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NEW ROTH CONVERSION OPPORTUNITIES: IS CONVERTING A TRADITIONAL IRA, 403(B) OR 401(K) A SMART MOVE, UNWISE OR MUCH ADO ABOUT NOTHING?

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EXECUTIVE SUMMARY

Roth IRA, Roth 403(b) and Roth 401(k) accounts are essentially mirror images of their traditional counterparts. Instead of offering income tax deferral on funding the accounts and income taxation on withdrawal from the accounts, the Roth accounts allow no income tax deferral benefits when assets are contributed to the accounts, but can allow for income tax-free appreciation inside the accounts and tax-free distributions from the accounts. Recent tax law changes create an opportunity to consider converting a traditional retirement account to a Roth account for many who historically have been unable to take advantage of this planning opportunity due to the significant income limitations imposed on such a conversion. Beginning in 2010, the income limitations that have been in place since the inception of the Roth IRA will be eliminated so anyone with a traditional IRA, 403(b) or 401(k) plan will now be able to make a Roth conversion. While the decision to convert to a Roth account can provide tax savings for some, it is not a wise move for all. The purpose of this *Trends and Issues* is to discuss the factors that should be considered in determining if the conversion of a traditional IRA, 403(b) or 401(k) to a Roth account is a smart move, unwise, or much ado about nothing. Typically the most important factor is a comparison between the marginal income tax rate in the conversion year and the marginal income tax rate in the withdrawal year if not converted, where this latter tax rate is usually a tax rate from a retirement year. If your future income tax rate is anticipated to be higher, converting to a Roth may be appealing, but if you anticipate your future income tax rate to be lower, converting may be unwise.

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HISTORY OF ROTH ACCOUNTS

Roth IRAs first became available to taxpayers in 1997. With the inception of the Roth, Congress effectively created a mirror image of the traditional IRA: contributions to a Roth IRA are never deductible, but the returns are income tax-free.

Since the Roth IRA's inception, it has grown in popularity. In 2006, Congress helped add to this popularity when it combined the features of the Roth IRA with the traditional 403(b) and 401(k) plans by implementing the Roth 401(k) and Roth 403(b) accounts. Because the Roth 403(b) and Roth 401(k) accounts allow much larger annual contributions than a Roth IRA - $16,500 (or $22,000 if over age 50) in 2009 for a Roth 403(b)/Roth 401(k), compared with just $5,000 (or $6,000 if over age 50) in 2009 for a Roth IRA - there has been a significant increase in the amount of funds inside all Roths since 2006.

Roth accounts can be established in one of two ways. Contributory Roth accounts are those originally established by making regular contributions to a Roth IRA, Roth 403(b) or Roth 401(k) plan. Since contributions to a Roth account are not deductible for income tax purposes, you pay taxes on these funds in the contribution year. Stated differently, contributions to a Roth account are made with after-tax dollars. By contrast, a Roth conversion is the act of taking pre-tax funds from a traditional IRA, 403(b) or 401(k) account and electing to affirmatively convert these funds to a Roth IRA, Roth 403(b) or Roth 401(k) account. Since the conversion of a traditional account to a Roth account is treated as a distribution of the converted amount for income tax purposes, the amount converted is included in your gross income except to the extent it is treated as a return of your investment in the plan (i.e., if you made non-deductible contributions, those are generally not subject to income tax upon conversion). In the year of the conversion, all converted tax-deferred amounts are subject to income tax; however, thereafter (as with all Roth accounts) the earnings inside the account and distributions from the account can occur income tax-free.

Prior to 2010, not all individuals are allowed to elect a Roth conversion. The tax code has historically imposed certain income limitations on those who can make such an election. To make the election, you must have modified adjusted gross income of $100,000 or less and must file your income tax return as either single or married filing jointly (the same income limitation applies to both statuses).[1]

In 2010, all previously imposed income limitations on who may elect to convert a traditional IRA, 403(b) or 401(k) account to a Roth account will be removed; there will no longer be an income limitation or a filing status restriction on your eligibility to elect a Roth conversion.

