TRUEPOINT INCORPORATED Wealth Counsel.

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To Roth or Not to Roth

A discussion of the 2010 Roth IRA conversion opportunity

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Introduction

- **Roth IRA Tax Law Change – January 1, 2010**
  - “Permanent” repeal of the $100,000 adjusted gross income limit
  - Separate status ‘threshold’ has been repealed

- **Increasing Taxes**
  - Most marginal tax rates are scheduled to increase 1/1/2011
  - Favorable tax rates are scheduled to increase on 1/1/2011
    - Qualified dividend rate – currently 15%; could be taxed at marginal rates
    - Long term capital gains rate – currently 15%; could increase to a minimum of 20%

- **Favorable Portfolio Valuations**
  - Relative portfolio value may still be depressed

- **Focus on Re-establishing Financial Security**
  - Roth IRAs facilitate wealth accumulation and transfer

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What Do the 2011 Tax Rates Look Like?

Marginal Tax Rates

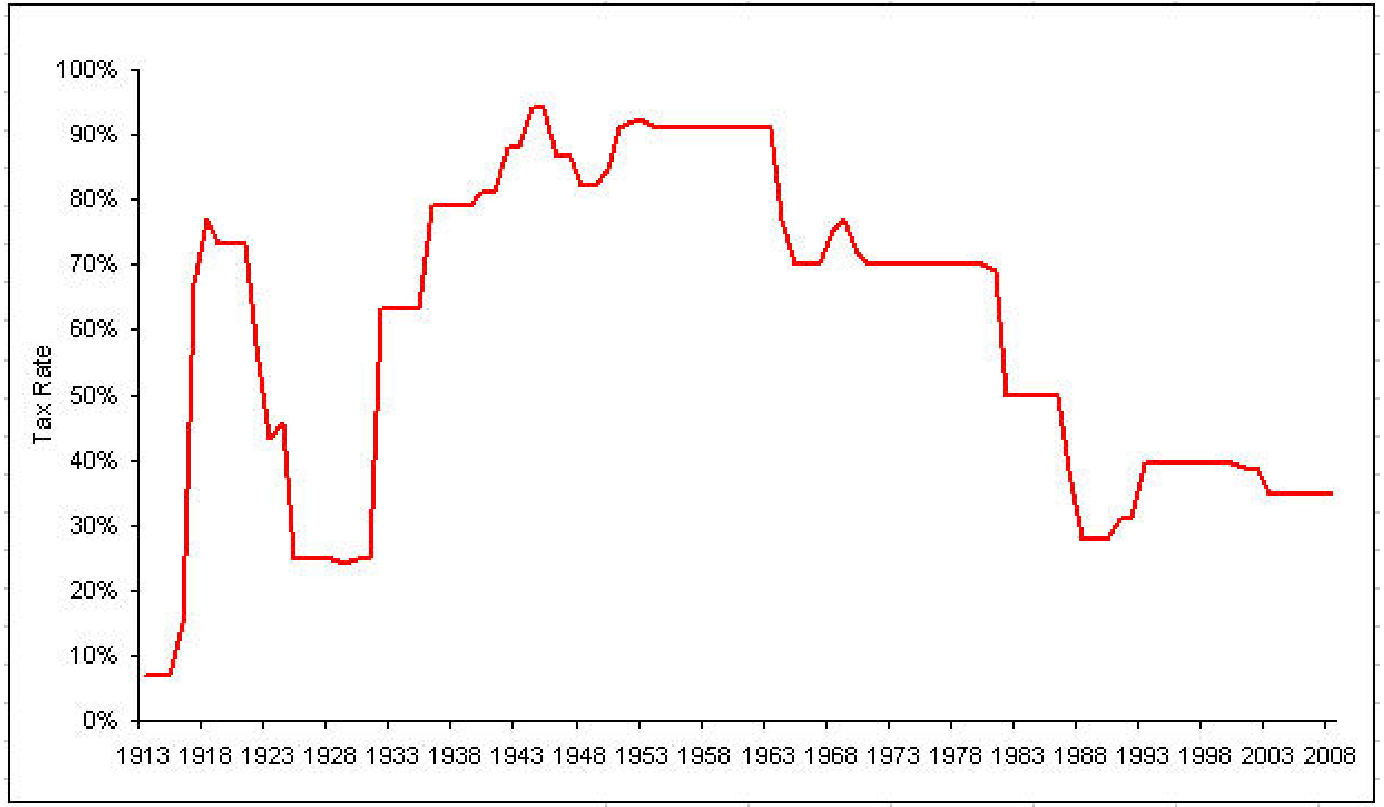
- The rate charged on the last dollar of income
- Critical part of a progressive tax system
- Often called ‘ordinary income tax’
- Applies to wages, IRA distributions, pensions, interest, etc.

