2010

Roth IRA Conversions II: Beyond the Basics (Slides)

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Roth IRA Conversions II: Beyond the Basics

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Roth IRAs — The basics

- Permissible conversions
- Recognition of income
  - Amount recognized
  - 2010 option to defer
- Withdrawals
  - Penalties
  - Income taxes on appreciation
- Required Minimum Distributions

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Roth IRAs — Beyond the basics

Understanding the major factors

Tax
- Income
- Estate
  - Section 691(c)
  - State death taxes

Investment returns

Time horizon

Roth IRAs — Beyond the basics

Conversion Issues

- Ed Slott's "Cream in the Coffee" rule
- Strategies to avoid the "Cream in the Coffee" rule
- 401(k) /403(b) option
  - **Potential Benefit:** Lower taxes
  - **Burden:** Assets stay in the qualified plan (until in-service distribution, retirement or death)

Roth IRAs — Beyond the basics

Roth IRA contributions

- Limited by modified adjusted gross income (MAGI) — 2010
  - $120,000 Single
  - $177,000 Married Filing Jointly
  - $10,000 Married Filing Separately
- Limited amount $5,000 – $6,000
- Exception swallows the rule
  - Make nondeductible contribution, then convert (don’t contribute)
  - **Issue:** Waiting period?

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Roth IRAs — Beyond the basics

STEP 1

- Make a nondeductible contribution to a Traditional IRA

STEP 2

- Hold in Traditional IRA for short period (some say for one day, others say until the end of the year)

STEP 3

- Convert Traditional IRA (repeat Step 1 next year)

Roth IRAs — Beyond the basics

Roth 401(k) contributions

- If a 401(k) plan allows for Roth IRA contributions:
  - Great way to put funds into a Roth IRA account
  - No MAGI or other income limitations
  - Same limit of contribution to regular 401(k) (that is, generally $16,500 for 2010)
- Beneficiary designation issue

At a 35% tax rate, a Roth 401(k) contribution of $16,500 (post-tax) is equivalent to a regular 401(k) contribution of $25,400 (pretax).

Roth IRAs — Beyond the basics

Payment of Conversion Tax

- Payment due – April 15 (16 or 17)
  - Run the numbers to make sure of correct payment
  - May want to pay full amount even if you plan to recharacterize (unless you are positive)
- Underpayment penalty rules
  - For the year of conversion, make sure you are penalty-proof using the 100%/110% Rule, 90% Rule, or “Pay as you go” Rule
  - For the year after conversion, you probably don’t want to use the 100%/110% Rule

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Roth IRAs — Recharacterization

- "Oops" provision
- Allows you to take a second look
- Latest date to recharacterize is October 15 (16 or 17)
  - Do not need to extend tax return to recharacterize
  - Don't file tax return until recharacterization

Planning Tips

- Don't wait until the last minute — recharacterize by October 1
- Remember late payment penalty rules

Roth IRAs — Recharacterization

Single account versus multiple accounts

- A single account is not as beneficial as multiple accounts
- Multiple accounts allow you to take advantage of recharacterization rules
- Sub-accounts count as one account

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Roth IRAs — Recharacterization example

Four asset classes in one Roth IRA

- With one account, participant would likely not recharacterize, because amounts have increased.

Example: Roth IRA assets are invested, as follows:

Asset Class	Value
Large Cap	$250,000
Mid Cap	250,000
Small Cap	250,000
International	250,000
Total	**$1,000,000**

One asset class in each of four Roth IRAs

- With separate Roth IRAs, it is likely that the participant would consider recharacterizing the Small Cap and International Roth IRAs (because they decreased in value)

In April 2011, the value of the Roth IRA increased to $1.1 million, but the values of the different asset classes have changed, as follows:

Asset Class	Value
Large Cap	$400,000
Mid Cap	450,000
Small Cap	100,000
International	150,000
Total	**$1,100,000**

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Roth IRAs — Recharacterization

Pull-out amount versus recharacterization

STEP 1

- Determine income

Formula:

$$\text{Income or Loss} = \{R \times [(ACB - AOB) \div AOB]\}$$

STEP 2

- Determine either the recharacterization amount or the pull-out amount

Formula:

$$POA = R + \{[(ACB - AOB) \div AOB] \times R\}$$

POA = Pull-out amount
R = Recharacterized amount
ACB = Adjusted closing balance
AOB = Adjusted opening balance

