

To Convert or Not to Convert, That is the Question

By Robert S. Keebler and Stephen J. Bigge

Robert Keebler weighs the considerations in whether to convert to a Roth IRA. 2010 will present an unprecedented opportunity for this planning in the right circumstances due to the elimination of the current AGI limitation and the ability to stretch the income tax due on the conversion over a two year period.

In January 2010, the world of IRA planning is about to change dramatically. As we near this date, when qualifying income limitations are eliminated, every client will be proffering the same question, “should I convert to a Roth IRA?” Unfortunately, the answer to this question is both mathematical and political. In order to be competitive, financial advisors, lawyers and CPAs will need additional training and better software to help their clients answer this multi-faceted question. In this article, we will analyze the mathematical aspects of Roth IRA conversions, while leaving the political debate to Congress.

In 1997, when I wrote “A CPA’s Guide to Making the Most of the New IRAs” for the American Institute for Certified Public Accountants, I identified eight reasons why someone should convert to a Roth IRA. While two of the reasons no longer apply, the remaining six reasons are still valid today.

- 1) To take advantage of favorable tax attributes (such as charitable deductions carryforwards, Net Operating Loss (NOL) carryforwards, investment tax credits, etc...)
- 2) Suspension of the lifetime required minimum distribution (RMD) rules

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- 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 account) are used to pay for the taxes due on the Roth IRA conversion
- 5) To better utilize an IRA owner’s Unified Credit
- 6) To effectively reduce the taxable estate of the IRA owner

In subsequent client experiences, we observed a new reason to convert to a Roth IRA: to hedge against the projected increase in tax rates when a first spouse dies.

Understanding Roth IRA conversions has neither been nor will ever be easy. Over the years, I have had the privilege of teaching and writing on Roth IRA conversions, read many books and articles and attended various seminars on this subject and have come up with a few general “rules of thumb”. In fact, the best way to truly understand a Roth IRA conversion and take advantage of its benefits is not by devising some complicated mathematical formula, but rather by the development of several fairly basic spreadsheet analyses.

The many variables with a Roth IRA conversion lends itself to the development of several spreadsheet analyses before arriving at an “optimum” scenario. Nevertheless, we have generally found that the following key factors need to be identified and addressed in order to best analyze a Roth IRA conversion:

- 1) Asset mix (i.e. qualified vs. non-qualified, liquid vs. illiquid)
- 2) Traditional IRA balance
- 3) Time horizon
- 4) Current and future cash flow needs
- 5) Current marginal tax rate vs. projected future marginal tax rate
- 6) Wherewithal to pay the income tax with non-qualified funds
- 7) Estate planning objectives

Based on the above factors, we have been able to isolate the following four types of Roth IRA conversions:

- 1) *Strategic conversions*—take advantage of a client’s long-term wealth transfer objectives.
- 2) *Tactical conversions*—take advantage of short-term client-specific income tax attributes which are set to expire.
- 3) *Opportunistic conversions*—take advantage of short-term stock market volatility, sector rotation and rotation in asset classes.
- 4) *Hedging conversions*—take advantage of projected future events which will result in the client being subject to higher tax rates within the near future.

Strategic Conversions

An ideal “strategic conversion” candidate would be a client who:

- a) Has “outside funds” (e.g. non-qualified liquid assets) to pay the income tax on the conversion,
- b) Will not need the Roth IRA to meet his/her annual living expenses,
- c) Desires to leave a tax-free asset to children or grandchildren, and
- d) Expects to be in the same or higher tax bracket in future tax years.

In this situation, the Roth IRA is viewed more as a wealth transfer tool rather than a retirement income vehicle. Because Roth IRA owners are not subject to the “required minimum distribution” (“RMD”) rules, the funds within the account are allowed to grow tax-free. Over a period of years, this growth can be exponential. Further, although Roth IRA beneficiaries are required to take RMDs each year, these withdrawals will be tax-free. Thus, the Roth IRA is the perfect retirement asset for which to transfer the greatest amount of wealth.

Notwithstanding the above, there are three factors which are critical to analyzing strategic conversions: (1) tax rate differential, (2) use of outside funds to pay income tax and (3) time horizon.

The first factor is the client’s current and projected future income tax brackets. From a mathematical perspective, assuming all other factors are held constant (and the income tax liability is paid with funds inside of the IRA), if a client’s current and future tax rates are the same, the client will be in the same economic position by converting to a Roth IRA conversion as if he did nothing at all.

