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Roth IRA Conversions – Key Rules and Strategies

I. What Does a Roth Conversion Mean – **Basic Rules**

A. Mechanics of the Conversion

- Taxpayer completes paperwork with IRA custodian to convert **some or all** of his or her traditional IRA into a Roth IRA.

- Retirement plans **eligible for Roth conversion** include a Traditional IRA, a 401(k) plan, an SEP IRA, a SIMPLE IRA, and a spousal IRA. SIMPLE IRAs are eligible only after participating in the plan for two years. Note that a new SEP IRA or SIMPLE IRA must be created to receive future contributions, but those contributions can later be converted to the Roth IRA as well.

- An **Inherited IRA** is NOT eligible for Conversion.

- A Roth Conversion has **no impact on one's choice of investments.** The same investments should be available regardless of whether one is invested in a Traditional or Roth IRA.

B. Taxation of the Conversion

- Taxable income is created equal to the **fair market value** of the converted amount on the day of conversion. In other words, one is taxed on the conversion just as if he had withdrawn the amount converted to a Roth IRA.

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- The **ten percent early withdrawal penalty does not apply** to taxable income from Roth conversions even if the taxpayer is under age 59 ½.

- The ten percent early withdrawal penalty WILL apply if amounts are withdrawn from the IRA within FIVE years of conversion, unless the taxpayer is over age 59 ½, and has had another ROTH IRA for at least five years.

- Future growth in the Roth IRA is **never taxable** (unless one makes a "nonqualified distribution"). A Roth IRA is **one of the very few types of tax-free income** that one can enjoy.

- Required Minimum Distributions (RMDs) at age 70 ½ are not required for Roth IRAs.

- The **"ordering rules"** for Roth IRA distributions are pro-taxpayer. Even if distributions are not "qualified" (generally after age 59 ½), **principal is considered distributed first.** Thus, one can always withdraw an amount up to his cumulative investment in the Roth IRA with no taxation. **Caution**: Beware of application of 10% penalty discussed above.

C. New Rules for 2010.

- **Gross income threshold** for eligibility to convert is removed. Previously, if taxpayers had modified adjusted gross income of > $100,000, they were not eligible for a Roth conversion. This eligibility requirement has been removed for 2010 and **all future years**.

- Taxpayers are able to **elect to defer their income** from a Roth conversion in 2010 to 2011 & 2012. If a taxpayer so elects, <u>the income from a Roth conversion in 2010 is deferred to ½ in 2011 and ½ in 2012</u>. This election will be made on the 2010 tax return. The election is made for all or none of the Roth conversion. This opportunity for deferral of taxable income **is only for Roth conversions made in 2010.**

D. <u>Timelines for Roth Conversions</u>

- January 1, 2010 – first date conversion can be effective for current year.
- December 31, 2010 – last date conversion can be made to be effective for the current year.
- April 15, 2011 – due date for tax to be paid for conversion effective for previous year, even if extension is filed for current year.
- October 15, 2011 – last date a Roth conversion can be "re-characterized".
- January 1, 2011: Earliest one can re-convert a 2010 Roth conversion that was "re-characterized". Must also be at least 30 days after the "re-characterization".

II. Advantage of a Roth IRA Conversion

A. <u>Inherent Advantages of Roth IRA</u>

- Roth IRAs are one of the **very few opportunities for completely tax-free income.** Traditional IRA's grow tax-deferred as long as the funds remain in the IRA, but of course are taxable once they are distributed.

- Roth IRA have **no requirement for Required Minimum Distributions** (RMDs) once one reaches age 70 ½. RMDs whittle down the value of a traditional IRA because they gradually reduce the amount of funds you have growing tax-free.

B. 10 Reasons to Convert to a Roth IRA

Noted IRA expert Robert S. Keebler, CPA, has identified ten circumstances when someone should consider converting to a Roth IRA:

1. Taxpayers who have **favorable tax attributes** such as charitable deductions carry-forwards, Net Operating Loss (NOL) carry-forwards, the zero percent capital gain or qualified dividend tax bracket, or unused itemized deductions, exemptions, or nonrefundable tax credits. The presence of these **favorable tax attributes** allows a taxpayer to hit the proverbial **Roth conversion grand slam. See Examples 1-3 at back of materials.** One caution in using this strategy is to consider the impact of a Roth conversion on other taxable items such as the percentage of Social Security benefits that are taxable or the amount of long term capital gains that qualify for the 0% tax bracket. In addition, **using a Roth Conversion to absorb a Net Operating Loss may not be the best strategy**. Consider the benefit of carrying back or forwards a Net Operating Loss. If the loss is carried to a year when you were in a high tax bracket, that is likely a better move than using it with a Roth Conversion.