Roth IRAs — Recharacterization example

Participant wants to recharacterize half of an account totaling $1 million, that is now worth $800,000

Formula:

AOB = $1 million ÷ ACB = $800,000

R = $500,000

POA = $500K + {[($800K – $1 million) ÷ $1 million] × $500K}

= $500K + {-0.20 × $500K}

= $500K – $100K

= $400K

POA = **Pull-out amount**
R = **Recharacterized amount**
ACB = **Adjusted closing balance**
AOB = **Adjusted opening balance**

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Roth IRAs — Recharacterization examples

Value on January 5, 2010, conversion of Traditional IRA:

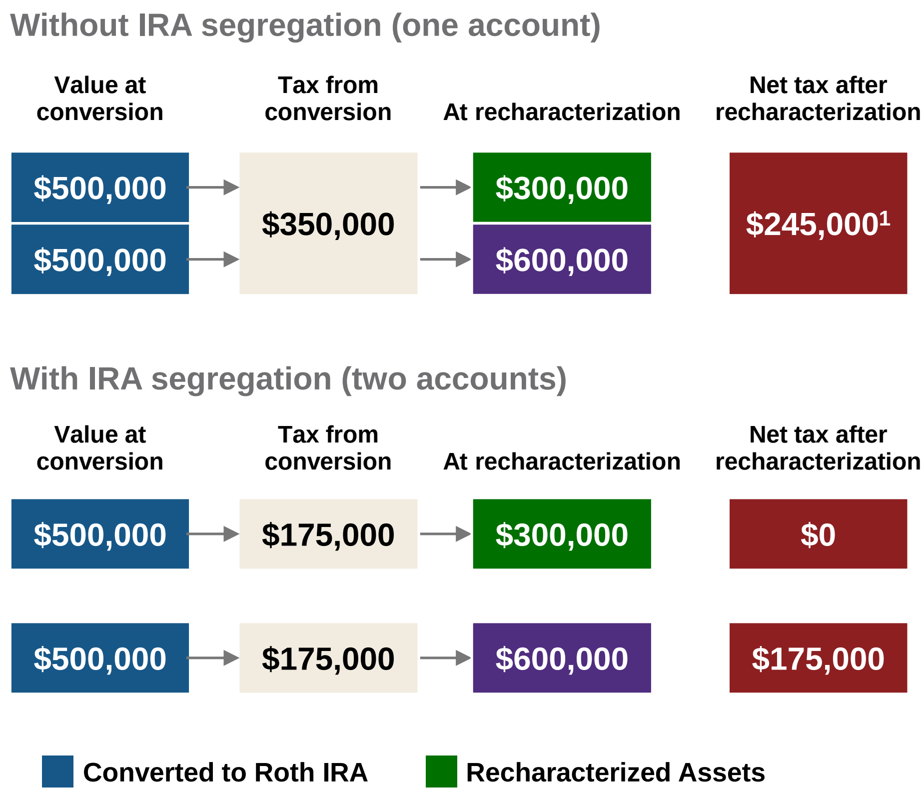
- $500,000 in equities
- $500,000 in bonds

Value of Roth IRA on November 5, 2010:

- $300,000 in equities
- $600,000 in bonds

By segregating the assets into two IRAs before conversion, participant can comply with IRS rules governing conversion.

By recharacterizing, participant's effective tax rate (based on recharacterization values for the single IRA account) is 39% ($245,000 ÷ $630,000[2]), whereas the effective tax rate for the separate IRA approach is 29% ($175,000 ÷ $600,000).



[1] The conversion amount will be $1,000,000 minus $300,000 = $700,000 × 35% = $245,000.

[2] Pursuant to Treas. Reg. § 1.408-5A Q&A 2, the amount that has to be distributed from the single Roth IRA on recharacterization is $270,000. Thus, the value of assets is $630,000 ($900,000 – $270,000).

Assumptions:

Income from conversion places participant in the 35% tax bracket.

Assets that are recharacterized all fall within the 35% tax bracket.

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Roth IRAs — Recharacterization example

On January 6, 2011, participant converts the recharacterized amount:

- 1 IRA — $270,000
- 2 IRAs — $300,000

In this case, by using two IRA accounts instead of a single IRA account, participant saves $59,500 in taxes.