These historic income limitations have prevented many individuals from being able to convert a traditional account to a Roth account. As such, a significant percentage of existing Roth accounts consist of "contributory Roth" accounts. As the income limitations for a Roth conversion are removed in 2010, it is anticipated that the amounts inside all Roth accounts will again swell in 2010 and thereafter as more individuals elect to convert large traditional accounts to a Roth account.

1 To calculate your modified adjusted gross income, begin with your adjusted gross income ("AGI") and subtract any income resulting from the Roth conversion. Then subtract any amount included in AGI by reason of a required minimum distribution from an IRA or traditional plan. Next, add your and your spouse's full Social Security benefits. Next, any miscellaneous deductions and exclusions are added if they were claimed in your AGI (e.g., deduction for traditional IRA contributions, student loan interest expenses, tuition expenses, foreign earned income and housing costs, income resulting from redemption of U.S. Savings Bonds (Series EE) used to pay higher education expenses, deduction for passive activity losses, and qualified adoption expenses paid by your employer).

DIFFERENCES BETWEEN TRADITIONAL AND ROTH ACCOUNTS

Traditional IRAs, 403(b)s, and 401(k)s are typically income tax-deferred retirement accounts funded with pre-tax dollars. Funds in traditional accounts grow tax-deferred until distribution. Distributions are taxed as ordinary income (except to the extent they represent a return of your basis in the account), and withdrawals made before age 59 ½ generally subject to an additional 10% penalty tax.[2] You must generally begin taking distributions from your traditional account when you reach your required beginning date ("RBD"). The RBD for a traditional IRA is April 1st of the calendar year following the year in which you attain age 70 ½. The RBD for your qualified plan (such as a 403(b), 401(k) or 457 plan) is generally April 1st of the calendar year following the later of: (a) the calendar year in which you attain age 70 ½, or (b) the calendar year in which you retire from employment with the employer maintaining the plan.[3]

In contrast, because you have already included contributions to your Roth IRAs, Roth 403(b)s, and Roth 401(k)s in your gross income, withdrawals of contributions from these accounts are always tax and penalty-free. However, withdrawals of investment earnings and growth from these accounts may be subject to a penalty and/or tax unless the individual meets two requirements.

The first requirement is that you must be at least age 59 ½ before taking a distribution from your Roth account. If this rule is met, then there will never be a penalty assessed on the distribution. The second requirement is the 5-year rule, which mandates the length of time that you must leave assets inside the Roth account. If this rule is not met, then the earnings on the account are all subject to income tax in the year of withdrawal. If neither of these rules are met, then the distribution may be subject to both a 10% penalty and income tax on the earnings.

Application of the 5-year rule differs between a Roth IRA and a Roth 403(b) or Roth 401(k) account. For all Roth IRAs, the 5-year rule begins on January 1st of the first year that the initial contribution was made to any Roth IRA. All Roth IRAs are essentially aggregated for this purpose.[4] For Roth 403(b)/Roth 401(k) accounts, each plan has its own 5-year rule (even if the same employer maintains the plans). If the individual has multiple Roth 403(b)/Roth 401(k) plans, these plans cannot be aggregated for purposes of the 5-year rule. There is one exception to this rule–if you rollover your entire Roth 401(k) or Roth 403(b) plan by direct rollover to another Roth 401(k) plan or Roth 403(b) plan, the starting date for whichever account is older begins the holding period for purposes of calculating the 5-year rule. Finally, if you rollover your Roth 403(b) or Roth 401(k) plan into a Roth IRA, the 5-year period begins on January 1st of the first year you have any Roth IRA account, regardless of whether the Roth IRA held money rolled over from a Roth 403(b) or Roth 401(k) account.

The required minimum distribution rules also differ between Roth IRAs and Roth 403(b)/Roth 401(k) plans. With a Roth IRA, you are not required to take any distributions during your lifetime. After death, however, the beneficiary of your Roth IRA must begin taking minimum distributions. By contrast, if you have a Roth 403(b) or Roth 401(k) account, you are required to begin taking minimum distributions once you reach your RBD (where the RBD is the

2 There are several exceptions to the 10% penalty that may apply if you take a distribution from your traditional plan prior to the age of 59 ½ including: disability, qualified higher education expenses, first-time home purchase, medical expenses and distributions in a series of substantially equal payments.

