

Wolf, Rogers, Dickey & Co.

Phone (740) 362-9031

Roth IRA

Analyzing the Conversion Opportunity

Beginning in January of this year, taxpayers with modified adjusted gross income (MAGI) of more than \$100,000 will be allowed to convert a traditional IRA to a Roth IRA. This change applies to all years beyond 2010, and additionally, your income taxes due on the conversion can be spread over two years if desired. For example, if you chose to convert this year, the conversion amount may be included as taxable income in 2011 and 2012 - helping to spread out the tax consequence.

While MAGI has been eliminated for ROTH conversions, it is important to note that MAGI limits still exist to fund a ROTH IRA.

Example:

Suppose you funded traditional IRAs from 2006 through 2009 and now, in 2010, you have \$40,000 in your account. Additional, let us suppose this entire account consisted of \$30,000 tax deductible dollars and \$10,000 of growth.

In this example, you'd need to pay income taxes on all \$40,000 in initial funding and growth when you convert to a ROTH IRA. However, the good news is you will never have to pay income taxes on this account again, regardless of future growth, and you can spread the tax liability over two years.

This document explores what such a conversion entails and whether it is advisable. The elimination of the MAGI conversion threshold is significant for several reasons. First, this threshold was never indexed for inflation, so over time its restrictiveness has increased. Second, this threshold does not distinguish between single filers and joint filers, thereby creating a subtle, but important, marriage tax penalty. ⁴Moreover, married couples who file separately are expressly prohibited from converting IRAs, regardless of their MAGI.

Because converting to a Roth IRA requires the taxpayer to recognize the value of the converted IRA as income in the year of conversion, the \$100,000 MAGI threshold effectively means that many—indeed, most—taxpayers who can afford to convert their IRAs are precluded from doing so. That state of affairs changes in 2010.

Benefits of Converting

A converted Roth account has two significant benefits that appeal to many taxpayers. First, distributions from such accounts are generally free of federal income tax as long as the account has been in existence at least five years.

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Benefits of Converting (continued):

To obtain this benefit, however, the accountholder must report the value of the account so converted as ordinary income in the year it is converted. In other words, a Roth IRA conversion involves trading today's income tax rates for tomorrow's tax rates. Of course, the tax rates that matter are those that will apply to the specific IRA owner. Thus, if that person expects to be in a lower tax bracket during the withdrawal phase of the IRA, a Roth conversion is not particularly attractive.

Guessing future tax rates is never easy, but the current political alignment in Washington, D.C., combines with anticipated funding for Social Security, Medicare, and other government initiatives to make higher future tax rates likely. Indeed, income tax rates are scheduled to rise to pre-2001 levels after 2010, even if Congress does nothing.

For conversions that take place in 2010 only, the converted amount is included in gross income in two equal amounts in 2011 and 2012, unless the taxpayer elects otherwise. Given the existing legislated increase in tax rates after 2010, taxpayers converting to a Roth IRA in 2010 may want to make that election and recognize the converted amount in that year.

In any case, converting an IRA represents a trade-off of today's income tax rates—which are known—for tomorrow's income tax rates—which are necessarily unknown, ignoring considerations about the time value of money.

The second major benefit of Roth IRAs is that these accounts are not subject to the “required minimum distribution” (RMD) rules that require accountholders to begin withdrawing funds when they are 70½ years old. This feature means that funds in a Roth IRA can be taken out on a more leisurely schedule than the RMD rules permit, or even not at all.

Accordingly, the Roth IRA appeals to retirees **who want to accumulate funds for their heirs**. To be sure, those heirs will be subject to the RMD rules when they inherit the Roth IRA, but the heirs will not owe any federal income tax on the funds that they withdraw from these accounts. And because their life expectancies are probably longer than the retiree's, the amount withdrawn from the IRA will be much smaller than if the retiree was applying the RMD rules. As a result, more of the balance in the Roth IRA remains to grow tax-free.

Indeed, this arrangement can be so significant that it raises the question of whether Roth IRAs are misnamed as “retirement” accounts since they need never fund the accountholder's retirement.

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Drawbacks of Converting

The most obvious drawback of converting to a Roth IRA is the requirement to pay income tax on the converted account's current fair market value, or at least the amount converted. To be sure, the applicable tax rate may be the lowest rate one will experience in the foreseeable future, but the inescapable fact is that an IRA conversion accelerates an income tax liability to the year of conversion that would otherwise be recognized over many years, possibly decades, in the future.

For some taxpayers, paying taxes earlier than required will be a bitter pill to swallow, perhaps an insurmountable barrier. This issue is compounded by the fact that the converted amount is added to the taxpayer's ordinary income for the year of conversion. Accordingly, this additional income will have collateral tax consequences beyond owing that taxpayer's marginal tax rate on the converted amount. Some of those consequences include the following:

1. The income figure that is used to determine how much of a taxpayer's Social Security benefits is subject to income tax will be higher, thereby increasing the amount of those benefits that is taxable.
2. The "means-testing" MAGI amount that determines how much certain high-income retirees must pay for their Medicare Part B benefits will be increased, thereby raising the retiree's health care costs without providing any additional benefits.
3. The 7.5%-of-AGI floor for deducting medical expenses will be higher, thereby reducing the amount of such expenses that can be deducted.
4. The AGI amount that is used to phase out taxpayers' personal exemptions and to limit their itemized deductions will be increased, thereby disallowing more of those deductions.

Each of these tax code interactions raises the effective federal income tax rate on an IRA conversion.

Many state income tax systems, moreover, peg their tax liability to a taxpayer's federal taxable income or liability. Accordingly, state income taxes may increase the converting taxpayer's out-of-pocket costs still further, though there might be an offsetting federal income tax deduction for these levies. But if the taxpayer is subject to the federal alternative minimum tax (AMT), this offset would not apply because the AMT does not allow the deduction of state and local taxes. Such a taxpayer would lose additional medical expense deductions, because the AMT applies a 10% floor to such deductions rather than the customary 7.5%.