Participant's effective tax rate for a single Roth IRA account is 38% ($339,500 ÷ $900,000), whereas the effective tax rate for two Roth IRA accounts is 31% ($280,000 ÷ $900,000)

Reconversion after recharacterization

	Value at conversion		Tax from conversion
1 IRA	$270,000	→	$94,500
2 IRAs	$300,000	→	$105,000

Total income tax comparison

	One Roth IRA account income tax		Two Roth IRA accounts income tax
2010 Tax	$245,000	→	$175,000
2011 Tax	$94,500	→	$105,000
Total Tax	$339,500		$280,000

Converted to Roth IRA | Recharacterized Assets

Assumptions:
Income from conversion places participant in the 35% tax bracket.
Assets that are recharacterized all fall within the 35% tax bracket.
This is a hypothetical example meant for illustrative purposes only.

Roth IRAs — Recharacterization

Convert all versus convert some

- No right way, hindsight is 20/20 on this one

Convert all	Convert some
• Leave a little behind (administrative purposes) • Consider effect of death during recharacterization • Consider impact of market forces	• When you recharacterize, recharacterize to a new Traditional IRA Account • May convert more, without waiting • Consider impact of market forces

Roth IRAs — Recharacterization

- Don't be in a hurry to recharacterize
  - Do a tax analysis to see if it makes sense to recharacterize — an increase in tax rates may make it more expensive to recharacterize and to reconvert
- Simplify — after recharacterization period ends, combine accounts
- Monitor accounts throughout the recharacterization period (that is, "care and feeding")

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Roth IRAs — Selection of assets to invest

- Asset allocation versus asset location
- Depends upon view of the market
  - Time horizon
  - Risk versus return
- Investing may be different in recharacterization period

Asset Allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

Roth IRAs — Analysis

Some adages:

- Just because you *can* do it; does not mean you *should* do it
  - Must run the numbers
- Just because conversion of some is good, does not mean that conversion of all is better
  - If 25% conversion is good, will 50% be better? Not necessarily

Major reason not to convert all

- Untimely consumption of the Roth IRA
  - Lifestyle
  - Taxes
    - Income
    - Estate
- Possible tax law changes (discussed later)

Roth IRAs — Myths and realities about paying taxes

Dispelling the myths and realities of paying tax with Roth IRA assets

- Taxes
  - Income
  - Estate
    - Tax apportionment

Myth	Don’t do it
Reality	It may still be beneficial

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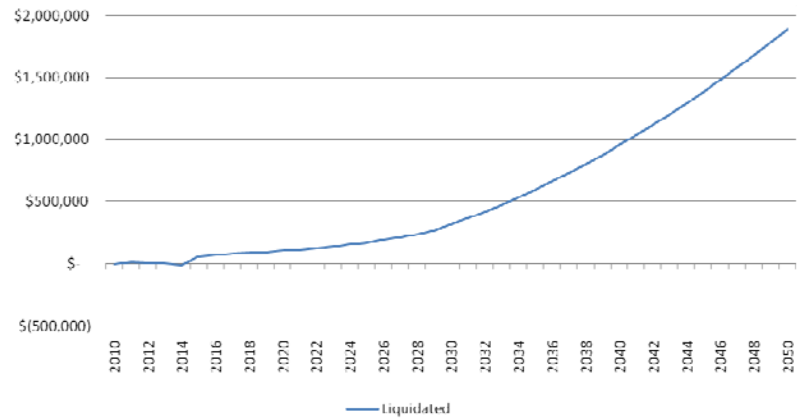
Roth IRAs — Tax example

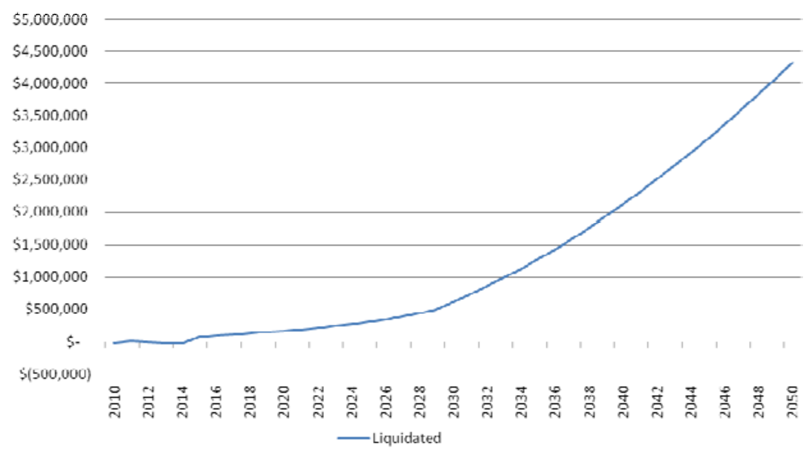
Single person ("P") is currently 65 years old.

