

The What, When and Why of Roth IRA Conversions

The Highlights

- Beginning January 1, 2010, taxpayers may convert a traditional IRA to a Roth IRA provided the holder pays income tax on the value of the traditional IRA at the time the conversion. Previously, this has been limited to those with income levels of less than \$100,000.
- The cause for much of the urgency surrounding this issue is driven by the fact the special tax treatment (distribution of taxes over a two-year period) will apply to conversions made between January 1 and December 31, 2010.
- The benefits of conversion, in general terms, are the projected long-term income tax savings, and the added flexibility afforded in the distribution process. These benefits will continue provided Congress does not at any point in the future decide to tax Roth IRAs.

The Details

The economics of the conversion of a traditional IRA to a Roth IRA work best when the holder satisfies two criteria:

- (1) the holder does not need or want to spend down the IRA funds during either his or his spouse's lifetime (e.g., the IRA is for the benefit of descendants)
- (2) the income tax on the converted amount will be paid from other (non-IRA) funds.

If the IRA holder is younger than 45, it may also make sense to convert the traditional IRA if withdrawals will begin after age 70. In general, the higher the IRA holder's effective tax rate in subsequent years, and the longer the holding period, the more tax effective the conversion. This analysis applies also to retirees who are rolling over 401(k)s and 403(b)s.

At Glenmede, our thinking is based on the following assumptions: tax rates will, in the next two to three years, increase to levels equivalent to 2001 rates; estate taxes will not change significantly from current levels in the next five-to-ten years; and Congress will not, in the future, tax Roth IRA accumulated earnings.

HOW A ROTH IRA COMPARES TO A TRADITIONAL IRA

	Converted Roth IRA	Traditional IRA
Funding	With after tax dollars	Most are pre-tax dollars, but can be funded with nondeductible contributions that are given special treatment in the conversion process
Tax on income/growth while accumulating in the IRA	None	None
Tax on distributions	None, so long as the withdrawn funds have been in the Roth IRA for at least 5 years and beneficiary is at least 59½	Ordinary income
Distributions required to IRA owner/funder	None	Beginning at age 70½
Distributions required to beneficiaries after death of owner/funder	Must take distributions at account owner's death or over the beneficiary's (children/grandchildren's) life expectancy	Must take distributions at account owner's death or over the beneficiary's (children/grandchildren's) life expectancy
Inclusion of IRA in taxable assets of IRA owner/funder	Yes	Yes

Of note, a Roth IRA is funded with after-tax dollars and is paid to the beneficiary in tax-free dollars. Outside the context of conversion, a taxpayer can fund a Roth IRA on an annual basis if the modified adjusted gross income is less than \$120,000 (joint \$176,000).

The Case Study

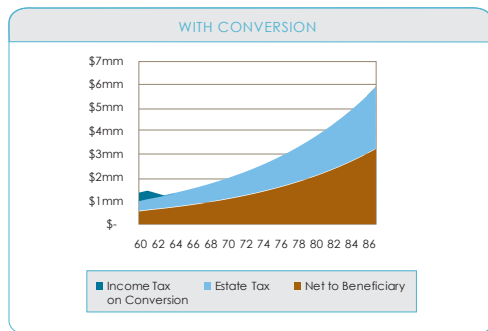
Our case study on the following page compares and contrasts a 60-year-old client holding a \$1,000,000 IRA with a 35-year-old client with a \$100,000 IRA. In each case, the portfolio is invested based on a 60% allocation to equities yielding 8%; 35% to taxable bonds yielding 5%; and 5% to cash yielding 4.25%. Funds accumulated outside the IRA are similarly allocated, however the bonds consist of tax-exempt assets. The tax rates for 2011 forward are set at 39.6% and 20% for ordinary income and long-term capital gains, respectively.

Scenario One

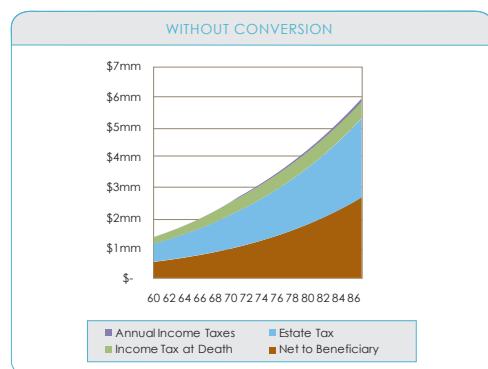
If the client of age 60 lives to his 86th year, and takes no withdrawals, the conversion advantage is \$565,048:

- \$1,000,000 in a traditional IRA
- \$347,000 in an investment account that will be used to pay income taxes (if conversion) or accumulated (if no conversion)
- **Conversion of IRA**—Net to beneficiary at client death = \$3,218,611
- **No Conversion of IRA**—Net to beneficiary at client death = \$2,653,563

With the conversion, the funds will grow to \$5,852,021. The client will have paid \$405,417 in income tax for 2011/2012 and will pay \$2,633,409 in estate tax upon his death. The net to beneficiary upon the client's death will be \$3,218,611.