2010 Rate	Scheduled 2011 Rate
10%	NA
15%	15%
25%	28%
28%	31%
33%	36%
35%	39.6%

For an individual in the 33% marginal bracket taking $200,000 from a traditional IRA will cost an additional $6,000 of federal tax in 2011.

How High Can They Go?

Historically speaking, our top federal marginal tax rate is low



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Objectives – To Help You Understand

- What is Roth IRA?
- What are its benefits?
- What is a Roth IRA conversion?
- Who should consider a conversion?
- Who should not consider a conversion?
- Can your decision be optimized?
- Are there other ‘paired’ strategies?

Roth IRA – What Is It?

A Roth IRA is…

- An Individual Retirement Account (IRA)
- Allowed under the United States tax law
- Established by the Taxpayer Relief Act of 1997
- Named for its chief legislative sponsor, Senator William Roth (dec.)
- Known most for its **tax-free** nature

A Comparison

Roth IRA

- Tax-free distributions
- Growth is tax-free
- Owners are exempt from required minimum distributions
- Non-spousal inheritors must take annual tax-free distributions
- No maximum age for making contributions
- Contributions are never tax-deductible

Traditional IRA

- Distributions are taxable
- Growth is tax-deferred
- Owners must take annual required minimum distributions
- Non-spousal inheritors must take annual taxable distributions
- Must be less than 70½ to contribute
- Contributions <u>may</u> be tax deductible

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What is it Really Worth?

A simple (and **incomplete**) comparison:

$1 million Roth vs. $1 million Traditional			
Roth IRA Balance	$1,000,000	Traditional IRA Balance	$1,000,000
Income Tax Rate	0%	Income Tax Liability (35%*)	($350,000)
Net Roth Balance	$1,000,000	Net Traditional Balance	$650,000

*35% tax rate applied to traditional withdrawal

The challenge, and hence complexity, is getting the million moved from the Traditional IRA to the Roth IRA

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How To Fund a Roth

- **Annual Contributions**
  - Must have earned income
    - Can contribute the lesser of $5,000 or earned income
    - Non-working spousal contributions are permitted
    - Catch-up contributions of $1,000 for those over 50 are permitted
  - Adjusted gross income must be less than
    - $177,000 (joint filing status)
    - $120,000 (single and head of household filing status)
    - $10,000 (married filing separately filing status)

OR

- **Convert an Existing Account**
  - Existing traditional IRA
  - Pre-tax qualified plan (i.e. 401(k) plan)

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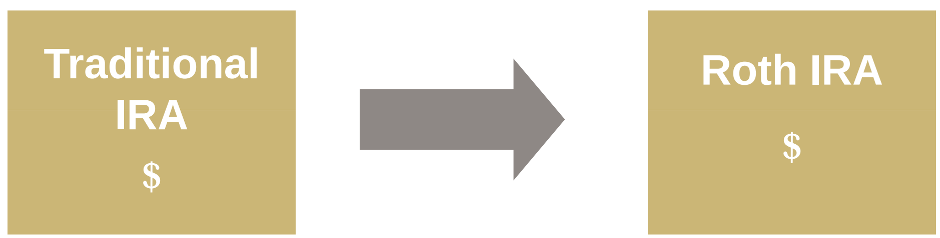
What is a Conversion?

A conversion is…

- A penalty-free transfer from a traditional IRA to a Roth IRA
  - Does not have to be the entire traditional IRA
  - Income taxes will be owed on the ‘taxable value’ of the converted amount



Concept:

Pay tax now, maximize wealth later

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The Costs of Conversion

Nothing is free:

- Income tax will be owed on the ‘taxable’ amount converted
- Conversion not considered ‘early withdrawal’ – no penalty
- 5-Year rule
  - If withdrawal within 5 years of conversion, the appreciation since conversion will be subject to tax and possibly penalty

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Taxes Owed on Conversion

Example:

- Tina Truepoint has a $100,000 traditional IRA with $0 basis
- She converts $100,000 to a Roth IRA in 2010
- She's in the 25% tax bracket

Before Conversion

Traditional IRA $100,000

Roth IRA $0

After Conversion

Traditional IRA $0

$100,000 →

Roth IRA $100,000

Tina will owe $25,000 of income tax

The 'Taxable Amount'

The 'taxable amount' is calculated as follows:

- The gross market value of the converted assets on the conversion date

  Minus

- The allocated basis

So, what is basis?