2. Suspension of the required minimum distribution (RMD) rules at age 70 ½ provides a considerable advantage to the Roth IRA holder.

3. Payment of income tax prior to the imposition of estate tax permits greater wealth to be transferred to future generations.

4. Taxpayers who can pay the income tax on the IRA from non IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields.

5. Taxpayers who need to use the IRA assets to fund their Unified Credit bypass trust (a.k.a. Credit Shelter Trust, Family Trust) are well advised to consider making a Roth election for that portion of their overall IRA funds.

6. Taxpayers making the Roth IRA election during their lifetime **reduce their overall taxable estate**, thereby lowering the effect of higher estate tax rates. That is, by paying the income taxes on the Roth conversion, one has reduced his taxable estate and increased the amount transferring to heirs after tax.

7. Because federal tax brackets are more favorable for married couples than single individuals, **Roth IRA distributions will not increase the tax bracket of the surviving spouse** whereas traditional IRA distributions may have increased her tax bracket and also caused a larger percentage of social security benefits to be taxable.

8. Roth IRAs are a **much better inheritance** for heirs since distributions to beneficiaries are tax-free.

9. Tax Rates are expected to increase in the near future.

10. The ability to 're-characterize" Roth conversions allows the taxpayer to have "20/20 hindsight", effectively allowing them to "undo" conversions that were not advantageous. **See Section VI for more detail.**

III. Key Factors in Making the Decision to Convert

A. Current vs. Future Tax Rates.

- This is the **most important factor**. In general, if one expects their future marginal tax rate at the time they expect to receive IRA distributions to be the **same or greater** as their present marginal tax rates, then a Roth conversion is advisable.

- This requires careful consideration because most taxpayers are in a **lower tax bracket during their retirement years.**

- This analysis requires one to be a **prophet** to predict what future tax rates will be.

- Consideration should be given that a **surviving spouse** will be subject to the more suppressed single tax rates while receiving IRA distributions. Consideration should also be given to the impact on one's marginal tax rate that IRA distributions have if they cause an increase in the portion of one's social security benefits to be taxable. Ask your CPA to "run the numbers" for various hypothetical outcomes.

- Will your **home state change in retirement**? For example, many retirees move to **Florida,** which has no state income tax. This reduction in your future tax rate is most certainly a factor.

- **Consider impact of new Medicare surtax**. Beginning in 2013, there will be a new Medicare surtax for high income taxpayers equal to 0.9% of one's earned income and 3.8% of one's investment income, capital gains, and rental income. **This tax will apply to single taxpayers with income greater than $200K and marrieds with income greater than $250K**. While IRA distributions will not be subject to this tax directly, because they increase one's gross income, which in turn increases the amount of investment and earned income subject to the tax, both IRA distributions and Roth conversions after 2012 could increase one's Medicare surtax.

- In the opinion of this CPA, a Roth Conversion is almost always a good strategy in an amount that will cause one's taxable income not to exceed the top of the 15% tax bracket, if one has sufficient cash reserves to pay the tax due upon conversion. This conclusion assumes that your state income tax rate will not drop due to a future move. Depending upon retirement income expectations, it may be a good strategy to do a Roth Conversion in an amount that will cause one's taxable income not to exceed the top of the 25% tax bracket.

- At the other income extreme, if one generally expects to always be in the highest tax brackets, A Roth conversion should be **seriously considered for 2010** as the higher brackets are almost certain to go up in the future.

B. Source of Funds to Pay the tax due on Roth Conversion.

- A Roth Conversion is more favorable if one has **other funds outside an IRA to pay the tax due** upon conversion.

- This advantage <u>can offset in part the disadvantage of one's future tax rate being lower than one's current tax rate.</u> However, it will not offset a spread of more than **6% - 8%** in the difference between current and future tax rates.