Example 1

Michael, age 40 and married, is considering converting \$100,000 to a Roth IRA. At the present time, Michael and his wife are in the 25 percent tax bracket and expect to be in that tax bracket for all future tax years. Given these assumptions, the amount of IRA assets available for Michael in thirty years is as follows:

Figure 1

	Traditional IRA	Roth IRA
Pre-Tax Account Balance (Current)	\$100,000	\$100,000
Less: Income Tax on Roth IRA Conversion @ 25%	—	(25,000)
After-Tax Account Balance (Current)	\$100,000	\$75,000
Growth Factor	400%	400%
Pre-Tax Account Balance (Year 30)	\$400,000	\$300,000
Less: Income Tax on IRA Withdrawal @ 25%	(100,000)	—
After-Tax Account Balance (Year 30)	<u>\$300,000</u>	<u>\$300,000</u>

Another critical factor in analyzing strategic conversions is the ability to use outside funds to pay the income tax liability on a Roth IRA conversion. If the client has outside funds for which to pay the income tax liability on a Roth IRA conversion, she will be in a better economic position than if she had kept all the funds within the traditional IRA.

Example 2

Elizabeth, age 75 and single, has a \$2,000,000 traditional IRA and \$700,000 in a taxable brokerage account (i.e. outside funds). Elizabeth is normally in the 35-percent tax bracket each year and in 2010 is eligible to convert to a Roth IRA. Assuming an income tax rate on the conversion of 35 percent, a pre-tax growth rate in the IRA of nine-percent and an after-tax growth rate of 7.5-percent in the taxable brokerage account, the amount of wealth

Figure 2

	Do Nothing			Roth IRA Conversion			Difference (\$)	Difference (%)
	Traditional IRA	Brokerage Account	Total	Roth IRA	Brokerage Account	Total		
Pre-Tax Account Balance (Current)	\$2,000,000	\$700,000	\$2,700,000	\$2,000,000	\$700,000	\$2,700,000		
Less: Income Tax on Roth IRA Conversion @ 35%	—	—	—	—	(700,000)	(700,000)		
Less: "Built-In" Income Tax @ 35%	(700,000)	—	(700,000)	—	—	—		
After-Tax Account Balance (Current)	<u>\$1,300,000</u>	<u>\$700,000</u>	<u>\$2,000,000</u>	<u>\$2,000,000</u>	<u>\$ —</u>	<u>\$2,000,000</u>	\$ —	0.00%
Pre-Tax Account Balance (Year 10)	\$4,734,727	\$1,442,722	\$6,177,449	\$4,734,727	\$ —	\$4,734,727		
Less: "Built-In" Income Tax @ 35%	(1,657,155)	—	(1,657,155)	—	—	—		
After-Tax Account Balance (Year 10)	<u>\$3,077,573</u>	<u>\$1,442,722</u>	<u>\$4,520,295</u>	<u>\$4,734,727</u>	<u>\$ —</u>	<u>\$4,734,727</u>	\$214,432	4.74%

Elizabeth will have in ten years under both scenarios is in Figure 2.

The final critical factor in analyzing strategic conversions is the client's time horizon. Obviously, the

more time funds can grow in a tax-deferred environment, the better the economic result. Even in cases when the client expects to be in a lower tax bracket in the future, if the client has outside funds to pay the

Figure 3

	Do Nothing			Roth IRA Conversion			Difference (\$)	Difference (%)
	Traditional IRA	Brokerage Account	Total	Roth IRA	Brokerage Account	Total		
Pre-Tax Account Balance (Current)	\$400,000	\$112,000	\$512,000	\$400,000	\$112,000	\$512,000		
Less: Income Tax on Roth IRA Conversion @ 28%	—	—	—	—	(112,000)	(112,000)		
Less: "Built-In" Income Tax @ 25%	(100,000)	—	(100,000)	—	—	—		
After-Tax Account Balance (Current)	<u>\$300,000</u>	<u>\$112,000</u>	<u>\$412,000</u>	<u>\$400,000</u>	<u>\$ —</u>	<u>\$400,000</u>	\$(12,000)	-3.00%
Pre-Tax Account Balance (Year 10)	\$786,861	\$200,575	\$987,435	\$786,861	\$ —	\$786,861		
Less: "Built-In" Income Tax @ 25%	(196,715)	—	(196,715)	—	—	—		
After-Tax Account Balance (Year 10)	<u>\$590,145</u>	<u>\$200,575</u>	<u>\$790,720</u>	<u>\$786,861</u>	<u>\$ —</u>	<u>\$786,861</u>	\$(3,860)	-0.49%
Pre-Tax Account Balance (Year 20)	\$1,547,874	\$359,199	\$1,907,073	\$1,547,874	\$ —	\$1,547,874		
Less: "Built-In" Income Tax @ 25%	(386,968)	—	(386,968)	—	—	—		
After-Tax Account Balance (Year 20)	<u>\$1,160,905</u>	<u>\$359,199</u>	<u>\$1,520,105</u>	<u>\$1,547,874</u>	<u>\$ —</u>	<u>\$1,547,874</u>	\$27,769	1.83%
Pre-Tax Account Balance (Year 30)	\$3,044,902	\$643,271	\$3,688,173	\$3,044,902	\$ —	\$3,044,902		
Less: "Built-In" Income Tax @ 25%	(761,226)	—	(761,226)	—	—	—		
After-Tax Account Balance (Year 30)	<u>\$2,283,677</u>	<u>\$643,271</u>	<u>\$2,926,948</u>	<u>\$3,044,902</u>	<u>\$ —</u>	<u>\$3,044,902</u>	\$117,954	4.03%

