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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

An individual may not convert an inherited IRA to a Roth IRA. However, the investor may convert an inherited 401(k) to an inherited Roth IRA

The most recent employment report indicated that 5.9 million Americans have been jobless six months or more. That is the highest number since records were kept in 1948,

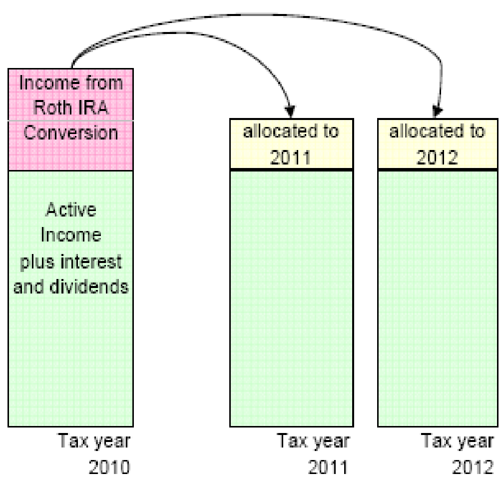
Roth IRA Conversions in 2010

Considerable attention has been paid to the window opening for Roth IRA conversions in 2010. Scheduled in a tax law enacted in May 2006, the rules on conversions will be opening up next month. Popular inquiry on the topic has increased. This article will address many of the opportunities and problems raised by expanded Roth IRA conversion options.

First let's define the mechanics of a Roth IRA conversion. An investor may convert some or all of his traditional IRA accounts, SEP-IRAs, 401ks, or 403b balances to a Roth IRA. These source accounts are tax-deferred. Ordinary income tax must be paid on any pre tax assets that are transferred. Once transferred, however, the gains on investments in the target Roth IRA account are free of tax. Someone undertaking a Roth IRA conversion is thus electing to pay taxes now in exchange for a tax holiday in the future.

Key Parts to the New Law

There are two key elements to changes in the law regarding Roth IRAs in 2010. The first is that eligibility to do a Roth IRA conversion will no longer be means tested. Income limits on conversion are *permanently* repealed. Since its inception in 1998, only families with incomes below certain levels have been allowed to contribute or convert funds to Roth IRAs. In 2010, the means test goes away for Roth IRA conversions and will not return. Notably, the means test remains in place for annual Roth IRA *contributions*.



The second important artifact of the new Roth IRA law is that taxes due on the converted assets can be distributed over the following two tax years – 2011 and 2012. In fact, that is the default tax treatment unless the investor opts to pay taxes in the 2010 tax year. A family can both income average and defer the income recognized from a Roth IRA. Sounds good at first glance …but caution should be exercised.

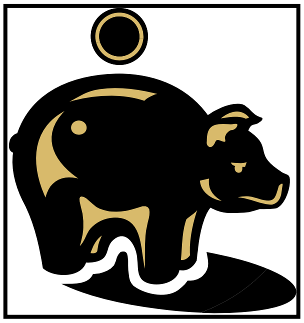
There is a high likelihood that tax rates will be going up in the near future. At some point, the massive fiscal stimulus the US economy has received will have to be paid for. Even if congress does nothing, the tax rate decreases implemented in the Bush administration will expire and higher rates will be reinstated after 2010. Today's top marginal tax rate will rise from 35% to 39.6% in 2011. Other tax brackets will shift upward across the board. The health care reform bill that passed the House in October included a 5.4% surtax on individual incomes in excess of $500,000. Even if the surtax does not become law, the handwriting is on the wall. Tax rates are going up after 2010.

That means that deferring income from 2010 to later years will probably place it in a higher tax bracket. There are some positives, however. The extra income is split into two equal pieces and may therefore keep the investor out of the next tax bracket. Secondly, the taxes are simply due later if they are allocated to subsequent tax years. Payments will be due in April 2012 and April 2013. The final tax bill on a conversion done on January 1st , 2010 will not be due in over 39 months!

Some Specific Roth IRA Conversion Strategies

There are other technical aspects to the Roth IRA conversion. Investors who convert to a Roth IRA can recharacterize or "negate" the conversion as late as October 15th of the following year. Some or all of the original amount may be sent back to where it came. IRA funds used to pay taxes may *not* be returned to the original account.

This last point reinforces a good financial planning rule. Pay taxes on Roth IRA conversions with outside funds. Remember earnings in a Roth are not taxed. It is desirable to keep these accounts as large as possible. Convert only enough tax-deferred assets so that you can pay the tax bill with cash on hand. Using funds from the



conversion to pay taxes will reduce the size of a key sheltered asset and will hamstring any effort to recharacterize it later.