3 A 5-percent owner is someone who owns more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or if the employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest of the employer. If you meet the definition of a 5-percent owner, then your RBD is April 1 of the calendar year following the calendar year in which you attain age 70 ½ regardless of when you actually retire.

4 For example, if you placed $5,000 in a Roth IRA on November 20, 2010, and do the same each November thereafter, the 5-year rule is met on January 1, 2015. Monies contributed on November 20, 2014 can be withdrawn tax-free on January 1, 2015. In addition, keep in mind that if you convert a traditional plan into a Roth IRA on January 10, 2015, the converted assets can be immediately withdrawn tax-free because you have already completed the 5-year rule for every Roth IRA you will ever own.

same as the traditional 403(b) or 401(k) accounts listed above). As a practical matter, if your Roth 403(b) or Roth 401(k) plan can be rolled over to a Roth IRA, then you can avoid minimum distributions by rolling the account into a Roth IRA (where no minimum distributions are required during your lifetime).

WHAT IS A ROTH CONVERSION?

A Roth conversion is the act of moving funds from an existing traditional IRA, 403(b) or 401(k) plan to a Roth account. A conversion is a taxable event for income tax purposes. When you convert any portion of a tax-deferred traditional account, you are treated as accelerating the distributions on that account for the converted portion and accordingly, the income tax on those distributions is also accelerated to the year of conversion. You will have to pay income tax on the converted assets in the year of conversion (except to the extent the distribution represents a return of any non-deductible contributions). The tax is paid at your applicable income tax rate.

As we shall see, there are several factors that could influence your decision to convert funds. One major factor, usually the most important factor, is a comparison between the marginal income tax rate in the conversion year and the marginal income tax rate in the withdrawal year if not converted, where this latter tax rate is usually a tax rate from a retirement year. This factor is discussed next. Later, we discuss other factors that might influence your decision to convert.

COMPARING MARGINAL TAX RATES

If you convert funds in 2010, there is a special rule that allows you to spread the income tax recognition from the conversion in equal portions over a two-year period beginning with the tax year 2011. This means you will be able to choose between splitting the converted funds into equal halves and reporting each half as taxable income on your 2011 and 2012 income tax returns or reporting the income on all converted funds in 2010. For simplicity, we assume you choose to report the income for 2010. We later explain that choosing to pay all of the income tax in 2010 will usually be wise; however, we also discuss the option to split the income between 2011 and 2012.

In our comparison, you must choose one of two strategies. First, convert funds to a Roth IRA and pay taxes this year. Then invest the funds in a Roth IRA for n years at which time the funds are withdrawn and spent. Second, let the funds in the traditional tax-deferred account grow income tax-deferred for n years, at which time the funds are withdrawn. Taxes are paid, and the remaining after-tax funds are spent. As we shall see, you should compare your 2010 marginal tax rate with the marginal tax rate on these funds if you do not convert. This latter tax rate is the marginal tax rate n years hence, which is probably a retirement year. Alternatively, if you die before withdrawing the funds from your traditional account, the funds eventually will be withdrawn and taxes paid at your beneficiary's marginal tax rate. In either case, a key comparison is between the marginal tax rates today if you converted and the expected marginal tax rate at withdrawal in the future if you choose not to convert. (If the income is split between 2011 and 2012, then the first tax rate should be the average marginal tax rate in 2011 and 2012.)

Let's compare the after-tax future values of funds held in traditional tax-deferred accounts if converted today (to a Roth account) or if withdrawn from the traditional account in retirement. We initially assume the taxes are paid with the converted funds. For simplicity, let's assume you are deciding whether to convert \$10,000 of pre-tax funds in a traditional 403(b) today. Whether converted or not, we assume the funds will be invested in the same asset, which will earn r per year pre-tax rate of return for n years, and the funds will be withdrawn and spent n years hence. If converted, the after-tax value will be \$10,000 $(1-t)$ today and \$10,000 $(1-t)(1+r)^n$ in n years, where t is the 2010 marginal tax rate (or average of marginal tax rates for 2011 and 2012), r is the asset's pre-tax rate of return, and n is the length of the investment horizon. The underlying asset could be stocks, bonds, cash, mutual funds or any other asset. If not converted, the pre-tax value in n years will be \$10,000 $(1+r)^n$ and the after-tax future value will be \$10,000 $(1+r)$n $(1-t_n)$,