income tax on a Roth IRA conversion and has a long time horizon, it is possible that a Roth IRA conversion would be more effective.

Example 3

Paul, age 45 and single, has a \$400,000 IRA and \$112,000 of non-qualified liquid assets. Right now, Paul is in the 28 percent tax bracket and expects to be in the 25 percent tax during his retirement years. Assuming a pre-tax growth rate in the IRA of seven-percent and an after-tax growth rate of six-percent in the taxable brokerage account, the amount of wealth Paul will have in the future is shown in Figure 4.

Tactical Conversions

“Tactical conversions” adhere to the same principles as strategic conversions, except that the Roth IRA in these types of conversions is used as a tool to realize short-term, unused special tax attributes. Such special tax attributes could include:

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

In a typical tactical conversion scenario, the client is faced with the possibility of losing a favorable tax attribute within the current year or in the near future. In order to realize this favorable tax attribute, the client must generate taxable income. Thus, in this case, the client uses the Roth IRA conversion to “free up” the unrealized favorable tax attribute while at the same time virtually paying little to no income tax on the Roth IRA conversion.

Example 4

In 2007, Tom and Mary Smith had the following sources of income, deductions, exemptions and credits:

Figure 4

Interest	\$3,000
Qualified dividends	5,000
Long-term capital gain	12,000
Partnership income (active)	30,000
NOL carryover	(100,000)
Itemized deductions	15,000
Exemptions (two personal, two dependency)	13,600
HOPE Credit – Child #1	1,650
Lifetime Learning Credit – Child #2	2,000

Knowing that they would have negative taxable income in 2007, thereby not being able to utilize the non-refundable college tax credits for their two children, Tom and Mary asked their CPA to determine how much they could convert to a Roth IRA so as to realize the full amount of these credits. Based on these facts, Tom and Mary’s CPA determined that they could convert \$120,000 to a Roth IRA. This was determined as follows:

Figure 5

Interest	\$3,000
Qualified dividends	5,000
Long-term capital gain	12,000
Roth IRA conversion	120,000
Partnership income (active)	30,000
NOL carryover	(100,000)
Adjusted Gross Income (AGI)	\$70,000
Less: Itemized deductions	(15,000)
Less: Personal & dependency exemptions	(13,600)
Taxable income	<u>\$41,400</u>
Gross income tax	\$3,728
Less: Education credits	(3,650)
Net income tax	<u>\$78</u>

Opportunistic Conversions

An “opportunistic conversion” is another type of tactical conversion that takes advantage of short-term economic conditions which are expected to reverse over time. A classic example of this would be a situation where a client’s IRA portfolio has languished recently due to a market correction, but is expected to turn around within the next year or two. Another example of an opportunistic conversion would be a situation where the client’s IRA portfolio holds a stock or a fund that is expected to have rapid growth within the near future.

Example 5

In 2007, Carla, age 57 and married, has a traditional IRA worth \$200,000. Within Carla’s IRA is a fund that is expected to increase the value of the IRA by 20-percent in a little over a year. In this case, assuming that Carla and her husband are going to be in the 25-percent tax bracket in both the 2007 and 2008 tax years, Carla would save \$10,000 ($\$200,000 \times .2 \times .25$) in taxes by converting to a Roth IRA in 2007 instead of waiting until 2008 or later.

Hedging Conversions

As the name implies, a “hedging conversion” is a type of Roth IRA conversion which is done to hedge against some future event that could result in higher taxes. In a nutshell, there are two main kinds of hedging conversions:

- a) Income tax hedging conversions
- b) Estate tax hedging conversions

An income tax hedging conversion is a hedging conversion which hedges against the likelihood of higher income tax rates in the future. A typical income tax hedging conversion scenario would involve a married couple where one spouse is expected to die within the near future. In this situation, in the year of death, the deceased client and the surviving spouse file a joint income tax return. However, going forward the surviving spouse will file a single income tax return. Assuming that the surviving spouse has the same taxable income in future years as when the client was alive, she will have to pay more income tax because she is now filing single. On the other hand, had the client and the surviving spouse converted to a Roth IRA in the tax years before the client died, they more than likely would have saved income tax.

