Family Tax Planning Forum

By Robert S. Keebler

Roth IRA Conversion Planning in 2011 and 2012

In early 2010, there was great fanfare over the repeal of the $100,000 modified adjusted gross income (MAGI) limitation. As the 2010 tax year came to an end, most people (not to mention many tax professionals) felt that Roth IRA conversion planning had lost its relevance as an effective income tax planning strategy, given that income tax rates were set to increase to their pre-2001 levels as of January 1, 2011. However, with the reinstatement of the so-called "Bush tax cuts" under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Relief Act"), Roth IRA conversions have once again become a powerful short-term and long-term income tax planning strategy, especially in 2011 and 2012.

Understanding the Basics of Roth IRA Conversions

Understanding Roth IRA conversions has neither been nor will ever be easy. Over the years, there have been a few general rules of thumb which have proven to be useful from a broad perspective. However, the best way to truly understand and analyze Roth IRA conversions (and take advantage of its benefits) isn't by following the over-generalizing rules of thumb or by devising some complicated mathematical theorem to find an "optimum" conversion amount. Rather, the best way to understand Roth IRA conversions and analyze them properly is to develop several fairly straightforward spreadsheet analyses whereby certain key variables are modified. Accordingly, the

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following is a summary of key variables that need to be identified and addressed in order to best analyze a Roth IRA conversion:

- Size of the traditional IRA
- Current marginal tax rate versus projected future marginal tax rate
- Ability to pay the income tax with nonqualified funds
- Time horizon
- Current and future cash flow needs

Types of Roth IRA Conversions

Once the key variables behind Roth IRA conversions have been identified, the next step is to determine what type of conversion best suits the current situation.

Opportunistic Conversions

The key objective behind this type of Roth IRA conversion is to take advantage of short-term economic conditions that are expected to reverse over time. For example, a taxpayer whose traditional IRA contains stock that is expected to incur significant growth within the near future may benefit from converting to a Roth IRA. As opposed to holding the stock in a traditional IRA, holding the quickly-appreciating stock in a Roth IRA would allow the stock's growth to occur completely tax-free. The concept of converting by asset class to multiple Roth IRAs with the tactic of recharacterizing the underperforming asset classes is another example of an "opportunistic conversion".

Example

Joe is currently considering converting $300,000 to a Roth IRA in 2011. One of the assets in his traditional IRA ($100,000 of ABC Inc. stock) has a lot of upside potential within the next year. The other two assets ($100,000 of LMN Co. stock and $100,000 of XYZ Corp. stock) are difficult to determine how they will perform. Accordingly, Joe converted his single traditional IRA into three separate Roth IRAs, one for each asset. On April 15, 2012, each Roth IRA had the values shown in Table 1.

Based on the results above, Joe recharacterized Roth IRA #2 and Roth IRA #3 back to a traditional IRA. By doing this, Joe only paid income tax on a $100,000 conversion which is now worth $150,000, thereby saving future income tax on the $50,000 of post-conversion growth.

Table 1.

	Conversion Value	4/15/2012 Value	Change in Value	% Change
Roth IRA #1 (ABC Inc. stock)	$100,000	$150,000	$50,000	50%
Roth IRA #2 (LMN Co. stock)	$100,000	$100,000	$0	0%
Roth IRA #3 (XYZ Corp. stock)	$100,000	$50,000	($50,000)	(50%)
TOTAL	$300,000	$300,000	$0	0%

Strategic Conversions

The key objective behind this type of IRA conversion is generally motivated by wealth transfer. Considering that Roth IRAs are not subject to "required minimum distributions" ("RMDs") when the IRA owner reaches age 70½, converting a traditional IRA to a Roth IRA will allow the IRA assets to continue to grow tax-free for a longer period of time, thus allowing greater wealth to accumulate for future generations. An ideal candidate for strategic conversion is one who (1) possesses "outside funds" (for example, nonqualified investment accounts) from which to pay the tax on the conversion, (2) anticipates being in the same or higher marginal income tax bracket in the future, (3) does not need to make withdrawals from the Roth IRA to meet his/her annual living needs, and (4) desires to leave a tax-free asset to his/her children or grandchildren.

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Tactical Conversions

This type of Roth IRA conversion is executed to take advantage of unused, short-term, special tax attributes that the taxpayer may otherwise not be able to utilize. A non-exhaustive list of these types of tax attributes includes NOL carryovers, current year ordinary losses, unused charitable contribution carryovers, nonrefundable tax credits, as well as alternative minimum tax credit carryovers. By converting to a Roth IRA, the taxpayer generates enough taxable income to fully utilize these tax attributes. If done correctly, the taxpayer could pay little to no income tax on the conversion.