where t_n is the marginal tax rate n years hence. By comparison, the after-tax future value if converted is \$10,000 $(1-t)(1+r)^n$, while the after-tax future value if not converted is \$10,000 $(1+r)^n (1-t_n)$. If the 2010 marginal tax rate equals the withdrawal year marginal tax rate, $t = t_n$, then these two values are the same. If the 2010 marginal tax rate is lower, $t < t_n$, then you will be able to spend more on goods and services (i.e., have a higher after-tax balance in the accounts) by converting the funds to a Roth IRA today. If the 2010 marginal tax rate is higher, $t > t_n$, then you will be able to consume more goods and services by not converting the fund. Clearly, a key factor in the decision to convert funds is the comparison between the two marginal tax rates. As the following examples show, if your future income tax rate is anticipated to be higher, converting to a Roth may be appealing , but if you anticipate your future income tax rate to be lower, converting may be unwise.

Figure 1 illustrates the importance of the two tax rates in terms of their influence on the level of future spending or the net value of the account in after-tax dollars. Without loss of generality, let's assume you will withdraw the funds and spend them after the asset's cumulative pre-tax return is 50%. Column A indicates that if the federal-plus-state marginal tax rates are 25% today, t, and n years hence, t_n, then the after-tax future values will be the same. If not converted, the \$10,000 pre-tax grows to \$15,000 pre-tax in n years. At withdrawal, the after-tax amount is \$11,250. If converted, the \$10,000 pre-tax becomes \$7,500 after taxes in a Roth IRA in 2010. The funds grow tax-exempt and are worth \$11,250 after taxes in n years. In either case, the \$10,000 of pre-tax funds today will finance the purchase of \$11,250 of goods and services n years hence. In this example, you may look to other factors to be discussed later to decide whether to convert funds today. As we shall see, many, but not all, of these other factors suggest converting the funds today.

FIGURE 1
EFFECT OF TAX RATES ON DECISION TO CONVERT TO ROTH IRA

	COLUMN A		COLUMN B		COLUMN C	
	TRADITIONAL	ROTH	TRADITIONAL	ROTH	TRADITIONAL	ROTH
Tax Rate in Conversion Year	n/a	25%	n/a	30%	n/a	20%
Tax Rate in Withdrawal Year	25%	n/a	20%	n/a	30%	n/a
Pre-Tax Balance	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000
Tax on Conversion	\$0	\$2,500	\$0	\$3,000	\$0	\$2,000
Balance after Conversion	\$10,000	\$7,500	\$10,000	\$7,000	\$10,000	\$8,000
Withdrawal Amount	\$15,000	\$11,250	\$15,000	\$10,500	\$15,000	\$12,000
Income Tax on Withdrawal	\$3,750	\$0	\$3,000	\$0	\$4,500	\$0
Balance	\$11,250	\$11,250	\$12,000	\$10,500	\$10,500	\$12,000

Column B illustrates that if you have a lower tax rate at withdrawal, $t_n < t$, you should not convert funds to a Roth IRA today. In this example, today's tax rate is 30%, while the tax rate n years hence is 20%. If converted today, the \$10,000 of pre-tax funds will be worth \$10,500 after taxes n years hence, \$10,000(1-0.3)(1.5), where 1.5 denotes the cumulative 50% pretax rate of return. If not converted, the \$10,000 before taxes will be worth \$12,000 after taxes n years hence, \$10,000(1.5)(1-0.2). Clearly, if you expect to be in a lower tax bracket in retirement, you should seldom, if ever, convert funds to a Roth IRA today.

