



# FIDUCIARY INSIGHTS

## Should You Convert Your IRA into a Roth IRA?

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**R**oth IRAs were first introduced in 1998, but until now have been irrelevant in financial and estate planning for most of our clients. This is changing as we approach 2010, when income limits on Roth IRA conversions will be eliminated. For the first time, many clients who have traditional IRAs (and certain other of retirement accounts) will be able to convert them into Roth IRAs. This article describes the opportunity for conversion, reviews the differences between a traditional IRA and a Roth IRA, and discusses who will benefit most from a conversion.

### The Opportunity – A Change in the Law

The Tax Increase Prevention and Reconciliation Act of 2006 eliminates the income limits on converting a traditional IRA to a Roth IRA beginning in 2010. From a federal budgetary perspective, this is a revenue raiser, allowing more individuals to convert and thus accelerating income taxes on otherwise tax-deferred assets. Prior to 2010, taxpayers could not convert their traditional IRA to a Roth IRA if their modified adjusted gross income exceeded \$100,000.

The same limit applied to single individuals and married couples. It should be noted that income limitations will still exist for direct contributions to a Roth IRA. For 2009, individuals with incomes over \$120,000 and married couples with incomes over \$176,000, cannot make direct contributions to a Roth IRA.

The value of any assets in an IRA converted to a Roth IRA is subject to income taxes in the year of the conversion. A unique opportunity for 2010 conversions exists with individuals being allowed to report the conversion income on their 2010 income tax return, or defer the income so that ½ is reported on their 2011 return and ½ on their 2012 return. The appropriate choice will depend upon one's anticipated income levels and tax rates for 2010 compared to 2011 and 2012.



### Distinct Features of Roth IRAs

There are a few notable differences between a traditional IRA and a Roth IRA, including:

*Contributions:* Most contributions to traditional IRAs are made with pre-tax dollars, while contributions to Roth IRAs are made with after-tax dollars.

*Tax-free versus tax-deferred growth:* The traditional IRA provides tax-deferred growth, as withdrawals are subject to ordinary income taxes (except for any basis from after-tax contributions). In contrast, the Roth IRA provides tax-free growth. Although contributions are made with after-tax dollars, all qualified withdrawals

are income tax-free. For a withdrawal to be considered as qualified, the Roth IRA must (1) have been in existence for at least five tax years and (2) the owner must be over age 59½ or meet some other qualifying event such as death, disability, or a withdrawal of up to \$10,000 for a first-time home purchase. The five-year requirement applies separately to inherited Roth IRAs, with the clock beginning to run when the decedent first established his/her Roth IRA.

*Minimum distribution requirements:* The owner of a traditional IRA must take required minimum distributions beginning at age 70½. With a Roth IRA, there are no required minimum distributions for the original owner or a surviving spouse as beneficiary. Accordingly, an owner and surviving spouse can allow the funds in a Roth IRA to grow tax-free throughout their lifetimes. Non spousal beneficiaries of Roth IRAs must generally take distributions over their life expectancies.

### Who Will Benefit Most?

Individual facts and circumstances will determine whether someone should convert all, some or none of their traditional IRA to a Roth IRA. Although conventional wisdom says you should not pay taxes earlier than required, the benefits of converting to a Roth IRA may challenge that rule of thumb. There are a few circumstances that clearly make it more appealing to convert to a Roth IRA. These include:

*A lengthy time frame:* The younger a person is the longer time he/she will have, assuming a normal life expectancy, to benefit from the tax-free compounding of a Roth IRA. If you do not anticipate needing the funds in the IRA to support your lifestyle in the foreseeable future, then conversion to a Roth may be advisable.

*Assets outside of the IRA to pay conversion taxes:* It generally only makes sense to consider converting from a traditional to a Roth IRA if you have sufficient assets outside of the IRAs to pay the taxes due on conversion. You do not want to use funds from your traditional IRA to pay conversion taxes. If you do, taxes will be due on these funds as well as penalties if you are under age 59½.

*Lower tax bracket:* If you enjoy a lower tax bracket now than you think you will after you begin taking distributions from your traditional IRA, a conversion may be advantageous. For most people, however, it will be very hard to make a decision based upon tax bracket considerations. Some commentators suggest that because your overall income may be lower after retirement, you may enjoy a lower tax bracket at that time, and thus may not want to pay a potentially higher tax rate today to convert to a Roth IRA. Others counter

that tax rates will likely be higher in the future, and therefore, you are better off paying taxes currently. The truth is that it is difficult to predict what our income will look like many years from now, and impossible to predict what the tax rates will be. Thus, you may want hedge your bets and convert a portion of your IRA assets to a Roth IRA. This will provide “tax diversification,” having both taxable and tax-free assets available to you in retirement.