Basis is defined as:

- The sum total of all non-deductible contributions
- Required to have been reported on Form 8606
- Upon conversion, basis is allocated, prorata, to calculate taxable income

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Conversion Tax: Impact of Basis

The Easy Example:

- Tina Truepoint has a $100,000 traditional IRA with $40,000 basis
- She converts $100,000 to a Roth IRA in 2010
- She's in the 25% tax bracket

Before Conversion

Traditional IRA	Roth IRA
$100,000	$0

After Conversion

Traditional IRA	→	Roth IRA
$0	$100,000	$100,000

Tina reports $60,000 of taxable income and owes $15,000 of income tax

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Conversion Tax: Impact of Basis

The Harder Example:

- Tina Truepoint has a $100,000 traditional IRA with $40,000 basis
- She converts $50,000 to a Roth IRA in 2010
- She's in the 25% tax bracket

Before Conversion

Traditional IRA	Roth IRA
$100,000	$0

After Conversion

Traditional IRA	→	Roth IRA
$50,000	$50,000	$50,000

50% of the basis is allocated to the conversion
Taxable income on conversion = $30,000; ($50,000 - $20,000)
Tina will owe $7,500 on this conversion

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Paying the Conversion Tax

Consider paying the tax with:

- Non-IRA portfolio assets and savings
- Adjusted withholding on other sources of income
  - i.e. Wages, Required Minimum Distributions, etc.
- Short-term borrowings if expecting inflow of assets in near term
  - i.e. P&G optionees; 2002 grant expires in February 2012
- Parents and grandparents could gift cash to children and grandchildren to cover their tax
- Children could gift assets to parents to cover their tax

Do not pay the tax from:

- The converted IRA assets
  - Lost opportunity for tax-free growth
  - Would be subject to penalty if under age 59 1/2

2010 Dilemma/Opportunity

Taxpayers have a choice of when to report the conversion and thus, when to pay the tax:

- Report 100% of the conversion in 2010
  - Consider if 2011 and/or 2012 income is expected to increase
  - Consider if tax legislation significantly increases tax rates

Or

- Report 50% in 2011 and the remaining 50% in 2012
  - The default reporting position
  - Consider if your income is projected to decrease in 2011 and/or 2012
  - Consider if funds needed to pay the taxes will become available after the 2010 tax due date

In either case – estimated tax payment plan must be carefully developed to avoid penalty

You Can Take a Mulligan

Recharacterization – an unusual ‘un-do’ opportunity

- Changes the Roth IRA back into your Traditional IRA
  - As if the conversion never occurred
  - No taxes or penalties incurred
  - May result in a refund if estimated payment plan included the conversion income
  - For 2010 conversions, recharacterization deadline is 10/15/11
- The downside
  - Cannot re-convert until the later of 30 days from the date of recharacterization or the tax year following the original conversion

Consider if:

- Roth balance decreases dramatically after conversion
- Other taxable income unexpectedly substantially increases
- Your personal circumstances change and the Roth IRA is no longer appropriate

A Mulligan Example

Example:

- Within months of converting her $100,000 Traditional IRA, Tina's Roth IRA plummets from to $70,000
- She decides to recharacterize 100% of the conversion

Before the Recharacterization

Traditional IRA
$0

Roth IRA
$70,000

After the Recharacterization

Traditional IRA
$70,000

$70,000

Roth IRA
$0

No taxes will be owed as a result of the recharacterization

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Can You Re-Convert after Recharacterizing?

Yes:

- After meeting the required time limits, Tina decides to reconvert the $70,000 back to her Roth IRA
- In this example, we're keeping her tax rate at 25%
- Her taxes on this 're-conversion' are $17,500

Before the 'Re-Conversion'

Traditional IRA	Roth IRA
$70,000	$0

After the 'Re-Conversion'