- Roth IRA funds are generally "tied up" for 5 years after conversion, so **one should not deplete one's "non-IRA" funds to pay the tax**.

C. <u>Time Horizon before IRA Distributions are Expected to Begin.</u>

- The **longer** the time horizon, the more advantageous is a Roth Conversion.

- The actual key factor is the **amount of growth in one's investments** expected between conversion date and distribution date. Naturally, the longer one's time horizon, the greater the expected growth.

- With no Required Minimum Distribution, an owner should **delay Roth IRA withdrawals as long as possible**. Your choice would always be to consume a taxable account first so that you stretch out the time you can earn tax-free income. However, depending on the size of the gain and your tax on such gain, you should withdraw from a Roth IRA before liquidating an investment that will create a sizeable capital gain. A Roth IRA is a <u>good asset to pass along to heirs since it is not taxable to your heirs</u>.

- This **advantage is harder to quantify**. However, if one is able to defer Roth distributions for a long enough time horizon beyond age 70 ½, this advantage would eventually offset the disadvantage of a significantly higher current tax rate.

D. Impact of College Financial Aid. If a taxpayer has college aid children, he should be mindful that a **Roth conversion will count as income** in the calculation of the parent's expect financial contribution (EFC).

E. See **Examples 4-11** in Back of Handout to Illustrate these Factors.

F. There are many on-line Roth conversion tools. A good one is **Fidelity's Roth Conversion Evaluator**. It can be found at http://personal.fidelity.com/. From there, do a search for "Roth Evaluator", and it should be the first search result. This converter does not consider the benefit of having no RMD's with a Roth. That benefit is very difficult to quantify.

IV. Strategies to Utilize in Making a Roth Conversion.

A. Start the Five Year Clock.

- In order to have a **"qualified distribution"** from a Roth IRA (a tax-free distribution), one must meet two criteria. One must be over age 59 ½, and one must have had a Roth IRA for at least five years.

- Essentially, this means **anyone age 55 or over** who does not have a Roth IRA, but who is considering making a Roth contribution or conversion in the future should contribute at least a minimal amount to a Roth IRA now to start the five year clock. **Caution:** Make sure one is eligible for a Roth IRA contribution.

B. <u>Convert when you expect IRA values are at their lowest.</u>

- Taxable income is determined by the fair market value of the IRA on the date of conversion.

- Immediately following a **market correction** is the optimal time to make a Roth Conversion.

- Does one's IRA portfolio contain a stock or fund expected to **grow rapidly in future years**.

C. <u>Establish Multiple IRA's for Maximum Flexibility.</u>

- Establishing multiple Roth IRAs upon conversion allows one to **take advantage of the re-characterization opportunities** discussed later in Section VI.

- Establishing multiple Roth IRAs upon conversion allows one to utilize the **"dollar cost averaging"** strategy to attempt to convert at the lowest values.

- Establishing multiple Roth IRAs upon conversion allows one to utilize **different investment strategies for different IRA's**. If one investment does well, then the taxpayer leaves that Roth conversion in tact, whereas another investment may do poorly, and it can be "re-characterized" without un-doing the conversion for the investment that is performing well.

- See Tax Rate Schedules at back of Handout.

D. Convert More than you think you should.

- We recommend **converting about 25% more** than you expect to be the optimal conversion amount.

- Actual taxable income may be less than projected for 2010. This may happen for instance if one loses their job, has lower than expected self employment income or investment earnings, or has higher than expected deductions. In such case the optimal Roth conversion amount will likely be higher. **By over-converting, you have met this optimal amount.**

- With the one-time opportunity to defer income to 2011, **facts may present themselves later** that make it apparent that 2011 income will be less than expected. This may unexpectedly cause a larger optimal Roth conversion for 2011. By over-converting, you have met this optimal amount.

- If actual facts play out close to projections, and one finds that he does not need the extra Roth Conversion amount, **then he simply "re-characterizes" a portion of the conversion before the deadline for doing so.** This deadline is the due date of one's return, and thus this decision can be delayed until as late as October 15 of the following year.

E. Should You Use the Jagen Strategy??

- **Jagen Investments** introduced a **new strategy in 2010 aimed at Roth conversion clients.**

- The Jagen fund design provides for a variance between the **net asset value (NAV)** and the **fair market value (FMV)** of each investor's interest in the fund.