Why might an investor want to undo a Roth IRA conversion? The most likely reason would be poor market performance. Suppose that an eager investor executed a Roth IRA conversion of all $100,000 of his eligible assets on January 1st 2010. By October 2011, the value of those assets had plummeted 40%. That is a scenario that invites recharacterization. The investor might be reluctant to pay a tax based on a $100,000 distribution for assets that are subsequently worth only $60,000.

"Using funds from the conversion to pay taxes will reduce the size of a key sheltered asset and will hamstring any effort to recharacterize it later."

For investors with larger IRA accounts, there may be some value in creating multiple target Roth IRA accounts – and segregating them by asset class. Why? There is a tax incentive keep the accounts that increase in value and recharacterize accounts that depreciate. By funneling like performing assets into multiple accounts we increase the likelihood that their respective performances will diverge.

The late recharacterization deadline allows us some hindsight to cherry pick accounts that have not performed well and revert them to tax deferred status. Consider an investor with a $1,000,000 IRA currently invested in 50% and 50% bonds with enough cash on hand to pay the taxes for conversion. This investor has a tax rate of 30%. If we split the conversion into two $500,000 accounts that are 100% stocks and 100% bonds, we can revert one or both accounts if investment progress is unsatisfactory.

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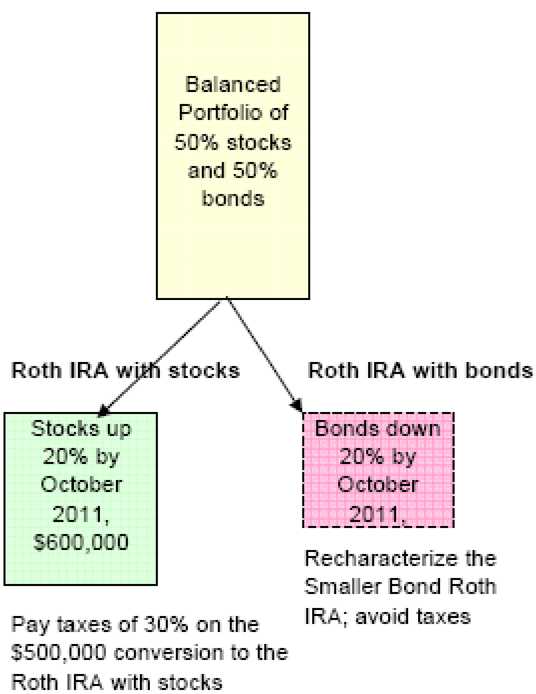
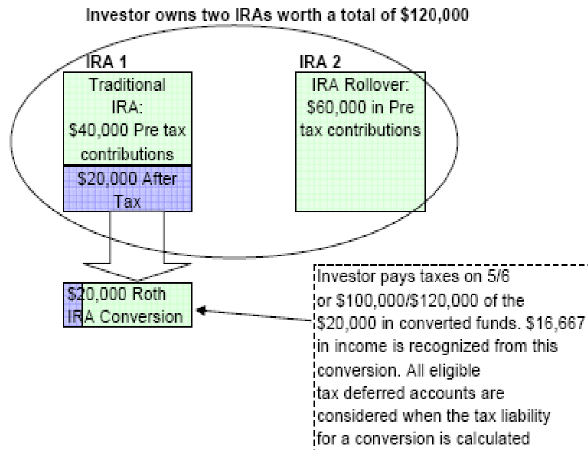


Note that the 30% tax payment occurs on a $500,000 tax liability for a total tax of $150,000. Yet the stock IRA is now worth $600,000 so the effective tax rate was 25%. The overall portfolio stayed the same in value – the two IRAs were collectively worth $1 million in October 2011. The investor uses the benefit of hindsight to negate the tax on the poorer performing asset.

Another detail is the pro rata rule. All IRAs are grouped together for the purposes of calculating the ratio of after tax contributions to total value. Any Roth IRA conversion, regardless of size or source account, is assumed to draw funds based on this ratio of pre and after tax assets. The pro rata rule prevents the investor from specifically designating after tax contributions for roll over to a Roth IRA to minimize or eliminate the tax liability. Consider the illustration below:



We pointed out earlier that the means test for Roth IRA contributions remains in place in 2010 and beyond. However, there is a way around this restriction. A high income earner may continue to make a non-deductible *traditional* IRA contribution in 2010 and beyond. The next day, this traditional IRA could be converted to a Roth IRA under current law.

Through this two step process, high income earners can effectively fund a Roth IRA without tripping the means test restrictions. Congress is aware of the loophole and may decide to either close it or simply abolish the means test. It remains a viable strategy as of this writing.

There are some interesting opportunities that will present themselves in the new year. We hope that you spend some time on the issue of Roth IRA conversion. It may add some value to your investment portfolio.