- At death, P leaves her Traditional IRA (after payment of estate taxes) to her child, "C", who is currently 45 years old.
- P has the following assets:
  - $1 million Traditional IRA (all taxable)
  - $9 million in other assets (with a $9 million tax basis)
- P lives to 84 years and C's life expectancy (based upon the Uniform Lifetime Tables) is 85 years
- All assets are invested on a balanced approach (that is, roughly 46% in fixed income assets, 47% in equities and 7% in alternative investments), yielding a linear post-income tax rate of return of 7.33%; the turnover rate is roughly 39%.

Taxes Paid With Roth IRA Assets



Taxes Paid With Non-IRA Assets



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Roth IRAs — Who should be the beneficiary?

Married couples — first to die

First marriage	Second marriage
• Outright to spouse; then children • Do you fund the credit sheltered trust or waste the lifetime exemption?	• Do you leave Roth to surviving spouse? • Do you leave it to child(ren) of the first marriage?

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Roth IRAs — Who should be the beneficiary?

Single persons — second to die

- Stretching the IRA

Outright	Conduit trust	Accumulation trust
• Outright gift	• Leave to grandchildren • Generation skipping tax (GST) implications • 2010?	• Do they work? • Drafting issues • Generation skipping tax (GST) allocation

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Roth IRAs — Who should be the beneficiary?

Charity

Do you leave Traditional IRA to charity, or do you convert your IRA and leave other assets to charity?

Three factors revisited

Tax (income and estate)

Investment returns
(positive and negative)

Time horizon

Roth IRAs — Who should be the beneficiary?

Charity – basic fact pattern

- Single person (“P”) is currently 65 years old
- At death, P leaves her Traditional IRA to charity and (after payment of estate taxes) the balance of her estate to her child, “C”, who is currently 40 years old
- P has the following assets:
  - $1 million Traditional IRA (all taxable)
  - $9 million in other assets (with $9 million tax basis)
- P lives to 84 years and C’s life expectancy (based upon the Uniform Lifetime Tables) is 85 years
- All assets are invested on a balanced approach (that is, roughly 46% in fixed income assets, 47% in equities and 7% in alternative investments), yielding a linear post-income-tax rate of return of 7.33%; the turnover rate is roughly 39%

This is a hypothetical example meant for illustrative purposes only.

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Roth IRAs — Who should be the beneficiary?

Charity Example 1 *

- No income tax
- No estate tax
- No investment return

Result

Value of assets at participant's anticipated death	No conversion	Conversion
Estimated value of Traditional IRA	$474,686	—
Estimated value of Roth IRA	—	$1,000,000
Estimated value of other assets (net of taxes, if any)	$9,525,314	$9,000,000
Total value of assets	$10,000,000	$10,000,000
Less assets passing to charity	($474,686)	($474,686)
Net assets passing to family	$9,525,314	$9,525,314
	Benefit/(Detriment) of conversion	**—**

Value of assets at end of beneficiary's life expectancy	No conversion	Conversion
Estimated value of other assets (net of taxes)	$9,525,314	$9,525,314
	Benefit/(Detriment) of conversion	**—**

*** See Slide 26 for factual data. Note: In this example, however, we assume no income tax, no estate tax and no investment return.**

This is a hypothetical example meant for illustrative purposes only.

Roth IRAs — Who should be the beneficiary?

