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What You Should Know About Roth Conversions in 2010 Fact Sheet

The Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) has provided increased incentives for individuals with sizable assets and income who previously may not have been eligible for a Roth IRA. If you are thinking about a Roth IRA conversion in 2010, here are some important points to consider when evaluating this opportunity.

1. No Modified Adjusted Gross Income (MAGI) Limits in 2010 for Roth Conversions – Beginning January 1, 2010, taxpayers will be able to convert to a Roth IRA without regard to their MAGI. Through 2009 if your MAGI is \$100,000 or less (either married filing jointly or single), you have the conversion opportunity. Currently, you cannot qualify for a conversion if you file a separate return from your spouse. Please note that the income limits for making annual Roth IRA contributions will not be eliminated in 2010.

2. Taxes Can Be Spread Over Two Years – The income taxes for a conversion in 2010 may be spread over two years, with half of the income resulting from the conversion included in tax filings in 2011 and 2012. All taxes on conversions before and after 2010 will be due in the year converted.

3. Pro-Rata Rules – Once you roll over after-tax money or make non-deductible contributions in your SEP, SIMPLE and/or Traditional IRA(s), you must keep a separate accounting for this money. This accounting must be done on IRS form 8606 so that you know how much of your future distributions or conversions will be non-taxable. It is important to understand that once you rollover or contribute after-tax money to an IRA, you cannot simply distribute or convert only the after-tax money from your IRA. This is known as the pro-rata rule. The pro-rata rule may be described as a blending of the before-tax and after-tax funds. Once the funds are blended, every distribution will contain some percentage of the two types of money. Keeping the after-tax funds in a separate IRA will not matter as the value of all SEP, SIMPLE and/or Traditional IRA(s) are looked at for purposes of determining the percentage of any distribution or conversion that is taxed and not taxed.

Pro-Rata Example

Carla, age 42, has contributed \$13,000 in after-tax money to her Traditional IRA in the past few years and has rolled her ex-employer's 401(k) containing \$7,000 of after-tax contributions to that account. She also has \$180,000 of before-tax money that she puts in a separate Traditional IRA. This year, because she is under the MAGI limits, she wants to convert \$20,000 from her "after-tax" Traditional IRA to her Roth IRA thinking she will have no tax consequences. However, due to the pro-rata rules most of the conversion will be taxable. It is important to note that keeping before-tax and after-tax money in separate IRAs will not avoid the pro-rata rules, as all Traditional, SEP and SIMPLE IRAs under your Social Security number are aggregated for determining the taxable portion of your conversion or distribution.

So, how much of the conversion will be taxable? Let's look at the formula.

Formula

| | | | | | | |
|---------------|---|--|---|--------------------------|---|------------------|
| The IRA Basis | } | $\frac{\text{After-tax money rolled over from plan} + \text{Non-deductible contributions}}{\text{Balance in ALL Traditional IRAs, including SEP and SIMPLE IRAs, as of 12/31 of the distribution year}}$ | X | Amount of IRA Withdrawal | = | Tax-Free Portion |
|---------------|---|--|---|--------------------------|---|------------------|

Note: Calculations done prior to the end of the distribution year may not reflect the actual tax-free portion.

Carla's Example

| | | | | | | |
|---------------|---|------------------------------|---|----------|---|---------|
| The IRA Basis | } | $\frac{\$20,000}{\$200,000}$ | X | \$20,000 | = | \$2,000 |
|---------------|---|------------------------------|---|----------|---|---------|

Note: Calculations done prior to the end of the distribution year may not reflect the actual tax-free portion.

Carla will owe ordinary income tax on \$18,000 of the \$20,000 conversion.

This example is hypothetical and is provided for informational purposes only. It is not intended to represent any specific return, yield or investment, nor is it indicative of future results.

4. Don't Pay for Your Roth Conversion from Your IRA – Taking a distribution from your IRA to pay the taxes due on the Roth conversion will result in additional income taxes, loss of tax deferral, and if you are under 59^{1/2}, a 10 percent premature penalty. In most instances, paying the taxes due on the Roth conversion in this manner will have a negative result for the investor. The simple rule is if you can't afford to pay for your conversion from an after-tax account, you may not be able to afford the conversion.

5. Roth Conversion from Your 401(k) – Effective in 2008, company plan balances can be converted to Roth IRAs if you meet MAGI conversion eligibility in effect through 2009. These conversions can be made through a direct rollover of before-tax and/or after-tax money from the plan to the ex-employee's Roth IRA or an amount can be distributed from the plan and rolled over to the Roth IRA within 60 days. A Roth conversion of after-tax amounts will not be taxable income. Any before-tax amount converted will be included in the IRA holder's gross income for the year. In any case the amount rolled over must be an eligible rollover distribution. The 10 percent penalty tax does not apply to the amount converted. If your MAGI is \$100,000 or less and you are a single or joint filer in the year of conversion, you qualify. Those who are married filing separately do not qualify. If you are over age 70^{1/2}, your Required Minimum Distributions (RMDs) are not included in the MAGI for purposes of qualifying for a conversion and you cannot convert your RMD.

6. Understand the Benefits of a Roth Conversion – Here are some of the key reasons individuals consider converting to a Roth IRA.

- a. Roth IRAs provide tax-free distributions of earnings after five years **and** age 59^{1/2}. If you believe that income tax rates will be higher when you retire or when you are ready to take distributions than they are now, converting may result in paying taxes at lower rates.
- b. Roth IRA owners are not subject to RMDs. Also, your spouse beneficiary, who rolls the account into their own Roth IRA, is not subject to RMDs from the Roth. So if you don't need to take distributions, the account can continue to compound tax-free.
- c. Roth IRA assets that have been in the account for at least five years and then inherited by your non-spouse beneficiaries can provide tax-free distributions paid over the beneficiaries single-life (term certain) life expectancy in their Inherited Roth IRA. Your non-spouse beneficiary begins taking RMDs the year following the year of your death.
- d. Converted amounts can be distributed without penalty after five years, beginning January 1 of the year of conversion and ending on December 31 of the fifth year. Each conversion has a separate five-year holding period. If you are under 59^{1/2} and take a distribution of converted amounts prior to the five-year holding period you may be subject to the 10 percent premature penalty.

7. Determine How Much to Convert – You do not have to convert the entire IRA. You may elect to do a one-time partial conversion or convert systematically over several years. This may be an option if you want to convert only an amount that will keep you in your current tax bracket. You do not need to have earned income to convert and you can convert if you are over age 70^{1/2}. Remember, you cannot convert your RMD.

8. You Can Recharacterize – If you convert to a Roth IRA and later change your mind, you can reverse the conversion through a recharacterization. You have until October 15 following the tax year of conversion to recharacterize. However, once you elect to recharacterize, you cannot convert again until January 1 of the year following the year of conversion, or if later, 30 days from the day you recharacterize.

Please keep in mind that our firm is not a tax or legal advisor. Your Financial Professional, working closely with your tax professional, can help you determine if a Roth conversion may be beneficial for you. For more information on Roth IRAs, ask your Financial Advisor to have a Roth Analyzer prepared for you.

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