Traditional IRA		Roth IRA
$0	$70,000 →	$70,000

Tina 'saved' $7,500 by un-doing the un-do

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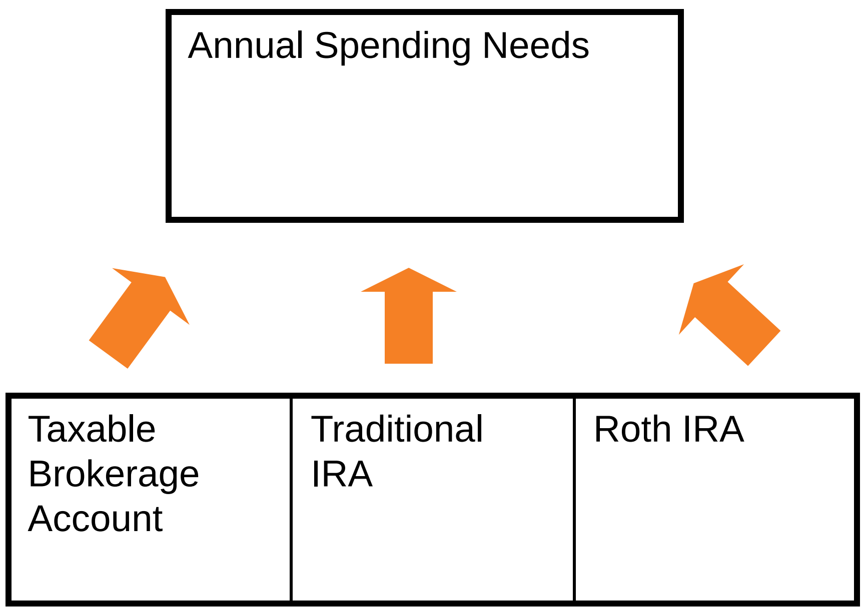
The Roth IRA conversion decision should include the following:

- Retirement income needs and sources
  - How will you fund your living expense needs?
  - Can you withstand the 5-year rule?
  - How much of your IRA is projected to be discretionary?
- Current and future income tax bracket expectations
  - Will your future tax rates be higher or lower?
  - Will your children's/grandchildren's tax rates be higher or lower than your rates?
- Is time on your side
  - How old are you?
  - Should the mortality expectation include that of your heirs?
- Non-retirement portfolio assets
  - Can you pay the tax with non-IRA assets?
- Estate legacy goals

Is tax diversification important to you?

Flexibility worst case created flexibility; changed future stuff change source of funding…..



Conversion Candidates

Ideal conversion candidates include:

- Believe tax bracket will be the same or higher when drawing income from retirement accounts
  - Tax bracket may be that of your heirs
  - Studies show that a benefit may still exist **even if your future tax rate decreases**
- Young individuals – account owner or beneficiaries
- Perennial high income earners (even into and through retirement)
- Wealthy families
  - Can leverage the law to maximize amounts left to heirs
- Those that are not projected to invade the converted accounts
- Can (**and are willing to**) pay the tax with assets other than the converted IRA
- The IRA basis is a significant percentage of the traditional IRA
- Those with unusual tax circumstances
  - Negative adjusted gross income
  - Itemized deductions exceed the adjusted gross income

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When Not to Roth

Converting now may not make sense if:

- If you intend to leave the IRA to charity
- If you are in your peak earning years now and can reasonably project certain years after retirement when your tax bracket may be lower
- If you intend to move to a state with a lower tax rate
- If the only source of paying the tax is directly from the converted IRA

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Fallacy of Optimization

Unless you can accurately predict the following items over your life and your heirs lives, you cannot optimize the conversion decision:

- Your actual spending needs, adjusted for inflation, and sources used to meet
- The date you and your spouse die
- The date your heirs die
- Federal, state and local income tax rates & future legislation for you
- Federal, state and local income tax rates and & future legislation for your heirs
- Federal and state estate tax law and future legislation
- Specific investments held and portfolio return of all investments

An Art and a Science

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Roth Conversion Paired Strategies

- **IRA Two-Step**
  - High income earners make non-deductible traditional IRA contributions for 2009 and 2010
  - Immediately convert to Roth

- **Charitable Stacking**
  - Accelerate multiple year donations into 2010
    - Consider donor advised funds
  - Charitable remainder trusts

- **Self-Employed**
  - Consider deferral of income and/or prepayment of many expenses
  - Creation and funding of defined benefit plans
  - Roll pre-tax basis of IRA to self-employed 401(k)

- **Multi-Year Conversion**
  - Staged conversions during low income years

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- **<u>Tax-Free</u> Growth and Distributions**
  - 100% tax free as long as certain conditions are met
  - No lifetime distribution requirements for owners
  - Distributions will not increase the taxability of social security benefits
  - Distributions will not increase the amount of Medicare premiums
  - Protects against rising tax rates
- **Wealth Transfers**
  - Increased amount passed to non-spousal heirs
  - Income tax burden not transferred to heirs
- **Tax Diversification**
  - Have an additional arrow in your quiver to draw upon

Disclosures

Internal Revenue Services (IRS) rules of practice require us to inform you that any tax advice included in this communication is not intended to be used, and cannot be used, for the purpose of avoiding any tax penalties imposed by the IRS.

We strongly encourage you to discuss the Roth IRA with your CPA and your financial advisor before implementing a conversion.