Column C illustrates that if you are in a lower tax bracket today than you expect to be in at withdrawal, $t < t_n$, you may have compelling reasons to consider converting funds to a Roth IRA today. In this example, today's marginal tax

rate is 20%, while the tax rate n years hence is anticipated to be 30%. If converted today, the $10,000 of pre-tax funds will be worth $12,000 after taxes n years hence, $10,000(1-0.2)(1.5). If not converted, the $10,000 before taxes will be worth $10,500 after taxes n years hence, $10,000 (1.5)(1-0.3). Clearly, if you expect to be in a lower tax bracket in 2010 than when assets may be withdrawn either in your retirement or by your beneficiary after your death, you should consider the advantages of converting funds to a Roth account.

If converting a traditional account to a Roth account is appealing, you should consider from which assets the income tax due on the conversion should be paid–from the converted funds themselves or from other after-tax assets. When possible, you should pay the taxes on the conversion with funds held in a taxable account outside the converted IRA, 403(b) or 401(k).[5] To understand why, let's return to the example in Column A except assume there is a separate taxable account containing $2,500 to pay taxes on the conversion. For simplicity, assume the pre-tax return on the underlying asset is 6% but its after-tax return if held in a taxable account for this taxpayer in the 25% tax bracket would be 4.5%. If the taxes are paid out of the Roth IRA, then the after-tax values of the Roth IRA and taxable account n years hence would be $7,500 (1.06)$n$ + $2,500 (1.045)$n$. If the taxes on the conversion are paid out of the taxable account then the after-tax value in n years will be $10,000 (1.06)$n$. That is, the taxable account is withdrawn this year to pay the taxes on the conversion, which leaves $10,000 in the Roth IRA. By paying taxes out of the taxable account, you keep more money in the tax-exempt Roth IRA to grow income tax-free. The higher-ending wealth when taxes are paid from the taxable account reflects the tax-exempt advantage of the Roth IRA.

In 2010, you may have a good idea what your 2010 tax rate will be (and a less clear idea of what the average of your marginal tax rates will be in 2011 and 2012). You will likely be more uncertain about what your tax rate will be in retirement. It is important to remember that you have some ability to control when the funds are withdrawn. Required minimum distributions set a minimum level of withdrawals, but you can try to time withdrawals beyond this minimum for years when you are in a low tax bracket. For example, if you have substantial medical expenses exceeding 7.5% of adjusted gross income then these deductible medical expenses may place you in a low tax bracket. By timing large withdrawals for such tax years, you may have some ability to control the future marginal tax rate, t_n.

OTHER FACTORS

As the preceding section illustrates, you should compare the marginal income tax rates in the conversion year with the anticipated marginal income tax rate in the withdrawal year when the funds will be spent. When one tax rate is anticipated to be much smaller than the other, this should help you determine whether conversion is desirable or undesirable. But when the anticipated tax rates are similar, you should consider other factors. This section discusses some of these other factors that may influence your decision to convert funds to a Roth IRA.

REQUIRED MINIMUM DISTRIBUTIONS

As stated previously, there are no required minimum distributions on a Roth IRA, while there are required minimum distributions from traditional accounts. Therefore, while required minimum distributions will eventually diminish the amount of funds in a tax-deferred retirement plan or IRA, Roth IRAs have the potential to keep growing larger over your lifetime.[6] This factor favors the conversion.

TAX DIVERSIFICATION

Most taxpayers have more funds in traditional retirement accounts that will eventually be taxed in future years than in Roth accounts. By converting some of the assets held in the traditional account, you can exercise what is referred

5 Note also that if you are younger than age 59 ½, you will likely incur a 10% penalty on any portion of the converted funds you use to pay the income tax liability. If you are older than age 59 ½, you can pay the tax from the converted assets without penalty.

6 Upon death, the minimum distribution rules do apply to the named beneficiary of a Roth plan, although qualified distributions to the beneficiary continue to be income tax-free.

to as "tax diversification." Having assets in both a traditional plan and a Roth plan allows you to better control how much cash flow comes from your pre-tax and after-tax sources during retirement. The funds converted will be taxed at the conversion year's tax rates, while the remaining assets held in the traditional account will be taxed at future tax rates. Since no one can be certain what will happen with future income tax rates, you may wish to convert some funds now and pay taxes at today's rates instead of retaining most funds in traditional retirement accounts, all of which will be subject to future tax rates. On a related theme, if you anticipate an increase in tax rates, you should, everything else the same, find conversion at today's tax rates to be relatively attractive.