- In other words, say an IRA has a NAV of $100,000. If the design allows for a **30% valuation discount**, the FMV of the IRA is only $70,000. The amount that is counted as taxable income in a Roth conversion is the FMV, or only $70,000 in this case.

- The design uses similar principles as are used to achieve **valuation discounts in family limited partnerships** in gifting and estate-planning strategies.

- The results can be dramatic. If the fund achieves a 30% valuation discount, then one in the marginal 35% tax bracket is only in a 24.5% tax bracket. What would otherwise be the **33%, 28%, 25%, and 15%** tax brackets become **23.1%, 19.6%, 17.5%, and 10.5%** tax brackets. Recall the significance of one's current marginal tax bracket in evaluating the favor of a Roth conversion.

- **Consider carefully any disadvantages** this product may have from an investment perspective. For example, likely the investment choices will be limited, and the products may not be very liquid. The tax tail should not wage the investment dog.

- To the best of my knowledge, **The Jagen Strategy has not been IRS tested as yet.**

V. Impact of Roth Conversions on Estate Planning

A. <u>See Examples 12-15 to see the potential impact of Roth Conversion on Estate Tax.</u>

- **Example 12**: Demonstrates estate tax savings by reducing one's taxable estate by the tax paid on the Roth Conversion. <u>Generally this advantage occurs when one has a taxable estate only because of IRA funds</u>.

- **Example 13**: Demonstrates that a Roth Conversion can <u>actually be disadvantageous</u> for estate planning if <u>heirs are expected to have a lower income tax rate than the taxpayer.</u>

- **Example 14: Demonstrates** that a Roth conversion will be advantageous for taxpayers in a high tax bracket if the proposed legislation to cap the benefit of itemized deductions at 28% become law.

VI. Re-Characterizing a Roth Conversion

A. <u>A Mulligan for Roth Conversions</u>

- **A Roth conversion is not a final decision**. It can be "un-done" by a Roth "**Re-Characterization**".

- Consider the re-characterization **if the value of your IRA goes down after conversion**. For example, say the IRA was worth $100,000 when you converted. Even though it drops to $80,000 by the time you file your tax return, you still must include the entire $100,000 in taxable income.

- A recommended strategy is to set **up several Roth IRA's with different types of investments.** That way, if only a certain investment declines, you can re-characterize just that Roth IRA.

- Consider the re-characterization if **your actual tax bracket is higher than you planned** when doing the conversion.

- You can re-characterize **all or only a portion** of the amount converted to a Roth.

B. Making the election to Re-Characterize.

- The re-character election can be made **on or before the due date (including extensions)** for filing the return for the year in which the Roth conversion was made. In other words, one can re-characterize his 2010 Roth conversion **anytime before October 15, 2011**, assuming an extension is filed for the return. This allows for a great deal of hindsight in making the election.

- The election is made by **notifying the trustee** of your intention to re-characterize. Make sure your intent is clearly communicated. The terms "convert", "rollover", "re-characterize", and "re-convert" can become very confusing and might be misunderstood.

C. "Re-Converting" after "Re-Characterizing"

- Without restrictions, one would simply re-characterize and re-convert every time the value of the IRA went down before year-end.

- A taxpayer **must wait until the later** of i)The beginning of the tax year following the tax year in which the Roth conversion was done, or ii) 30 days; before one can re-convert a re-characterized IRA.

- The practical effect of the above rule is if one re-characterizes in the same year the original conversion was made, he must wait until January 1 of the following year to re-convert. If one re-characterizes in the year following the original conversion, one must wait 30 days to re-characterize.

- One effect of the above rule is that **the Roth conversion is delayed one year** as a result of the re-characterization.

- There is no rule to prevent one from converting a **second IRA** to a Roth IRA on the same day a re-characterization election was made. **This is another benefit of having multiple IRA's**.

VII. Wrap-up – Q&A

Stancil & Company would like to gratefully acknowledge Surgent-McCoy, CPE, LLC for making available their materials for use in developing this presentation.

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Roth Conversion Illustrations
Impact of Favorable Tax Attributes

Caution: Examples 1-3 assume that Joe Taxpayer is not receiving Social Security benefits. The advantages of the Roth conversion will be diminished if the conversion income increased the amount of Social Security benefits that are taxable.