Figure 6 is summary of the tax brackets for the four main filing statuses.

Example 6

Carl and Nancy, ages 75 and 70, respectively, have been retired for several years and have had the following sources of income and deductions on a year-by-year basis.

In addition to the above, Carl and Nancy had the following retirement assets:

In 2007, Carl was diagnosed with a medical condition whereby it was ascertained that he would not be expected to live much more than three years. Because of this situation, Carl and Nancy sought the advice of their CPA as to what actions should be taken, from an income tax perspective, before Carl passed away.

Figure 6

Tax Rate	Single		Married Filing Jointly		Married Filing Separately		Head Of Household	
	Floor	Ceiling	Floor	Ceiling	Floor	Ceiling	Floor	Ceiling
10%	\$ —	\$7,825	\$ —	\$15,650	\$ —	\$7,825	\$ —	\$11,200
15%	\$7,826	\$31,850	\$15,651	\$63,700	\$7,826	\$31,850	\$11,201	\$42,650
25%	\$31,851	\$77,100	\$63,701	\$128,500	\$31,851	\$64,250	\$42,651	\$110,100
28%	\$77,101	\$160,850	\$128,501	\$195,850	\$64,251	\$97,925	\$110,101	\$178,350
33%	\$160,851	\$349,700	\$195,851	\$349,700	\$97,926	\$174,850	\$178,351	\$349,700
35%	\$349,701	————	\$349,701	————	\$174,851	————	\$349,701	————

Figure 7

Interest	\$3,600
IRA distributions	48,000
Social Security (gross)—Carl	16,500
Social Security (gross)—Nancy	7,500
State income taxes	\$2,000
Real estate taxes	1,500
Charitable contributions	1,500

Figure 8

Traditional IRA	\$850,000
Roth IRA	150,000
Taxable investment account	250,000

Upon reviewing Carl and Nancy’s financial position and their cash flow needs, the CPA calculated the taxable income and income tax liability on a pre-mortem and post-mortem basis based on the assumption that Nancy would continue to withdraw \$48,000 per year from Carl’s IRA after he passes away.

Figure 9

	Before Carl's Death	After Carl's Death
Interest	\$3,600	\$3,600
IRA distributions	48,000	48,000
Social Security (taxable)—Carl	14,025	0
Social Security (taxable)—Nancy	6,375	6,375
Adjusted Gross Income (AGI)	\$72,000	\$57,975
Less: Standard deduction	(12,800)	(6,650)
Less: Personal exemptions	(6,800)	(3,400)
Taxable income	<u>\$52,400</u>	<u>\$47,925</u>
Income tax liability	<u>\$7,078</u>	<u>\$8,405</u>

Seeing that a portion of the \$48,000 IRA distribution after Carl’s death would be subject to the 25-percent marginal income tax rate, the CPA suggested to Carl that he consider converting \$10,000 per year from his traditional IRA to a Roth IRA. By converting only

Figure 10

	2007	2008	2009	2010	2011	2012	TOTAL
\$10,000 Roth IRA conversion	\$8,578	\$8,578	\$8,578	\$5,905	\$5,905	\$5,905	\$43,449
No Roth IRA conversion	\$7,078	\$7,078	\$7,078	\$8,405	\$8,405	\$8,405	\$46,449

\$10,000 per year, all of the Roth IRA conversion income would be taxed at Carl and Nancy’s marginal income tax rate of 15-percent.

From 2007 until his death in 2009, Carl converted \$10,000 to his Roth IRA each year, paying \$1,500 (\$10,000 x .15) of additional income tax on each conversion. After Carl’s death, Nancy took \$38,000 from Carl’s traditional IRA and \$10,000 from Carl’s Roth IRA, both of which were rolled over to accounts in her name. By converting to a Roth IRA before death, Carl and Nancy saved over \$3,000 in income taxes over a period of six years. This can be shown in Figure 10.¹

Like an income tax hedging conversion, an estate tax hedging conversion hedges against the possibility that the combined income and estate tax on a traditional IRA will be higher than converting to a Roth IRA.

In the context of traditional IRAs, qualified retirement plans and Roth IRAs, the gross value of these accounts will be included in the decedent’s gross estate. However, even though these accounts are included in a decedent’s gross estate, they will not receive a step-up in basis since they are deemed to be Income in Respect of a Decedent (IRD).