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Drawbacks of Converting (continued):

A countervailing factor is that the tax owed is determined by the fair market value of the investments in the IRA, and those investments are probably worth significantly less than they were a few years ago. Thus, if the IRA is converted to a Roth IRA at today's depressed market values, the income tax due will be less than if the value of the investments were higher.

This purported advantage is less appealing than it first appears, however. For this purpose, assume that the value of the IRA "before" assets declined was \$100,000 and that the account has suffered a 40% loss in value. Assume further that the rate at conversion and at ultimate withdrawal is the same—say, 30%. Finally, assume that over some indeterminate period of time, the value of the account doubles. The relevant comparison can be illustrated as follows:

	<i>Regular</i>		<i>Roth</i>
Value "before"	\$100,000		
Current value	\$60,000	→ → →	60,000
Tax upon conversion @ 30%			(18,000)
Value in Roth account			\$42,000
Market doubles	\$120,000		\$84,000
Tax upon withdrawal @ 30%	(36,000)		
Value in regular IRA	\$84,000		

As this chart demonstrates, the value of the IRA to be converted certainly affects the amount of tax paid at the time it is converted, but *ceteris paribus*, the ultimate after-tax benefit to the account holder is unaffected by such market fluctuations.

This conclusion does not hold, however, if the tax rate on ultimate disposition exceeds the tax rate on conversion. In other words, converting an IRA to a Roth IRA must be understood as a hedge against higher income tax rates in the future—due either to a general elevation of the rate structure or to the taxpayer's moving into a higher tax bracket during the account's withdrawal phase—and not really a mechanism for taking advantage of diminished investment values in the account.

One reason for moving into a higher tax bracket would be the death of the taxpayer's spouse, which requires the taxpayer to use the unmarried taxpayer rate schedule of §1(c) rather than the more favorable joint filing rates of §1(a).

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Other Major Caveats

There are at least four further considerations that must be evaluated in making the decision to convert to a Roth IRA.

First, if the accountholder has any IRA that contains nondeductible contributions, all of that person's IRAs must be aggregated in determining how much of the converted account is not subject to income tax. Nondeductible contributions are not taxed when converted to a Roth, but the aggregation process will derive a ratio of nondeductible (and therefore tax-free) contributions based on all of a person's IRAs.

For example, assume that the taxpayer has an IRA funded with deductible contributions that is now worth \$70,000 and a separate IRA funded with nondeductible contributions of \$20,000 that is worth \$30,000. The total IRA value, therefore, is \$100,000 and the nondeductible ratio is 20% ($\$20,000 \div \$100,000$). If the taxpayer converts \$10,000 from the nondeductible IRA, this ratio will be applied to this distribution and \$2,000 ($\$10,000 \times 20\%$) will be tax-free.

Second, if the retiree expects to bequeath most or all of the Roth IRA, what tax brackets will the designated beneficiaries be in? That is, the alternative to converting an IRA is leaving the account as it stands and letting the ultimate beneficiaries take distributions from the account and pay income tax at their own effective tax rates. Accordingly, if the intended beneficiaries will likely be in lower tax brackets than the retiree is in currently, converting the account to a Roth IRA may increase the total intergenerational tax burden. Third, when an accountholder converts to a Roth IRA, what will be the source of the funds used to pay the applicable income tax? That is, will that person need to sell other assets, thereby triggering possible recognition of previously deferred capital gains? Even so, many taxpayers have potential capital losses or loss carry forwards available to offset this liability.

Alternatively, the accountholder might use funds from the converted IRA itself to pay the income tax that is owed on the conversion. Doing so obviously reduces the amount in the Roth IRA that can grow thereafter on a tax-free basis. But as long as tax rates remain the same during the period involved, paying the tax from funds within the account or from outside the account produces the same result, at least if the time value of money is ignored. There is, however, one exception to this happy symmetry: if the accountholder is not yet 59½ years old, the funds withdrawn from the account to pay the tax on the conversion are subject to the 10 percent penalty on early distributions.

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Other Major Caveats (continued):

Finally, the accountholder needs to consider how he or she might otherwise use the funds that pay the tax on converting to a Roth IRA. That is, paying this tax imposes an “opportunity cost” in terms of possibly deploying the funds in question to alternative investments. Municipal bonds, for example, might generate income free of federal, and possibly state, income tax. Low- or no-dividend stocks and undeveloped land might appreciate faster than the investments in the Roth IRA, and if the retiree owns these assets until his or her death, those assets would pass to that person's heirs with a step-up in basis that eliminates any income tax on the appreciation realized to that date.

Still other uses for the funds that would pay the tax on conversion might include charitable donations, payments of grandchildren's college tuition, vacations, or other expenditures that might enhance the person's lifestyle, such as in-home health care.

Conclusion

The elimination of the \$100,000 threshold for converting an IRA to a Roth IRA substantially enlarges the universe of taxpayers who can realistically consider this strategy. In addition, many taxpayers who have not been able to fund a Roth IRA because of income restrictions on such contributions can effectively circumvent those restrictions via a Roth IRA conversion.

Doing such a conversion is not necessarily optimal for any given taxpayer, however, even in an investment environment of significantly diminished account values. A Roth IRA conversion is simply a hedge against increased income tax rates in the future, but there are several countervailing considerations that must be evaluated beyond a retiree's passionate desire to minimize his or her income tax obligations. **And the biggest imponderable of them all remains unresolved—namely, whether future Congresses will honor these conversion decisions and not reduce the tax exemption that distributions from Roth IRAs currently enjoy.**

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