

# Reasons Why You May Consider a Roth Conversion

Beginning in January 2010, IRA planning dramatically changed when MAGI (Modified Adjusted Gross Income) limits and tax filing status were eliminated for those wishing to convert to a Roth IRA. This is thanks to Robert S. Keebler, CPA, M.S.T., and Stephen J. Bigge, CPA, both associated with the Green Bay, Wisconsin, firm of Baker Tilly Virchow Krause, LLP for their study and analysis of the Roth IRA.

In their study, published in the “Journal of Retirement Planning” (May-June, 2007), they found seven reasons why someone may consider converting to a Roth IRA:

1. To take advantage of favorable tax attributes (such as charitable deductions carry forwards, Net Operating Loss (NOL) carry forwards, investment tax credits, etc.)
2. Suspension of the lifetime required minimum distribution (RMD) rules
3. The payment of income tax prior to the imposition of estate tax allows for greater wealth to be transferred to future generations (due to the fact that no income tax deduction is allowed for state death taxes levied on IRAs)
4. Greater growth potential, to the extent that outside sources (i.e. taxable brokerage accounts) are used to pay for the taxes due on the Roth conversion
5. To better utilize an IRA owner’s Unified Credit
6. To effectively reduce the taxable estate of the IRA owner
7. To hedge against the projected increase in tax rates when a spouse dies

Keebler and Bigge completed studies using several spreadsheet analyses and in their work have discovered that generally these key factors need to be identified and addressed in order to best analyze a Roth conversion:

1. Asset mix of qualified versus non-qualified and liquid versus non-liquid assets
2. Traditional IRA balance
3. Time horizon
4. Current and future cash flow needs
5. Current marginal tax rate versus projected future marginal tax rate
6. Ability to pay the income tax with non-qualified funds
7. Estate planning objectives

Based on their studies and the information listed, we will briefly discuss four types of Roth conversions that may need to be considered. The strategies discussed may not be suitable for your personal situation. As with all strategies of this type, while your financial professional is eager to work with you in your retirement planning, the advice of your tax and legal advisor will be important in your decision on whether or not you should convert to a Roth IRA, since our firm does not render tax or legal advice.

### **Strategic conversions**

In a strategic conversion, the Roth IRA is viewed as a wealth transfer tool, not a retirement income vehicle. After conversion, the Roth IRA owner is not subject to RMDs so the full balance of the account is able to compound tax-free. At death, non-spouse Roth IRA beneficiaries will begin to take RMDs from their Inherited Roth IRAs the year following the Roth IRA owner's year of death, but the distributions will generally be income tax-free<sup>1</sup>. This may make the Roth an excellent option to transfer wealth to heirs.

Strategic conversions should be considered and special heed paid to:

- Tax rate difference between current and future income tax brackets
- Ability to use non-IRA funds to pay income taxes due
- Time horizon with the realization that the longer a Roth can grow prior to any distributions the better

### **Tactical conversions**

In a tactical conversion, the Roth is used as a tool to realize short-term, unused special tax attributes, such as:

- Net Operating Loss (NOL) carry forwards
- Business and other ordinary losses
- Deductions and exemptions in excess of income
- Charitable contributions carry forwards
- Non-refundable tax credits

With this method, an investor completes the conversion to generate taxable income. This then helps the investor realize a favorable tax attribute and may result in virtually little or no income tax on the Roth conversion.

### **Opportunistic conversions**

An opportunistic conversion might allow an investor to take advantage of short-term economic conditions that are expected to reverse over time. An example may be an IRA portfolio that has lost value due to market conditions, but is expected to rebound in the future. An investment that is expected to have rapid growth in the near future is another example.

When considering a given IRA portfolio, it may be wise to establish several Roth IRAs, segregating them with each holding a group of assets. For instance, one IRA may hold your large-cap assets, another mid-cap, a certain industry or sector. Then depending on the economic environment, while you may choose to convert all IRAs, you could recharacterize any Roth IRA account that may have a poor performance to take full advantage of the conversion strategies, and thus eliminate the income associated with that conversion while allowing the other Roth account(s) to remain unchanged. This may allow you greater control of the conversion opportunities.

### **Hedging conversions**

Finally, a conversion may be considered to hedge against some future event that might result in higher taxes. These may include both income tax and/or estate tax. In situations where a couple, currently filing a joint tax return, experiences a health decline in one spouse that may result in death, the surviving spouse could be quickly forced into a single tax filing status.

If the survivor's income doesn't decrease after the first death, he or she could pay significantly more in taxes as a single filer. Converting to a Roth IRA in a year where the tax filing status remains joint could result in fewer tax dollars being due.

Roth conversion planning is quite complex. With the advent of the changes in the MAGI rules just around the corner, we know that you will be interested in learning if a Roth conversion might make sense for your financial future. We are pleased to offer this information and look forward to working with you in evaluating your unique situation. Please contact your financial professional at our firm for a Roth conversion illustration.

<sup>1</sup>Qualified Roth IRA distributions are not subject to state and local taxation in most states. Qualified Roth IRA distributions are also federally tax-free provided a Roth account has been open for at least five years and the owner has reached age 59½, or meets other requirements. Roth IRA distributions may be subject to a 10 percent Federal tax penalty if taken prior to age 59½.

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