*Estate planning:* If you anticipate that your estate will owe estate tax at your death, converting to a Roth IRA can be a wonderful strategy for transferring part or your wealth to younger generations in your family. Income taxes paid on the conversion will reduce your taxable estate. In addition, withdrawals from a Roth IRA by a beneficiary will be income tax free, unlike withdrawals from a traditional IRA. Since distributions will not be required during your lifetime, the Roth IRA should grow to be a larger asset to pass on to heirs.

*Gifts to charity:* If you plan to leave your IRA to charity, then it does not make sense to pay taxes today to convert it to a Roth IRA.

*Tax deduction carryforwards:* If you have a significant carryforward, such as a charitable deduction carryforward that might otherwise expire, you should consider converting at least sufficient traditional IRA assets to enjoy the full benefit of the carryforward.

*Start the clock:* If you participate in an employer sponsored Roth 401(k), you may wish to convert at least a modest amount of traditional IRA assets to a Roth IRA. Establishing a Roth IRA will start the five-year clock ticking and may accelerate your ability to receive the Roth 401(k) assets in a tax-free qualified withdrawal.

### What Can Be Converted?

Most IRAs can be converted to Roth IRAs. Taxpayers can convert a traditional deductible, nondeductible or rollover IRA to a Roth IRA. Even SEP-IRAs and SIMPLE IRAs can be converted (as long, in the case of the SIMPLE IRA, you have had your SIMPLE IRA more than two years). One notable exception is that you cannot convert an IRA you inherited from someone other than your spouse to a Roth IRA. A person over age 70½ can convert a traditional IRA to a Roth IRA, after taking minimum distributions required in the year of conversion.

Conversion is not an all-or-nothing proposition. Assuming the law does not change, you can elect to convert all, some, or none of your traditional IRAs to a Roth IRA in any given year, with conversions allowed in multiple years. So, if you

want to manage your tax liability, you can convert some of your IRA each year over a number of years. Please note that tax liability can be deferred to the following two years only for conversions in 2010.

If you are converting only a portion of your traditional IRA to a Roth IRA, you cannot lower your tax burden by only converting IRAs that hold non deductible contributions. To calculate the tax liability on the conversion, you must aggregate all of your non-Roth IRAs and determine what percentage of the whole includes already taxed, non deductible contributions, versus deductible contributions and earnings that were not previously taxed. Any amounts that you convert will be treated as having the same ratio of nontaxable versus taxable as the whole, regardless of the basis characteristics of the IRA account that you actually convert.

### What If I Change My Mind?

The conversion decision is more forgiving than one might expect. If you convert and then change your mind, maybe because of a change in your circumstances or a significant decrease in the investment value of your account because of market volatility, you can “recharacterize” your conversion. This recharacterization must be completed before the due

date, including extensions, of your federal income tax return for the year you originally made the conversion. After a recharacterization, you cannot convert that or any other traditional IRA asset to a Roth IRA until the first day of the tax year after the original conversion or 30 days after the recharacterization, whichever is later.

### Conclusion

Under the new tax law, Roth IRA conversions will become an important planning opportunity for many high income individuals. The first step in evaluating this opportunity for any client will be to consider the role that a Roth IRA might play in that person’s overall financial and estate plan. If you would like to discuss your situation, please contact your Fiduciary Trust Company Account Officer.

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### *Year-end tax planning check list*

- ✓ **Capital gains and losses** – Many individuals now have capital loss carryovers due to aggressive selling in their investment portfolios last year. These carryovers will allow those who want to rebalance their portfolios in light of the recent market rally to do so without triggering significant tax liabilities.
- ✓ **Charitable gifts from IRAs** – Clients over age 70½ who have IRAs and are interested in charitable giving should consider making contributions from their IRAs before year end. The tax law provision allowing tax-free charitable contributions up to \$100,000 paid directly from IRAs is scheduled to expire after 2009.
- ✓ **Minimum required distributions** – As a reminder, this year individuals over age 70½ are not required to take minimum distributions from IRAs and other retirement accounts. Minimum distribution requirements will go back into effect in 2010.
- ✓ **Annual exclusion gifts** – The annual gift tax exclusion for 2009 is \$13,000 per gift recipient from each donor—an increase from the 2008 level of \$12,000. Married couples can gift as much as \$26,000 per donee if they choose to split their gifts. If you have significant assets and transferring wealth is part of your overall financial plan, you should consider making annual exclusion gifts before year end.

*This article was first published in Fiduciary Trust’s Fall 2009 Perspective. The commentary was authored by Jody R. King, Esq., CPA and Vice President who specializes in income and estate tax and other financial planning issues.*

*If you would like to learn more about Fiduciary Trust Company and its wealth management services, please contact Randy Kinard at 617-574-3432.*