Because traditional IRAs and other qualified retirement plans are items of IRD, the Internal Revenue Code assesses an income tax on distributions that occur after the account owner’s death. In these situations, where an estate tax has been imposed upon the same funds that are subject to income tax, an income tax deduction for the federal estate tax paid on IRD is designed to help mitigate the effect of double-taxation. (This is commonly referred to as an “IRC §691(c) deduction”.)

The calculation in Figure 11 outlines this concept.

Even if a client expects to be in the same income tax bracket in the future as she is today, it generally is better for the client to convert to a Roth IRA today and pay the income tax on the conversion. At first blush, this may not seem logical. However, when you factor in federal and state estate taxes, the reason for doing an Roth IRA conversion before death becomes more evident.

Under general mathematical principles, it would

Figure 11

Total Value of IRA Included in Taxable Estate	\$1,000,000
Gross Federal Estate Tax @ 45%	\$(450,000)
State Death Tax @ 10%	<u>(100,000)</u>
TOTAL ESTATE TAXES	<u>\$(550,000)</u>
Total IRA Value	\$1,000,000
Less: IRC §691(c) Deduction	<u>(450,000)</u>
Taxable IRA Value	\$550,000
TOTAL INCOME TAX @ 40%	<u>\$(220,000)</u>
Total IRA Value	\$1,000,000
Less: Federal Estate Tax	(450,000)
Less: State Death Tax	(100,000)
Less: Income Taxes	<u>(220,000)</u>
Net IRA Value	<u>\$230,000</u>
% of IRA Lost to Taxes	77.00%

first appear that doing a Roth IRA conversion prior to death would not have any impact on the client from an income tax perspective. This would be true if a federal income tax deduction were allowed for the entire amount of estate taxes (both federal and state) paid on the traditional IRA. However, the federal tax law does not allow an income tax deduction for any state estate taxes paid on IRD.

Figure 12

	Traditional IRA	Roth IRA
Total IRA Balance	\$2,000,000	\$2,000,000
Less: Income Taxes Paid on Roth IRA Conversion (35%)	—	<u>(700,000)</u>
IRA Balance Subject to Estate Tax	\$2,000,000	\$1,300,000
Federal Estate Tax (45%)	\$900,000	\$585,000
State Estate Tax (10%)	<u>200,000</u>	<u>130,000</u>
Total Estate Tax	\$1,100,000	\$715,000
Total IRA Balance	\$2,000,000	
Less: IRC §691(c) Deduction	<u>(900,000)</u>	
IRA Balance Subject to Income Tax	\$1,100,000	
Federal Income Tax (35%)	\$385,000	\$700,000
Total Taxes	<u>\$1,485,000</u>	<u>\$1,415,000</u>

Because of this, the taxpayer is losing a part of the IRA balance to state estate taxes for which the beneficiaries are not receiving a corresponding deduction on their income tax returns. Conversely, the client's estate would be allowed an estate tax deduction for all income taxes (both federal and state) paid prior to death. Accordingly, it is more tax efficient to incur an income tax before incurring an estate tax.

Figure 12 illustrates this point.

Roth IRA Segregation Conversion Strategy

A client who chooses to convert to a Roth IRA always has the option to eliminate the income tax liability associated with the conversion by "recharacterizing" (i.e. undoing) the entire amount. If some of the assets have increased in value while others have decreased since the time of conversion, however, it would be more favorable to recharacterize only those assets that have experienced a loss. Unfortunately, the IRS anticipated this strategy and, in Notice 2000-39, promulgated the "anti-cherry picking rules".

In particular, the anti-cherry picking rules were designed specifically to prevent clients from recharacterizing only those Roth IRA assets that declined in value. The effect of these rules is to prorate all gains and losses over the entire Roth IRA instead of on an asset-by-asset basis, regardless of the specific asset recharacterized.

Example 7

On January 3, 2007, Roger converted \$200,000 of his traditional IRA to a Roth IRA. At the time of conversion, the traditional IRA consisted of 50-percent Large-Cap Fund (\$100,000) and 50-percent Mid-Cap Fund (\$100,000). As of April 15, 2008, the Large-Cap Fund had declined in value to \$75,000, while the Mid-Cap Fund had increased in value to \$112,500. Thus, the total value of the Roth IRA account declined to \$187,500. Should Roger choose not to recharacterize any of his Roth IRA conversion, he would have to pay income tax on the \$200,000 conversion amount, even though the Roth IRA is currently only worth \$187,500. Accordingly, Roger would like to recharacterize all of Large-Cap Fund, but none of Mid-Cap Fund. This is shown in Figure 13.