Example 1 - Use of Favorable Tax Attributes - zero percent capital gain rate, and unused refundable tax credits

Joe Taxpayer	No Roth Conversion	Roth Conversion
Salary	53,000	53,000
Interest	3,000	3,000
Qualified Dividends	8,000	8,000
Long Term Capital Gain	15,000	15,000
Rental Loss	(20,000)	(20,000)
Roth Conversion	-	35,000
Gross Income	59,000	94,000
Itemized Deductions	(22,000)	(22,000)
Exemptions	(14,600)	(14,600)
Taxable Income	22,400	57,400
Income Tax	0	4,323
Tax Credits		
Refundable Education Credits	(1,000)	(1,000)
Nonrefundable Education Credits		(1,500)
Residential energy Credit		(1,500)
Tax Due (refund)	(1,000)	323
Conversion Amount		35,000
Cost of Conversion		1,323
Federal Tax Rate		3.78%

Roth Conversion Illustrations
Impact of Favorable Tax Attributes

Caution: Examples 1-3 assume that Joe Taxpayer is not receiving Social Security benefits. The advantages of the Roth conversion will be diminished if the conversion income increased the amount of Social Security benefits that are taxable.

Example 2 - Use of Favorable Tax Attributes - zero percent capital gain rate, unused itemized deductions and unused refundable tax credits

Joe Taxpayer	No Roth Conversion	Roth Conversion
Salary	-	
Interest	5,000	5,000
Qualified Dividends	22,000	22,000
Long Term Capital Gain	8,000	8,000
Rental Loss	(7,000)	(7,000)
Roth Conversion	-	50,000
Gross Income	28,000	78,000
Itemized Deductions	(18,000)	(18,000)
Exemptions	(7,300)	(7,300)
Taxable Income	2,700	52,700
Income Tax	0	2,568
Tax Credits		
Residential energy Credit		(1,500)
Tax Due (refund)	-	1,068
Conversion Amount		50,000
Cost of Conversion		1,068
Federal Tax Rate		2.14%

Roth Conversion Illustrations
Impact of Favorable Tax Attributes

Caution: Examples 1-3 assume that Joe Taxpayer is not receiving Social Security benefits. The advantages of the Roth conversion will be diminished if the conversion income increased the amount of Social Security benefits that are taxable.

Example 3 - Use of Favorable Tax Attributes - zero percent capital gain rate, unused itemized deductions, unused refundable tax credits, and expiring charitable contribution carryforward

Joe Taxpayer	No Roth Conversion	Roth Conversion
Salary	-	
Interest	5,000	5,000
Qualified Dividends	22,000	22,000
Long Term Capital Gain	8,000	8,000
Rental Loss	(7,000)	(7,000)
Roth Conversion	-	75,000
Gross Income	28,000	103,000
Itemized Deductions	(14,000)	(14,000)
Expiring Charitable Contribution C/F		(30,000)
Exemptions	(7,300)	(7,300)
Taxable Income	6,700	51,700
Income Tax	0	2,418
Tax Credits		
Residential energy Credit		(1,500)
Tax Due (refund)	-	918
Conversion Amount		75,000
Cost of Conversion		918
Federal Tax Rate		1.22%

Roth Conversion Illustrations
Impact of Tax Rate & Time Horizon

Assumptions - Examples 4-6

Traditional IRA Available for Conversion	**$50,000**
Other Funds Available to pay tax on Conversion	**$0**

Taxpayer is over age 59 1/2, or has a Roth IRA that is over 5 years old from which tax will be paid.

Note: These examples **do NOT attempt to quantify the advantage of having no RMDs with Roth IRAs**. Once RMD's begin, the value of the Roth IRA will grow faster than the Traditional IRA. These examples only compare the after tax value of a Traditional IRS vs. a Roth IRA at a point in the future before distributions begin.

