to have a "qualified distribution".

### A Strong Case: Managing Your Income Tax Bracket Strategy

Some clients with a significant portion of their total assets in their Traditional IRA are in a low income tax bracket, because they are not yet age 70½ and required to make withdrawals. Converting some or all of their IRA and paying income taxes at today's income tax brackets may be the best choice, as the required distributions from the Traditional IRA after age 70½ will push them into a higher income tax bracket. If tax brackets increase in the next few years, this strategy will be even more compelling. Clients with unusually large tax deductions may be able to convert at very little tax cost.

### Other Key Points

**Caution: The 10% Penalty.** You should be careful if you are under age 59½ and might need to use the Roth IRA funds within 5 years of conversion. The withdrawal may be subject to an additional 10% penalty.

**Tax can be paid over two years.** If you convert some or all of your Traditional IRA to a Roth in 2010, the tax due on the conversion can be deferred. Half the income can be reported in each of 2011 and 2012, instead of 2010. Taxpayers should be careful though, as income tax rates are scheduled to increase in 2011.

**Undo it: Re-characterization.** If the value of the Roth IRA falls between when you convert in 2010 and October 15, 2011, you may want to reverse the entire conversion and start the process again, paying the income tax on a lower conversion value. You have to wait until a new calendar year and not less than 30 days before you can begin the conversion process again. There are also some traps that might prevent re-characterization, so be sure to talk with your tax advisor before you convert. We would not encourage wholesale conversions just because the process can be unwound.

**Your estate plan.** If you convert a portion or all of your IRA to a Roth, be sure that your estate plan is reviewed for any changes. Some estate plans leave all IRAs to charity, and you probably do not want your Roth IRA to go to charity.

**State income taxes.** You should be careful to check the state tax treatment of any conversion. The states may have less favorable treatment.

### Conclusion

The tax law change will allow many more individuals to enjoy the benefits provided by the Roth IRA. Some of these benefits are so compelling it would not be surprising to see Congress remove this option at some point. For those able to take advantage, the Roth IRA can be a great vehicle to pass wealth to future generations as well as a tool to use the lower income tax brackets. Even if the benefit to you is small, you may want to consider rolling over a small amount of your traditional IRA to a Roth to start the clock on the five year premature distribution rule. Especially for clients with a large portion of their assets in IRAs and other employee benefit plans, the Roth can provide some diversification and flexibility. Please let us know if we can help in any way.

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