Without the anti-cherry-picking rules, Roger could recharacterize the Large-Cap Fund and eliminate

Figure 13

	Value at Date of Conversion	Value at Date of Recharac-terization	Increase / Decrease in Value
Large-Cap Fund	\$100,000	\$75,000	\$(25,000)
Mid-Cap Fund	<u>100,000</u>	<u>112,500</u>	<u>12,500</u>
Total	<u>\$200,000</u>	<u>\$187,500</u>	<u>\$(12,500)</u>

\$100,000 of income tax liability (the value of Large-Cap Fund on the conversion date). However, these rules require that Roger prorate the gains and losses of the entire Roth IRA for purposes of determining the amount recharacterized.

In this case, in order to determine the amount recharacterized, Roger must first calculate the value of Large-Cap Fund as a percentage of the total value of the Roth IRA as of the recharacterization date. This percentage is 40-percent ($\$75,000/\$187,500$). Once the percentage has been determined, the value of the IRA, as of the date of conversion, is multiplied by the 40-percent figure. Thus, if Roger were to recharacterize the Large Cap Fund, he could reduce his taxable income by only \$80,000 ($\$200,000 \times .4$) instead of by \$100,000.

Notwithstanding the above, the anti-cherry-picking rules can be avoided by specifically identifying assets to be transferred to newly established Roth IRAs, one Roth IRA for each grouping of assets. Typically, the grouping of assets would be a particular fund, stock or grouping of stocks within a market sector. Returns for different stocks, funds or market sectors could vary significantly. Some may decrease in value and others increase. Consequently, if the investment performance of one Roth IRA investment is poor, the client may re-characterize this "segregated" Roth IRA back to a traditional IRA to eliminate the ordinary income associated with that conversion, while allowing the other Roth IRAs to remain unchanged. The goal is to put different types of investments (e.g., consumer goods, energy, communications, transportation, etc.) into "segregated" IRAs, convert each segregated IRA to a Roth IRA and thereafter re-characterize only those Roth IRAs that under-performed.

Example 8

Assume the same facts as in Example 7, except that instead of creating a single Roth IRA, Roger decides to create two separate Roth IRAs, one for the Large-Cap Fund ("Roth IRA #1") and one for the Mid-Cap

Fund (“Roth IRA #2”). In this case, Roger would recharacterize Roth IRA #1 because the value of the Large-Cap Fund has gone down since the time of conversion. Provided that Roger recharacterized the entire amount held in Roth IRA #1, he will not owe any income tax on this conversion. Rather, Roger will only recognize ordinary income on the conversion to Roth IRA #2 (\$100,000). Figure 14 shows the amount of Roth IRA conversion income that Roger would recognize in this example and in Example 7.

By segregating the IRA into two separate Roth IRAs, under the above facts, Roger saves over \$5,000 in tax!

What has been described above is commonly referred to as the “Roth IRA Segregation Conversion

Figure 14

	Example 1	Example 2	Difference
Value on date of conversion	\$200,000	\$200,000	\$ —
Value of Roth IRA at recharacterization	\$190,000	\$190,000	\$ —
Ordinary income recognized	\$120,000	\$100,000	\$(20,000)
Ordinary Income Tax @ 28%	\$33,600	\$28,000	\$(5,600)

Strategy” and the steps for accomplishing this strategy are as follows:

- 1) Identify specific groups of assets and create new traditional IRAs for each asset “class”.
- 2) Convert the separate traditional IRAs to separate Roth IRAs.
- 3) Extend the tax return and pay income tax on the total Roth IRA conversion.
- 4) Recharacterize specific underperforming Roth IRAs back to the traditional IRAs
- 5) File the extended income tax return reporting the Roth IRA conversions and recharacterizations.

The key to making this strategy work is to transfer assets expected to produce different returns into different IRAs. Assets with high correlation coefficients would be placed in the same IRA while assets with low or negative correlation coefficients would be placed into separate IRAs. This would give the taxpayer the best chance of segregating the gain assets from the loss assets.

Roth Conversion Timetable

- **January 1, 2007.** First date in which a 2007 Roth conversion may take place.
- **December 31, 2007.** Last date in which a 2007 Roth IRN conversion may take place.
- **April 15, 2008.** Due date for the 2007 income tax return and the last date in which the tax liability on a 2007 conversion may be paid.

- **October 15, 2008.** Last date in which a recharacterization of a 2007 conversion may be made.

Given the above timetable, the client is able to make a Roth IRA conversion decision early in 2007, wait to determine what effect the market may have on her Roth IRA and thereafter make a final recharacterization decision more than nine months after the year in which the conversion takes place. As a result, if executed properly, the client is afforded the opportunity to make a decision with “20/20 hindsight.”