Hedging Conversions

This type of Roth IRA conversion is done as a "hedge" against a future tax increase. Hedging conversions can be further subdivided into two types of conversions: (a) income tax hedging conversions and (b) estate tax hedging conversions. Both types of hedging conversions are generally executed during the current time period so as to lower overall taxes in the future, taking into consideration the potential for higher income tax rates and/or estate tax rates that could be enacted by Congress.

> During the short time period of 2011 and 2012, there is a "window of opportunity" for people to take advantage of lower income tax rates, thereby sheltering future growth from higher income taxes.

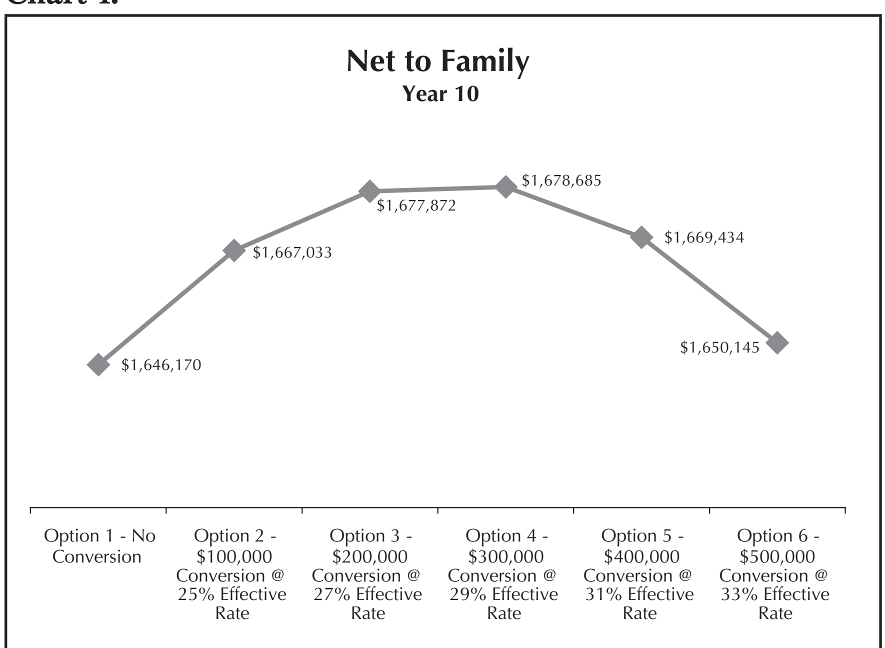
Analyzing Roth IRA Conversions on an Incremental Basis

In theory, each dollar a person converts to a Roth IRA will potentially be less valuable to him/her than the previous dollar converted to a Roth IRA. In other words, if a person converts $150,000 to a Roth IRA, the first $50,000 converted is more beneficial than the second $50,000 and the second $50,000 converted is more beneficial than the third $50,000 converted. The primary reason for this is because, on an incremental basis, a person is most likely paying a higher effective income tax rate on the next conversion amount than on the previous conversion amount.

When analyzing the appropriate amount to convert, one should not analyze the efficacy of a Roth IRA conversion as one large amount, but rather a series of smaller conversion amounts. In this case, the first thing to do would be to break the entire conversion amount up into smaller, more logical amounts based on a person's particular tax situation. From this point, a person would analyze each smaller conversion on an incremental basis to determine the overall income tax and economic impact from that particular conversion. To the extent that a particular conversion amount provides an overall incremental benefit, the conversion would be kept. On the other hand, a conversion amount that does not provide an incremental benefit would be recharacterized.

Chart 1 illustrates a $500,000 total conversion whereby the total conversion is analyzed on a $100,000 incremental basis.

Chart 1.



As indicated in the above chart, the first three $100,000 conversions provide an incremental benefit, but the fourth and fifth $100,000 conversion amounts do not. Thus, the person would recharacterize $200,000 of the $500,000 total conversion.

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Conclusion

While some feel that Roth IRA conversion planning is dead, nothing could be further from the truth. During the short time period of 2011 and 2012, there is a "window of opportunity" for people to take advantage of lower income tax rates, thereby sheltering future growth from higher income taxes. If analyzed appropriately using Roth IRA conversion software and executed properly, the wealth passed on to future generations can be astonishing.