Without the conversion, the funds will grow to \$5,834,280. The client will have paid \$1,172,521 in income tax over the years and will pay additional income tax of \$555,291 and estate tax of \$2,625,426 upon death. At this time, the net to beneficiary will be \$2,653,563.

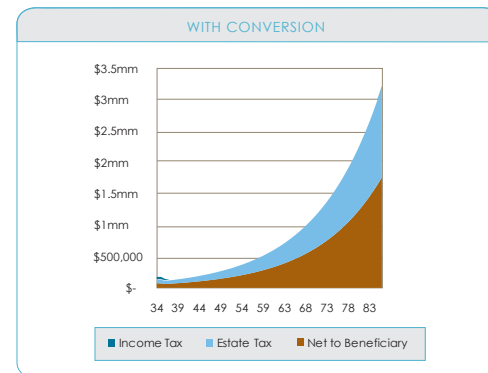


Scenario Two

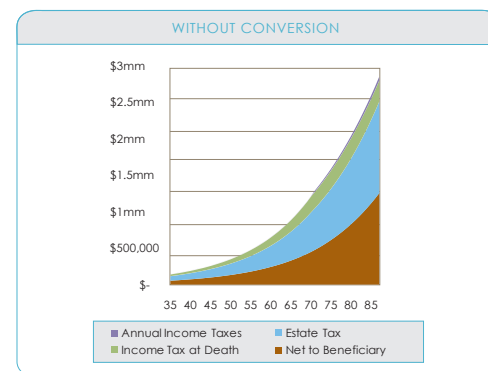
If the client of age 35 lives to his 86th year, and takes no withdrawals, the conversion advantage is \$514,886:

- \$100,000 in a traditional IRA
- \$35,000 in an investment account that will be used to pay income taxes (if conversion) or accumulated (if no conversion)
- **Conversion of IRA**—Net to beneficiary at client death = \$1,764,232
- **No Conversion of IRA**—Net to beneficiary at client death = \$1,249,346

With the conversion, the funds will grow to \$3,207,694. The client will have paid \$36,938 in income tax in 2011/2012 and will pay \$1,443,462 in estate tax upon his death at age 86. The net to beneficiary upon the client's death will be \$1,764,232.



Without conversion, the funds will grow to \$2,789,892. The client will have paid \$592,647 in income tax over the years and will pay additional income tax of \$285,095 and estate tax of \$1,255,452 upon death. At this time, the net to beneficiary will be \$1,249,346.



Further Considerations

- 1. Not all traditional IRA assets must convert at the same time.** This allows taxpayers to (a) determine if a portion of the IRA (less than all) should be 'reserved' for future beneficiaries (converted but not spent) and (b) convert portions of the traditional IRA based on the affordability of the incurred taxes (which are paid from a non-IRA fund).
- 2. Income tax for 2010 conversions:** a taxpayer can choose to (a) pay all the tax on his 2010 income tax return (i.e., on April 15, 2011) or (b) pay no tax on the 2010 return but include half the 'income' in each of 2011 and 2012 returns. Given the uncertainty of tax rates, we recommend that all converting taxpayers consider putting their 2010 income tax returns on extension until October 15, 2011. A wait-and-see approach up until the latest possible date may clarify some tax-rate issues.
- 3. Roth IRAs can be re-converted into traditional IRAs.** This provides tremendous flexibility. As a practical matter, the re-conversion can happen as late as October 15th of the year following the year of the conversion (i.e., October 15, 2011 for 2010 conversions). If circumstances change—tax rates, significant market downturn or a premature death—the tax-situation can be re-evaluated. Provided the circumstances do not occur within the same tax year, the taxpayer may even re-re-convert.
- 4. Potential Complications:** The evaluation of the benefits of conversion become complicated if the taxpayer (1) does a roll-over (say, from an employer plan to a traditional IRA) in the same year as a conversion; (2) has charitable deduction carryovers; (3) has carryover net operating losses; (4) has Alternative Minimum Tax credits or (5) has made after tax contributions to the traditional IRA.

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