BENEFICIARY CONSIDERATIONS

When deciding whether or not to convert, careful analysis should also be given to whom you have chosen as the beneficiary of your retirement accounts after your death. Pre-tax funds in traditional retirement accounts will eventually be subject to income taxes, either when you or, after your death, your beneficiary, withdraws the funds. If your beneficiary will be in a higher tax bracket at the time the assets are withdrawn than you would be at conversion, then you should consider converting your traditional account to a Roth account. For example, if you currently are at a 25% marginal tax rate and your beneficiary is anticipated to have a 35% tax rate, then $100 converted to a Roth will be worth $75 after taxes versus $65 if left for your beneficiary. On the other hand, if you plan to leave the traditional retirement account to a beneficiary with a lower tax rate than you would have at conversion then, everything else the same, you should not convert the funds to a Roth account. For example, if your beneficiary after your death is a charity, conversion from a traditional account to a Roth will not make sense; if the retiree has a 25% marginal tax rate, while the charity has a 0% tax rate, then $100 converted to a Roth account will be worth $75 after taxes to the retiree versus $100 if left for the charity.

SIZE OF MEDICARE PART B PREMIUM AND TAXATION OF SOCIAL SECURITY BENEFITS

Since funds converted from a traditional retirement account to a Roth account are counted as taxable income in the conversion year, a Roth conversion may affect the size of the Medicare Part B premium and the taxable amount of Social Security benefits. In contrast, withdrawals from a Roth IRA are tax-free (if the account has been in existence for at least five years and you are at least age 59 ½). This factor usually favors converting funds, especially if the conversion occurs before age 65 or before Social Security benefits begin.

ITEMIZED DEDUCTIONS

Taxpayers can deduct certain expenses to the degree they exceed a percent of Adjusted Gross Income. For example, medical expenses are deductible to the degree they exceed 7.5% of AGI. Business expenses, casualty losses, and investment expenses are also deductible to the degree they exceed a percentage of AGI. In the year of conversion, AGI is higher due to the extra taxable income. So, everything else the same, you may refrain from converting funds to a Roth IRA in years you plan to use these itemized deductions. Similarly, you may wish to convert funds in a given year when you will not have such itemized deductions. This factor could either encourage or discourage conversion in a particular year.

CONVERSION STRATEGIES

For most individuals who are just becoming eligible to consider a Roth conversion when the income limitation ceases to apply in 2010, the primary question will be should I convert or should I not. When that question is answered, if conversion makes sense, there are several conversion strategies to consider. This section examines a few of the more common strategies.

CONVERT TO TOP OF LOW TAX BRACKET

The decision to convert is not an all-or-nothing decision. A partial conversion may make sense. Suppose you have $100,000 of pre-tax funds in a traditional IRA that you can convert to a Roth IRA in 2010. You are financially healthy and expect to be in the 15% federal income tax bracket during your retirement years *given the current tax code*. However, you may be afraid there will be a general rise in tax rates, so you decide to convert sufficient funds each year to take your taxable income to the top of the 15% tax bracket. With the help of your tax accountant, you convert $20,000 in 2010. Furthermore, you plan to withdraw additional funds in 2011 and future years as long as the funds will be subject to a 15% or lower tax bracket. There are several good points about this strategy. First, you recognize that eventually the $100,000 will be subject to income tax. Your strategy allows you to withdraw the funds as long as the tax rate is "low" or, perhaps better stated, lower than you expect it to be in the future. You manage the embedded tax liability on the tax-deferred retirement accounts by withdrawing these funds in a tax-efficient manner. As this example demonstrates, this strategy may require a series of partial conversions each year. There is no limit in the number of times you can convert assets from a single plan in the same year.