Example 4 - Tax Paid from IRA

		Retain Traditional	Roth Conversion
Current IRA Balance		50,000	50,000
Current Marginal Tax Rate	**32%**		
Tax Paid - Conversion			(16,000)
Balance After Conversion		50,000	34,000
Growth	100%	50,000	34,000
Balance Prior to Distribution		100,000	68,000
Future Marginal Tax Rate	**32%**		
Tax Cost - Distribution		(32,000)	-
Balance after Distribution		68,000	68,000
Advantage (Disadvantage) Roth Conversioı		**$0**	

Example 5 - Tax Paid from IRA

Current IRA Balance		50,000	50,000
Current Marginal Tax Rate	**32%**		
Tax Paid - Conversion			(16,000)
Balance After Conversion		50,000	34,000
Growth	100%	50,000	34,000
Balance Prior to Distribution		100,000	68,000
Future Marginal Tax Rate	**22%**		
Tax Cost - Distribution		(22,000)	-
Balance after Distribution		78,000	68,000
Advantage (Disadvantage) Roth Conversioı		**($10,000)**	

Example 6 - Tax Paid from IRA

Current IRA Balance		50,000	50,000
Current Marginal Tax Rate	**22%**		
Tax Paid - Conversion			(11,000)
Balance After Conversion		50,000	39,000
Growth	100%	50,000	39,000
Balance Prior to Distribution		100,000	78,000
Future Marginal Tax Rate	**35%**		
Tax Cost - Distribution		(35,000)	-
Balance after Distribution		65,000	78,000
Advantage (Disadvantage) Roth Conversioı		**$13,000**	

Roth Conversion Illustrations
Impact of Tax Rate & Time Horizon

Assumptions - Examples 7-10

Traditional IRA Available for Conversion	**$50,000**
Other Funds Avaialbe to pay tax on Conversion	**$50,000**

Note: These examples **do NOT attempt to quantify the advantage of having no RMDs** with Roth IRAs. Once RMD's begin, the value of the Roth IRA will grow faster than the Traditional IRA. These examples only compare the after tax value of a Traditional IRS vs. a Roth IRA at a point in the future before distributions begin.

Example 7 - Tax Paid with Outside Funds

		Traditional IRA		Roth Conversion	
		IRA Funds	**Other Funds**	**IRA Funds**	**Other Funds**
Current Balances		50,000	50,000	50,000	50,000
Current Marginal Tax Rate	**32%**				
Tax Paid - Conversion					(16,000)
Balance After Conversion		50,000	50,000	50,000	34,000
Growth	50%	25,000	17,000	25,000	11,560
Balance Prior to Distribution		75,000	67,000	75,000	45,560
Future Marginal Tax Rate	**32%**				
Tax Cost - Distribution		(24,000)			
Balance after Distribution		51,000	67,000	75,000	45,560
		67,000		45,560	
		118,000		120,560	
Advantage (Disadvantage) Roth Conversion		**$2,560**	2.17%		

This example illustrates the advantage of paying the tax on the Roth conversion outside of IRA - compare to Example 1

Example 8 - Tax Paid with Outside Funds - Longer Time Horizon than Example 4

Current Balances		50,000	50,000	50,000	50,000
Current Marginal Tax Rate	**32%**				
Tax Paid - Conversion					(16,000)
Balance After Conversion		50,000	50,000	50,000	34,000
Growth	100%	50,000	34,000	50,000	23,120
Balance Prior to Distribution		100,000	84,000	100,000	57,120
Future Marginal Tax Rate	**32%**				
Tax Cost - Distribution		(32,000)			
Balance after Distribution		68,000	84,000	100,000	57,120
		84,000		57,120	
		152,000		157,120	
Advantage (Disadvantage) Roth Conversion		**$5,120**	**3.37%**		

This example illustrates the advantage of paying the tax on the Roth conversion outside of IRA - compare to Ex. 1 - and the advantage of a longer time horizon before withdrawals allowing for more growth - compare to Ex. 4

Roth Conversion Illustrations

Impact of Tax Rate & Time Horizon

Example 9 - Tax Paid with Outside Funds - Longer Time Horizon & Lower Future Tax Rate

Current Balances		50,000	50,000	50,000	50,000
Current Marginal Tax Rate	**32%**				
Tax Paid - Conversion					(16,000)
Balance After Conversion		50,000	50,000	50,000	34,000
Growth	100%	50,000	34,000	50,000	23,120
Balance Prior to Distribution		100,000	84,000	100,000	57,120
Future Marginal Tax Rate	**26%**				
Tax Cost - Distribution		(26,000)			
Balance after Distribution		74,000	84,000	100,000	57,120
		84,000		57,120	
		158,000		157,120	
Advantage (Disadvantage) Roth Conversion		**($880)**	**-0.56%**		