Determining the Proper Amount to Convert

Assume for a moment that the assets within a traditional IRA are only expected to grow at around five-percent. In this situation, an “opportunistic conversion” is out of the question. Accordingly, the decision to convert now becomes more strategic and driven by long-term economics. Given these

assumptions, a conversion of the entire traditional IRA to a Roth IRA would be imprudent. In this case, the “optimum” conversion amount will be somewhere between a 100-percent conversion and no conversion at all.

The key to finding the “optimum” conversion amount will depend on the client’s current and future projected income tax rates. As discussed earlier, to the extent that the client expects the future tax rate to be the same or higher than the current tax rate, little harm can be done by converting to a Roth IRA.

In many cases, the client will be in a higher income tax bracket in the future. The primary reason for this is that, upon reaching age 70½, required minimum distributions (RMDs) must come from the traditional IRA. Depending on the size of the client’s traditional IRA and the “other income” generated outside of the IRA (e.g. taxable dividends and interest, Social Security, etc.) the client will most likely be in a higher tax bracket once RMDs begin. Thus, in choosing the “optimum” amount to convert to a Roth IRA, the client most likely would convert an amount which would be taxed at a rate that would be the same or less than the client’s projected future tax rate.

Example 9

Linda, age 65 and married, has \$100,000 in a traditional IRA which she is considering converting to a

Figure 15

	Do Nothing			Roth IRA Conversion			Difference (\$)	Difference (%)
	Traditional IRA	Brokerage Account	Total	Roth IRA	Brokerage Account	Total		
Pre-Tax Account Balance (Current)	\$100,000	\$25,000	\$125,000	\$100,000	\$25,000	\$125,000		
Less: Income Tax on Roth IRA Conversion @ 25%	—	—	—	—	(25,000)	(25,000)		
Less: "Built-In" Income Tax @ 28%	(28,000)	—	(28,000)	—	—	—		
After-Tax Account Balance (Current)	<u>\$72,000</u>	<u>\$25,000</u>	<u>\$97,000</u>	<u>\$100,000</u>	<u>\$—</u>	<u>\$100,000</u>	\$3,000	3.00%
Pre-Tax Account Balance (Year 10)	\$215,892	\$49,179	\$265,071	\$215,892	\$—	\$215,892		
Less: "Built-In" Income Tax @ 28%	(60,450)	—	(60,450)	—	—	—		
After-Tax Account Balance (Year 10)	<u>\$155,443</u>	<u>\$49,179</u>	<u>\$204,621</u>	<u>\$215,892</u>	<u>\$—</u>	<u>\$215,892</u>	\$11,271	5.51%
Pre-Tax Account Balance (Year 20)	\$466,096	\$96,742	\$562,838	\$466,096	\$—	\$466,096		
Less: "Built-In" Income Tax @ 28%	(130,507)	—	(130,507)	—	—	—		
After-Tax Account Balance (Year 20)	<u>\$335,589</u>	<u>\$96,742</u>	<u>\$432,331</u>	<u>\$466,096</u>	<u>\$—</u>	<u>\$466,096</u>	\$33,765	7.81%

Roth IRA. At the present time, Linda and her husband are in the 25 percent tax bracket and expect to be in the 28 percent tax bracket once her RMDs begin. Assuming a brokerage account balance of \$25,000 generating an after-tax growth rate of seven-percent and a pre-tax growth rate of eight-percent for the IRA, the amount of wealth Linda will have in the future is shown in Figure 15.

IRA "Stretch-Out" Considerations

Along with the above considerations, when determining whether or not to convert to a Roth IRA, one must consider that Roth IRAs are not subject to the RMD rules like traditional IRAs. However, it is important to point out that Roth IRA beneficiaries are subject to the RMD rules. Nevertheless, the distributions the beneficiaries take from the Roth IRA will generally not be subject to income tax. Thus, depending on the size of the client's IRA, his life expectancy and the ages of the beneficiaries, the total amount of additional wealth that will be created by the client converting to a Roth IRA can be staggering.

Example 10

Mark, age 69 and single, is considering converting \$100,000 to a Roth IRA. At the present time, Mark is in the 25 percent tax bracket and expects to be in the 25 percent tax bracket for the foreseeable future. In addition, Mark has named his son, Chris (age 42), as beneficiary of his traditional IRA. It is expected that Chris will also be in the 25 percent tax bracket when he inherits Mark's IRA.