Separately, this example also illustrates why we think most taxpayers should pay taxes on 2010 conversions in 2010 instead of splitting the income tax on the conversion between 2011 and 2012 tax years. In 2010, you convert $20,000 because this is the amount that would be subject to a low 15% tax rate. If this $20,000 is split between 2011 and 2012, you would likely have little idea if it will be taxed at 15% or 25% or perhaps another rate. Given the large deficits and budget uncertainty at the federal level, many people believe that individual income tax rates will be higher by 2011 and 2012 (at a minimum for taxpayers in the current top two brackets – 33% and 35%). This suggests tha–at least for taxpayers currently in the top two brackets, and maybe for all taxpayers – they pay the tax on the 2010 conversions on their 2010 income tax returns before tax rates rise. Similarly, in this example, you should plan your 2011 and 2012 conversions, if any, for those years when you have a good idea at what tax rate the conversions would be taxed. There is little benefit to deferring taxes for one or two years, and the option to split the withdrawal may cause you to lose the ability to withdraw funds to the top of a low tax bracket.

RECHARACTERIZATION

A recharacterization undoes a Roth conversion.[7] It has been called the "do-over option," offering a free second look to taxpayers who are considering a Roth conversion. A recharacterization can be exercised any time before the due date of your income tax return for the year of the conversion, including extensions. The extension date can be used for the recharacterization even if you timely filed your income tax return by April 15th.

Continuing with the above example, if you convert a $20,000 traditional IRA in early 2010 to a new, separate Roth IRA and a bear market decreases the account's value to $15,000, you can then recharacterize the Roth IRA, which changes these funds back into the tax-deferred traditional IRA account. The reasoning behind this recharacterization is that you do not wish to pay taxes on $20,000 of assets that are now only worth $15,000. Recharacterizations for 2010 can be made through October 15, 2011.

One of the most common reasons to reverse a conversion is that the portfolio's value has declined after the conversion to a Roth account. To apply the recharacterization strategy above, consider establishing a "new" Roth account to hold each year's conversion amount which is separate from any of your other Roth accounts. The advantage of having a "new" Roth account is that it is easy to identify the funds being recharacterized. If the funds are commingled with an existing Roth IRA account, the recharacterization process can become more complicated. After the expiration of the recharacterization period or October 15th of the year following the year of conversion, the funds in the new Roth account can then be transferred and combined with your other Roth IRA

7 The recharacterization must be made on a "trustee-to-trustee" basis instead of by rollover, the original contribution and net income must be transferred back, and irrevocable notice must be given to the plan trustee.

account if desired. Taking this strategy a step further, consider establishing a new, separate Roth account to separate assets. For example, if the $20,000 is split evenly between two mutual funds then each fund could be placed in a separate Roth account. This would allow you to recharacterize a fund that loses value, while not recharacterizing the fund that rises in value.

In terms of timing of the conversion, there is an advantage to converting funds early in the year. Suppose you convert $20,000 early in the year. If the asset rises in value, you will have more than $20,000 in the Roth account but only have to pay taxes on $20,000. If the asset falls in value, then you can recharacterize back to a traditional account for that year (and later convert the lower sum into a Roth account in a subsequent year). Recall the strategy where you wanted to convert sufficient funds to raise your taxable income to the top of the 15% tax bracket discussed earlier. A problem with converting funds early in the year is that you may not know how much should be converted to raise your taxable income to the top of the 15% bracket. One strategy to address this would be to convert more than enough to push you to the top of that tax bracket–say $30,000 early in 2010. Then, in 2011, when your 2010 income is known, you recharacterize $10,000 or whatever amount is necessary to set your 2010 taxable income at the top of the 15% tax bracket.

This example illustrates that there could be multiple reasons why a taxpayer may choose to recharacterize a Roth conversion. These reasons include a decline in the value of the converted asset and the conversion pushed the taxpayer into a higher income tax bracket.

After you recharacterize, you can re-convert to a Roth IRA again, but the re-conversion cannot occur until the later of (a) the taxable year following the taxable year of the original conversion, or (b) 30 days after the original recharacterization. Expanding on the example above, if you originally converted a $20,000 traditional IRA on January 30, 2010, and later recharacterized it after the value decreased to $15,000 on October 15, 2011, you would not be able to re-convert these funds until November 14, 2011.