Charity Example 2 *

- No income tax
- No estate tax
- Investment return

Result

Value of assets at participant's anticipated death	No conversion	Conversion
Estimated value of Traditional IRA	$2,161,915	—
Estimated value of Roth IRA	—	$4,315,834
Estimated value of other assets (net of taxes, if any)	$40,996,420	$38,842,502
Total value of assets	$43,158,335	$43,158,335
Less assets passing to charity	($2,161,915)	($2,161,915)
Net assets passing to family	$40,996,420	$40,996,420
	Benefit/(Detriment) of conversion	**—**

Value of assets at end of beneficiary’s life expectancy	No conversion	Conversion
Estimated value of other assets (net of taxes)	$190,354,810	$190,354,810
	Benefit/(Detriment) of conversion	**—**

- **See Slide 26 for factual data. Note: In this example, however, we assume no income taxes and no estate taxes**
- **This is a hypothetical example meant for illustrative purposes only.**

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Roth IRAs — Who should be the beneficiary?

Charity Example 3 *

- No income tax
- Estate tax
- No investment return

Result

Value of assets at participant's anticipated death	No conversion	Conversion
Estimated value of Traditional IRA	$474,686	—
Estimated value of Roth IRA	—	$1,000,000
Estimated value of other assets (net of taxes, if any)	$6,813,923	$6,288,609
Total value of assets	$7,288,609	$7,288,609
Less assets passing to charity	($474,686)	($474,686)
Net assets passing to family	$6,813,923	$6,813,923
	Benefit/(Detriment) of conversion	**—**

Value of assets at end of beneficiary's life expectancy	No conversion	Conversion
Estimated value of other assets (net of taxes)	$6,813,923	$6,813,923
	Benefit/(Detriment) of conversion	**—**

* See slide 26 for the basic factual data. In this example, we assume that estate taxes are those that existed in 2009, and that there is no state death tax. Also, we assume no income tax and no investment returns.

This is a hypothetical example meant for illustrative purposes only.

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Roth IRAs — Who should be the beneficiary?

Charity Example 4*

- Income tax
- No estate tax
- No investment return

Result

Value of assets at participant's anticipated death	No conversion	Conversion
Estimated value of Traditional IRA	$474,686	—
Estimated value of Roth IRA	—	$1,000,000
Estimated value of other assets (net of taxes, if any)	$9,395,575	$8,650,000
Total value of assets	$9,870,261	$9,650,000
Less assets passing to charity	($474,686)	($474,686)
Net assets passing to family	$9,395,575	$9,175,314
	Benefit/(Detriment) of conversion	**($220,261)**

Value of assets at end of beneficiary's life expectancy	No conversion	Conversion
Estimated value of other assets (net of taxes)	$9,395,575	$9,175,314
	Benefit/(Detriment) of conversion	**($220,261)**

See slide 26 for factual data

*See slide 26 for the basic factual data. We assume that in 2010 the income taxes will be as the law exists at the time of the presentation (July 2010), and that in future years the provisions of EGTRRA will likely sunset. Further, we assume that capital gains and dividend income will be taxed at 20% and that the recent changes under the Health Care Act will be in place in the future (i.e., the new 3.8% Medicare tax on net investment income will be applicable). Further, we assume that there are no estate taxes and no investment returns.
This is a hypothetical example meant for illustrative purposes only.

Roth IRAs — Who should be the beneficiary?

Charity Example 5 *

- Income tax*
- Estate tax**
- No investment return

Result

Value of assets at participant's anticipated death	No conversion	Conversion
Estimated value of Traditional IRA	$474,686	—
Estimated value of Roth IRA	—	$1,000,000
Estimated value of other assets (net of taxes, if any)	$6,742,566	$6,096,109
Total value of assets	$7,217,252	$7,096,109
Less assets passing to charity	($474,686)	($474,686)
Net assets passing to family	$6,742,566	$6,621,423
	Benefit/(Detriment) of conversion	**($121,144)**

Value of assets at end of beneficiary's life expectancy	No conversion	Conversion
Estimated value of other assets (net of taxes)	$6,742,566	$6,621,423
	Benefit/(Detriment) of conversion	**($121,144)**

* See slide 26 for the basic factual data. In this example 5, we have the same assumption for income taxes as in Example 4, (see slide 30) and the same assumption for estate tax as we did in Example 3 (see slide 29). Here we also assume that there is no investment return.

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Roth IRAs — Who should be the beneficiary?