This example illustrates that a longer time horizon (higher growth) can overcome the disadvantage of a higher current tax rate

Example 10 - Tax Paid with Outside Funds - Longer Time Horizon & Higher Future Tax Rate

Current Balances		50,000	50,000	50,000	50,000
Current Marginal Tax Rate	**22%**				
Tax Paid - Conversion					(11,000)
Balance After Conversion		50,000	50,000	50,000	39,000
Growth	200%	100,000	78,000	100,000	60,840
Balance Prior to Distribution		150,000	128,000	150,000	99,840
Future Marginal Tax Rate	**30%**				
Tax Cost - Distribution		(45,000)			
Balance after Distribution		105,000	128,000	150,000	99,840
		128,000		99,840	
		233,000		249,840	
Advantage (Disadvantage) Roth Conversion		**$16,840**	**7.23%**		

This example illustrates the best conditions for a Roth Conversion - a longer time horizon (higher growth) and a higher future tax rate

Example 11 - Roth conversion tax free by virtue of using available deductions that otherwise go unused.

Current Balances		50,000		50,000	
Current Marginal Tax Rate	**0%**				
Tax Paid - Conversion					-
Balance After Conversion		50,000	-	50,000	-
Growth	100%	50,000	-	50,000	-
Balance Prior to Distribution		100,000	-	100,000	-
Future Marginal Tax Rate	**30%**				
Tax Cost - Distribution		(30,000)			
Balance after Distribution		70,000	-	100,000	-
		-		-	
		70,000		100,000	
Advantage (Disadvantage) Roth Conversion		**$30,000**	**42.86%**		

This example illustrates the proverbial "home run" of Roth Conversions

Roth Conversion Illustrations
Effect on Estate Tax

Example 12: Benefit of Roth Conversion on Estate Tax when taxable estate is created by an IRA

Gross Estate Value		4,000,000		4,000,000
Roth Conversion			1,250,000	
Current Tax Rate / Tax on Converson	40%		(500,000)	(500,000)
Estate Exemption Amount		(3,500,000)		(3,500,000)
Taxable Estate		500,000		-
Estate Tax Rate / Estate Tax	45%	(225,000)		-
Funds to Heirs		3,775,000		3,500,000
Traditional IRA funds to Heirs			1,250,000	
Income Tax to Heirs	32%	(400,000)	(400,000)	
Itemized Deduction for IRD property	32%	72,000	(225,000)	
Net after-tax to Heirs		**3,447,000**		**3,500,000**
Roth Conversion Savings				**53,000**

Example 13: Disadvantage of Roth Conversion on Estate Tax when taxable estate is not created by an IRA, and heirs have lower tax rate.

Gross Estate Value		6,000,000		6,000,000
Roth Conversion			1,000,000	
Current Tax Rate / Tax on Converson	40%		(400,000)	(400,000)
Estate Exemption Amount		(3,500,000)		(3,500,000)
Taxable Estate		2,500,000		2,100,000
Estate Tax Rate / Estate Tax	45%	(1,125,000)		(945,000)
Funds to Heirs		4,875,000		4,655,000
Traditional IRA funds to Heirs			1,000,000	
Income Tax to Heirs	28%	(280,000)	(280,000)	
Itemized Deduction for IRD property	28%	126,000	(450,000)	
Net after-tax to Heirs		**4,721,000**		**4,655,000**
Roth Conversion Savings (Disadvantage)				**(66,000)**

Roth Conversion Illustrations
Effect on Estate Tax

Example 14: Benefit of Roth Conversion on Estate Tax if heirs will be in a high tax bracket and the benefit of itemized deductions is capped at 28%

		No Roth Conversion		Roth Conversion
Gross Estate Value		8,000,000		8,000,000
Roth Conversion			2,500,000	
Current Tax Rate / Tax on Converson	40%		(1,000,000)	(1,000,000)
Estate Exemption Amount		(3,500,000)		(3,500,000)
Taxable Estate		4,500,000		3,500,000
Estate Tax Rate / Estate Tax	45%	(2,025,000)		(1,575,000)
Funds to Heirs		5,975,000		5,425,000
Traditional IRA funds to Heirs			2,500,000	
Income Tax to Heirs	40%	(1,000,000)	(1,000,000)	
Itemized Deduction for IRD property	28%	315,000	(1,125,000)	
Net after-tax to Heirs		**5,290,000**		**5,425,000**
Roth Conversion Savings (Disadvantage)				**135,000**