NON-DEDUCTIBLE CONTRIBUTIONS

Income limits prevent many people from making tax-deductible contributions to a traditional retirement account. However, non-deductible contributions (subject to IRS limits) can generally be made to your traditional retirement accounts, even if you are a higher-income taxpayer. Suppose you make a non-deductible contribution of $5,000 in 2009 to a traditional IRA. These funds will grow tax-deferred until withdrawal or converted to a Roth IRA, at which time all deferred returns (i.e., the account assets in excess of the original $5,000 contribution) will be taxable as ordinary income. At withdrawal or conversion, only the deferred returns are subject to taxes, while the $5,000 basis can be withdrawn income tax-free.

This suggests a couple of unique planning opportunities for individuals who have made non-deductible contributions to their traditional plans. Consider Tom who is single and 55 years old. His 2009 AGI makes him ineligible to contribute to a Roth IRA or to make a deductible contribution to a traditional IRA. In late December 2009, he makes a $6,000 non-deductible contribution to a traditional IRA and files Form 8606, which tells the IRS that he made the non-deductible IRA contribution. Early in 2010, he converts these funds to a Roth IRA. If the market value at conversion is $6,000 or less, he would owe no taxes since the cost basis is $6,000. The strategy allows him to indirectly contribute to a Roth IRA for 2009.

There are a few potential complications to this scenario. At the end of 2009, suppose Tom had $14,000 of pre-tax funds in one traditional IRA plus the $6,000 non-deductible contribution in another traditional IRA. Ideally, he may wish to convert the $6,000 non-deductible amount. However, the IRS says when calculating the taxable and non-taxable amounts of a conversion, all of Tom's traditional IRAs are treated as a single IRA so that all withdrawals and conversions are taken on a pro-rata basis from taxable and tax-free funds in his traditional IRAs. So, if he

withdraws $6,000 from his traditional IRAs then it would be considered a withdrawal of $6,000 from accounts with an aggregate value of $20,000 ($14,000 + $6,000) – or 30% of the accounts' values. Applying this aggregate withdrawal percentage to each account, $4,200 ($14,000 * 30%) or 70% of the $6,000 withdrawal is considered taxable and $1,800 ($6,000 * 30%) or 30% tax-free (or Tom's return of investment).

Continuing with the above scenario, if Tom has an employer plan (401(k) or 403(b) plan), he may instead rollover from his traditional IRAs the taxable portion of all of his traditional IRAs ($14,000 in our example) to his employer 403(b) plan (assuming the plan allows for such), leaving him with just the non-deductible $6,000 contribution in his traditional IRAs. Tom can then convert the $6,000 traditional IRA to a Roth IRA and minimize or completely eliminate the tax impact of the conversion.

The calculation of taxable and non-taxable amounts of a conversion differ for a 401(k) or 403(b) plan. With these employer plans, the accounts are not aggregated for conversion purposes as they are with traditional IRAs so taxpayers can pick and choose from which accounts they wish to convert. For example, assuming Tom has a 403(b) plan with $14,000 of pre-tax funds and $6,000 of after-tax funds, Tom can choose to just convert the $6,000 non-deductible portion of his 403(b) plan to a Roth. This will also generally allow for a tax-free conversion.[8]

CONCLUSION

Recent tax law changes create an opportunity to consider converting a traditional retirement account to a Roth account for many who have been unable to do so previously due to the significant income limitations imposed on such a conversion. Beginning in 2010, the existing income limitations will be eliminated so anyone with a traditional IRA, 403(b) or 401(k) plan will now be able to make a Roth conversion. While the decision to convert to a Roth account can provide tax savings for some, it is not a wise move for all. Typically the most important consideration is a comparison between the marginal income tax rate in the conversion year and the marginal income tax rate in the withdrawal year if not converted, where this latter tax rate is usually a tax rate from a retirement year. If the future income tax rate is anticipated to be higher, converting to a Roth may be appealing, but if the future income tax rate is expected to be lower, converting may be unwise. When the anticipated tax rates are similar, other factors should be considered, such as required minimum distributions, tax diversification, beneficiary taxation, taxation of Social Security benefits, Medicare Part B premium amounts, and itemized deductions. If conversion makes sense, there are several conversion strategies to consider—converting to top of low tax bracket, recharacterization, and use of non-deductible contributions.

8 This specific strategy has only been blessed by IRS Private Letter Ruling 9840041. You should consult with your tax advisor prior to implementing this strategy.

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