Charity Example 6 *

- Income tax
- Estate tax
- Positive investment return

Result 1

Value of assets at participant's anticipated death	No conversion	Conversion
Estimated value of Traditional IRA	$2,161,915	—
Estimated value of Roth IRA	—	$4,315,834
Estimated value of other assets (net of taxes, if any)	$17,209,499	$15,083,635
Total value of assets	$19,371,415	$19,399,468
Less assets passing to charity	($2,161,915)	($2,161,915)
Net assets passing to family	$17,209,499	$17,237,553
	Benefit/(Detriment) of conversion	**$28,054**

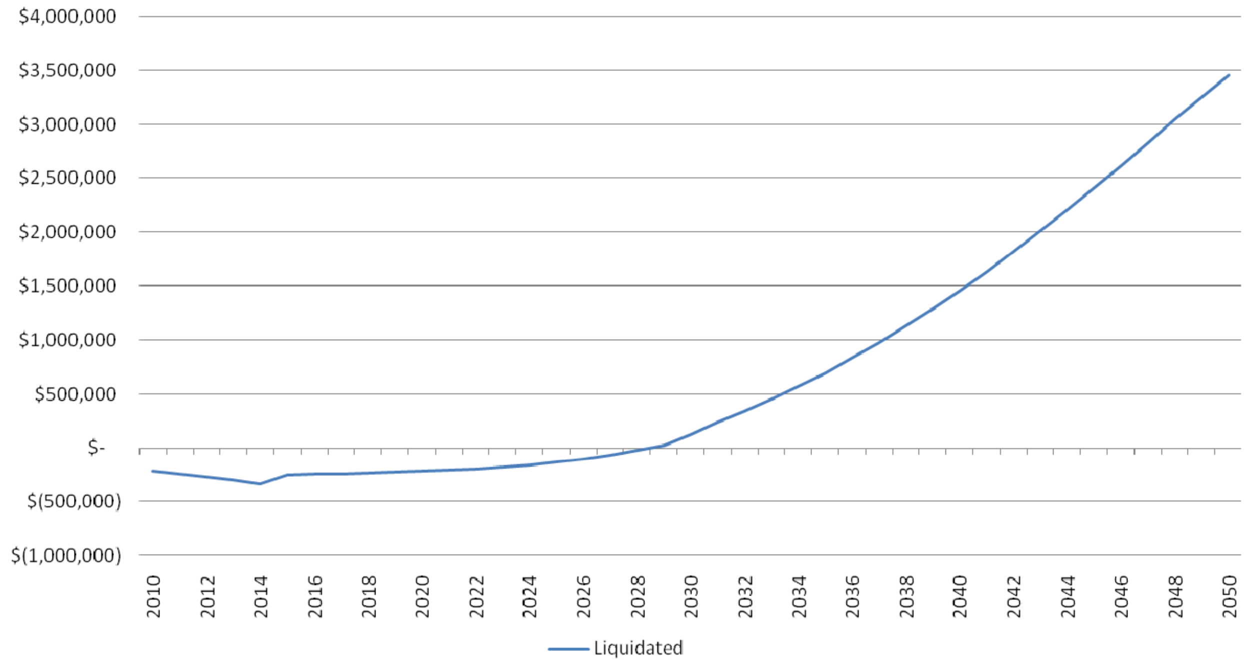
Value of assets at end of beneficiary's life expectancy	No conversion	Conversion
Estimated value of other assets (net of taxes)	$54,113,006	$57,571,325
	Benefit/(Detriment) of conversion	**$3,458,320**

* See Slide 26 for the basic factual data. In this examples we have the same assumption for income tax as in Example 4 (see slide 30), the same assumptions for estate tax as in example 3 (see slide 29) and the same assumptions for investment return (see slide 28).
This is a hypothetical example meant for illustrative purposes only.

Roth IRAs — Who should be the beneficiary?

Charity Example 6

Result 2



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Roth IRAs — Who should be the beneficiary?

Charity Example 7

- Income tax*
- Estate tax**
- Negative investment return***

Result 1

Asset Class	No conversion	Conversion
Estimated value of Traditional IRA	$367,303	—
Estimated value of Roth IRA	—	$773,781
Estimated value of other assets (net of taxes, if any)	$5,595,244	$5,065,508
Total value of assets	$5,962,547	$5,839,289
Less assets passing to charity	($367,303)	($367,303)
Net assets passing to family	$5,595,244	$5,471,986
	Benefit/(Detriment) of conversion	**($123,258)**

Value of assets at end of beneficiary's life expectancy	No conversion	Conversion
Estimated value of other assets (net of taxes)	$5,595,244	$5,471,986
	Benefit/(Detriment) of conversion	**($123,258)**