TAX RATES

2009 Federal

(use for "Quick Tax" calculation only)

Single

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$8,350	**$0.00**		**10%**	$0
8,350	33,950	**835.00**		**15%**	8,350
33,950	82,250	**4,675.00**		**25%**	33,950
82,250	171,550	**16,750.00**		**28%**	82,250
171,550	372,950	**41,754.00**		**33%**	171,550
372,950	–	**108,216.00**		**35%**	372,950

Married Joint & Qualifying Widow(er)

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$16,700	**$0.00**		**10%**	$0
16,700	67,900	**1,670.00**		**15%**	16,700
67,900	137,050	**9,350.00**		**25%**	67,900
137,050	208,850	**26,637.50**		**28%**	137,050
208,850	372,950	**46,741.50**		**33%**	208,850
372,950	–	**100,894.50**		**35%**	372,950

Married Separate

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$8,350	**$0.00**		**10%**	$0
8,350	33,950	**835.00**		**15%**	8,350
33,950	68,525	**4,675.00**		**25%**	33,950
68,525	104,425	**13,318.75**		**28%**	68,525
104,425	186,475	**23,370.75**		**33%**	104,425
186,475	–	**50,447.25**		**35%**	186,475

Head of Household

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$11,950	**$0.00**		**10%**	$0
11,950	45,500	**1,195.00**		**15%**	11,950
45,500	117,450	**6,227.50**		**25%**	45,500
117,450	190,200	**24,215.00**		**28%**	117,450
190,200	372,950	**44,585.00**		**33%**	190,200
372,950	–	**104,892.50**		**35%**	372,950

Trusts & Estates

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$2,300	**$0.00**		**15%**	$0
2,300	5,350	**345.00**		**25%**	2,300
5,350	8,200	**1,107.50**		**28%**	5,350
8,200	11,150	**1,905.50**		**33%**	8,200
11,150	–	**2,879.00**		**35%**	11,150

TAX RATES

2010 Federal

(use for "Quick Tax" calculation only)

Single

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$8,375	**$0.00**		**10%**	$0
8,375	34,000	**837.50**		**15%**	8,375
34,000	82,400	**4,681.25**		**25%**	34,000
82,400	171,850	**16,781.25**		**28%**	82,400
171,850	373,650	**41,827.25**		**33%**	171,850
373,650	–	**108,421.25**		**35%**	373,650

Married Joint & Qualifying Widow(er)

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$16,750	**$0.00**		**10%**	$0
16,750	68,000	**1,675.00**		**15%**	16,750
68,000	137,300	**9,362.50**		**25%**	68,000
137,300	209,250	**26,687.50**		**28%**	137,300
209,250	373,650	**46,833.50**		**33%**	209,250
373,650	–	**101,085.50**		**35%**	373,650

Married Separate

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$8,375	**$0.00**		**10%**	$0
8,375	34,000	**837.50**		**15%**	8,375
34,000	68,650	**4,681.25**		**25%**	34,000
68,650	104,625	**13,343.75**		**28%**	68,650
104,625	186,825	**23,416.75**		**33%**	104,625
186,825	–	**50,542.75**		**35%**	186,825

Head of Household

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$11,950	**$0.00**		**10%**	$0
11,950	45,550	**1,195.00**		**15%**	11,950
45,550	117,650	**6,235.00**		**25%**	45,550
117,650	190,550	**24,260.00**		**28%**	117,650
190,550	373,650	**44,672.00**		**33%**	190,550
373,650	–	**105,095.00**		**35%**	373,650

Trusts & Estates

Taxable Income Over	But Not Over	Tax	+	% on Excess	Of the Amount Over
$0	$2,300	**$0.00**		**15%**	$0
2,300	5,350	**345.00**		**25%**	2,300
5,350	8,200	**1,107.50**		**28%**	5,350
8,200	11,200	**1,905.50**		**33%**	8,200
11,200	–	**2,895.50**		**35%**	11,200