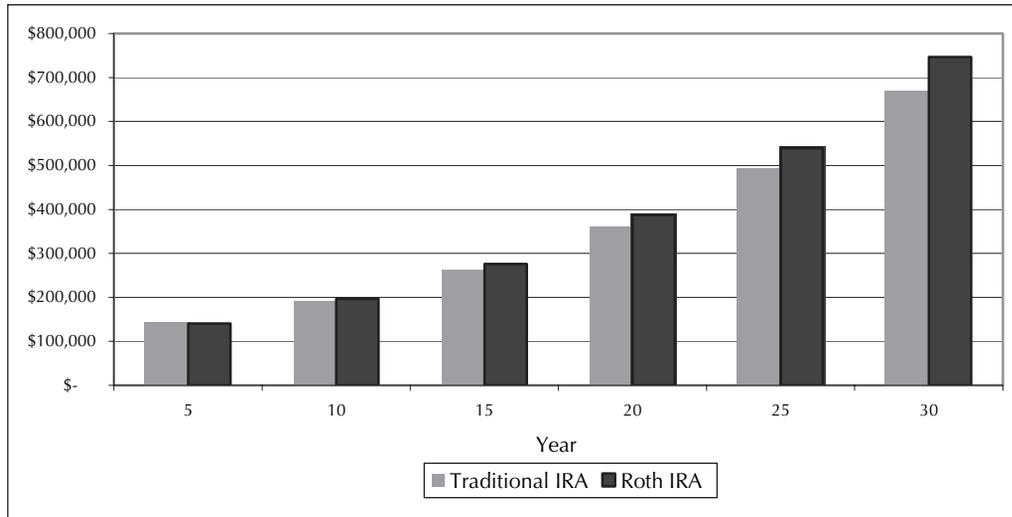
The following are the other pertinent facts and assumptions:

Mark's assumed age at death	86
Taxable investment account	\$25,000
Yield rate (i.e. dividends and interest)	2.00%
Growth Rate	5.00%
Ordinary income tax rate	25.00%
Capital gains tax rate	15.00%

As evidenced by the chart in Figure 16, Chris would have over \$80,000 more assets in 30 years if Mark were to convert \$100,000 to a Roth IRA during the current year.

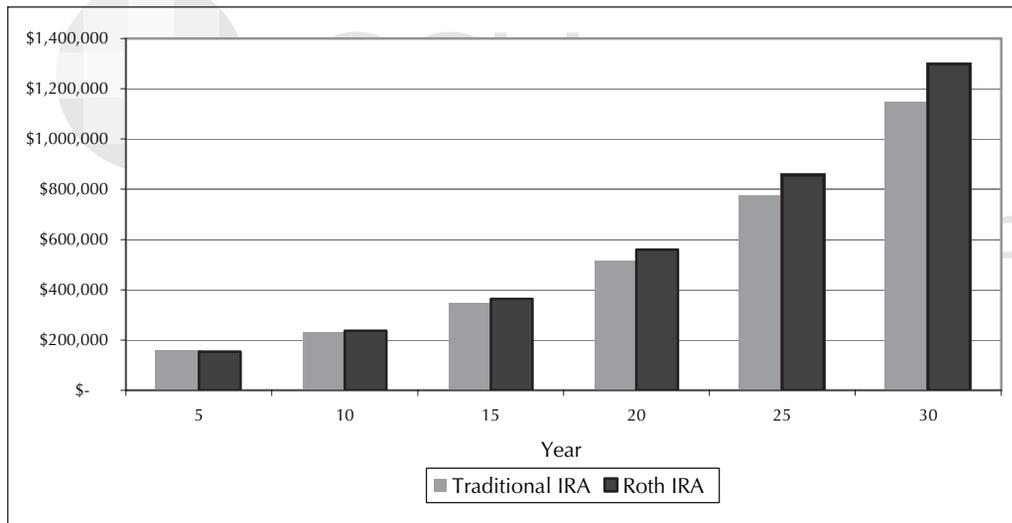
Using the same assumptions as above, except that the growth rate is seven-percent, Chris would have over \$150,000 more assets in 30 years if Mark were

Figure 16 Net Investment Assets



to convert \$100,000 to a Roth IRA. This is shown as follows:

Figure 17 Net Investment Assets



more clients will seek professional advice to determine the feasibility of a Roth IRA conversion. While

Conclusion

Roth IRA conversion planning is still relatively new and only a modest number of people have taken advantage of this planning thus far. The main reason for the relatively few people taking advantage of Roth IRA conversion planning is the current \$100,000 AGI limitation. However, as 2010 quickly approaches, more and more clients will seek professional advice to determine the feasibility of a Roth IRA conversion. While quite complex, with a good understanding of the basic mathematical principles behind Roth IRA conversions, one will be able to convey the power of tax-free deferral to his/her client.

ENDNOTES

¹ For sake of simplicity and comparability, all tax liabilities were determined by reference to the tax law in affect during the 2007 tax year.

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