

Looking for a Roth Conversion Strategy? Divide and Conquer

By John Jenkins, AEP, EA, CFP®

The blitz is on. Every day my inbox floods with emails from mutual fund companies offering the latest in Roth Conversion calculators. The deluge proves that while conversion is a terrific opportunity, the fact that there are no easy rules of thumb is creating plenty of confusion. In fact, according to Google data, the number of people “Googling” the exact phrase “Roth IRA conversion” has tripled since January 2009.

Here’s the opportunity in a nutshell: Thanks to a provision in the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005, the \$100,000 income restriction on Roth IRA conversion eligibility was lifted as of January 1, 2010. This opens the door to a tax planning opportunity for millions of taxpayers who currently hold well over \$1 trillion in tax-deferred IRA and defined contribution plan assets.

Interestingly, in spite of the increased interest from consumers and mutual fund companies, studies indicate that only about 10 percent of investors are ready to convert. For many, the upfront tax consequence may be prohibitive. I suspect, however, that in many more cases people are just plain confused and frozen into inaction. After all, perhaps more than any other financial transaction you’ll make this year, deciding to convert your traditional IRA to a Roth IRA depends on a comprehensive analysis of your current personal finances and some general assumptions about the future federal tax code and your own future tax liability.

The conversion opportunity boils down to analyzing if it’s beneficial to pay taxes now as a way to potentially avoid paying more taxes later. Generally, the economics of converting your traditional IRA to a Roth IRA will work best when you do not need or want to spend funds from your Roth IRA during your lifetime but rather, plan to pass the asset untouched to your heirs, and you have assets apart from your qualified retirement plans to pay the income tax due on your conversion.

Obviously, the higher your effective tax rate in years following the conversion and the greater your holding period, the more tax effective the conversion becomes. And while nobody has a crystal ball to predict future tax rates, or even whether you will indeed be able to pass on all your Roth assets, we can make the following assumptions. First, tax rates likely will, in the next two-to-three years, increase to levels equivalent to 2001 rates. Also, when the estate tax is re-instated, it will not change significantly from current levels in the next five to ten years.

When considering a possible conversion, we suggest clients ask two questions: 1. “What are the benefits of converting?” and 2. “If conversion makes sense, then what is the ideal amount I should convert?” That is to say, conversion is not black and white, all or nothing.

“Divide and conquer now.”

In fact, a successful conversion strategy might be to “Divide and conquer now.” If you cannot afford to pay taxes on converting your entire traditional IRA, you might choose to divide your account and do a partial conversion now. After all, there is a special tax incentive for conversions made during the 2010 calendar year. Specifically, federal law allows you to delay paying taxes by electing to include the taxable portion of the 2010 conversion ratably in taxable income for 2011 and 2012. Thus, if you converted a \$100,000 IRA in 2010, you could choose to report \$50,000 in ordinary income in 2011 and \$50,000 in

2012. If you complete a Roth IRA conversion in 2011 or beyond, you cannot split the income or tax bill over two years.

All gains and losses to the entire Roth IRA, regardless of the actual stock or fund re-characterized must be pro-rated. For segregation of gains and losses to work in Roth conversions, assets need to be segregated into multiple traditional IRAs first (no co-mingled money; under IRS rules, you have to consider the entire value of all of your IRAs when converting and figuring taxes on the conversion, if you have nondeductible IRA contributions), then convert into separate Roth IRAs. This strategy is complex and could lead to additional account fees, transfer fees, conversion fees and re-characterization fees.

Note, however, if you decide to undo the Roth IRA conversion and have used the funds from your initial IRA to pay the taxes, that amount cannot be part of the re-characterization. For example, if you withdrew \$100,000 out of your traditional IRA and rolled just \$80,000 into a Roth, you only have \$80,000 to re-characterize.

For most of us, the conversion question will be answered only after multiple twists and turns. For example, if, in determining whether to convert to a Roth, you assume you will be in a lower tax bracket in retirement, there are additional variables to consider. You might be planning to retire to a state that does not have income taxes. Conversion could also increase your annual income and push you into a higher tax bracket, potentially causing you to lose some or all of your personal exemptions and itemized deductions. Your investigation is worth the time and effort. Remember, for those working to build and retain retirement capital, a Roth IRA could offer three substantial benefits:

- Tax-free growth that is especially attractive considering income tax rates are likely to go up in the future
- Tax diversification that provides flexibility in retirement income distribution planning
- No required distribution at age 70 ½ that helps transform your retirement savings into a financial legacy

Your professional financial advisor can help you do the math and discern how a Roth works into your overall retirement plan. What's more, your advisor can help ensure you comply with additional conversion rules. With a Roth IRA, for example, withdrawals are tax-free once you've owned the account for five years and reached the age of 59.5. However, when you do a Roth IRA conversion, a five-year clock applies from the conversion date. Your advisor can also help you to ascertain whether you can convert some of your 401(k) assets to a Roth IRA. In general, plan participants in 401(k)s, 403(b)s and 457 plans can do Roth conversions as long as they are eligible to take a distribution from their plan and the funds are eligible for rollover to an IRA. You also need to determine if your plan allows in-service distributions.

Remember, although the opportunity to choose not to pay taxes this year, but divide the tax between 2011 and 2012, is good only for conversion done in 2010, the lifting of the \$100,000 income limit for a Roth conversion is not a one-year deal. There is currently no sunset listed for this tremendous benefit. So you have plenty of time to meet with your advisor and carefully weigh your options.

About John Jenkins and Asset Preservation Strategies, Inc.

John Jenkins is president and founder of San Diego-based Asset Preservation Strategies, Inc., which provides a team of financial professionals collaborating to address all of the elements of successful wealth management. He has conducted numerous financial planning workshops during his career and has been a guest on the PBS show "The Money Makers" and its successor, "The Financial Advisors," as well as the syndicated news magazine show "Heartbeat of the City." Jenkins has also authored and co-authored several financial planning books and publications. He is frequently quoted in the financial press, including

Financial Planning News, The San Diego Union-Tribune, the La Jolla Light and the San Diego Business Journal. He has been named for three years in a row as a 5 Star, Best in Client Satisfaction Wealth Manager by San Diego Magazine based on surveys of more than 30,000 clients of wealth managers and data from more than 4,000 financial service professionals. Learn more at www.asset-preservation.com

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