* See Slide 26 for the basic factual data. For income taxes, we used the same assumption as in Example 4 (see Slide 30). For estate taxes we used the same assumptions as in Example 3 (see Slide 29). However, for investment return, we assume that there would be negative returns of 5% per year for the first 5 years, and zero returns for the next 36 years.
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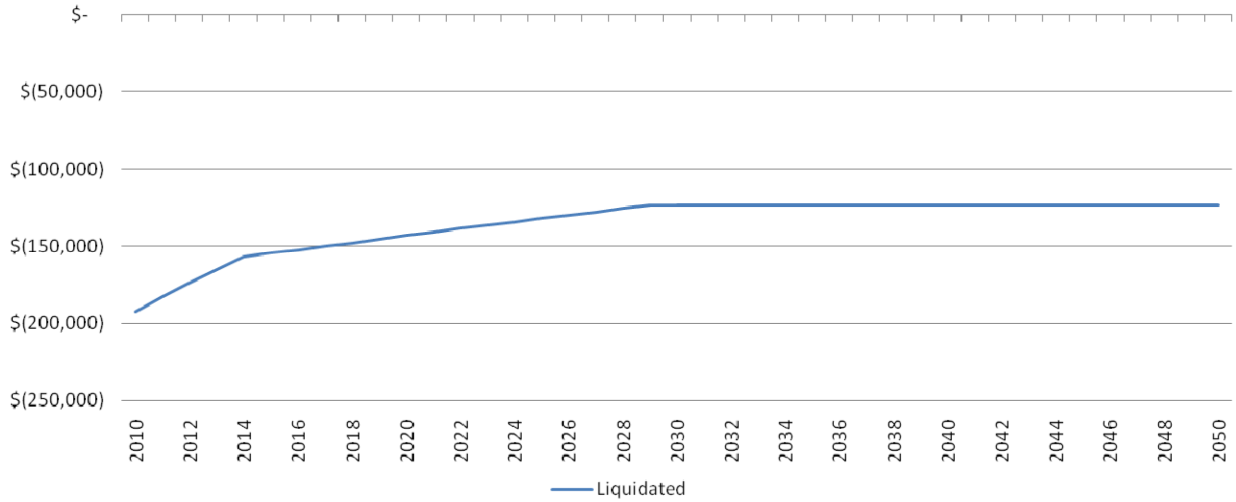
Roth IRAs — Who should be the beneficiary?

Charity Example 7

Result 2



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Roth IRAs — Charity examples summary

- **Positive returns —** It is likely that it will be beneficial over the life expectancy of the beneficiary (assuming income and estate taxes)
- **Negative returns —** Not beneficial

Roth IRAs — Charity impact

Impact of the $100,000 deduction for those who are 70½

- What do you do in 2010 if participant has not taken the RMD?
- What do you do in light of rising tax rate environments?

Roth IRAs — What do you do with 401(k) accounts?

- Can you convert 401(k) and 403(b) accounts?
  - Look at the agreement
  - In-service distributions
  - Can't go back
  - Consider a Roth 401(k)
- Maybe able to take the "cream from the coffee"
- Inherited 401(k) — a beneficiary can convert an inherited 401(k), but not an inherited IRA

Roth IRAs — Asset protection issues

Roth IRA Participant	Inherited IRA
State law • Florida – If a resident — protects all – What if residence is not known? • Varies in other states **Bankruptcy** – 401(k) – IRA — $1 million – Trace SEP IRA or SIMPLE IRA **If creditor issues** – For bankruptcy, may not want to convert • ERISA plans • IRA in excess of $1 million	**State law** • Florida – *Robertson v. Deeb,* 16 So.3d 936 (2nd DCA 2009) – F.S. § 222.21 exempting IRAs from claims does not apply to inherited IRAs • Other states — similar results **Federal bankruptcy** • Two cases – For – Against • Trust option – Conduit trust – Accumulation trust

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Roth IRAs — Caveats

- Future taxes
  - Section 83 analogy
  - 15% accumulation tax
    - Historical perspective 1997/1998
- GST implications — leaving to grandchildren
- Rising income taxes — maybe not for the beneficiaries
- Using up other assets — reticence to "sell principal"
- Psychological issues
  - 100%
  - Voluntary tax
- Uncertain times — uncertain of future