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## **AN INTRODUCTION TO ROTH IRA CONVERSIONS**

One of the more powerful financial and wealth transfer planning opportunities available today is the ability to convert a traditional IRA into a Roth IRA and, in doing so, convert future taxable income into future tax-free income. Although income tax must be paid on the converted amount, the payment of this initial tax liability can result in significant future tax savings.

In order to implement a Roth IRA conversion, an IRA owner transfers all or a portion of his/her traditional IRA and/or certain qualified retirement plans to a Roth IRA. Except for previous after-tax contributions, the amount transferred to the Roth IRA is taxable income to the IRA owner for which he/she must pay income tax. When “qualified” Roth IRA distributions occur, the distribution will be tax-free to the IRA owner and his/her future beneficiaries. The most common qualified Roth IRA distribution is one made after the IRA owner reaches age 59 1/2 and has a Roth IRA account that is at least 5 years old.

Prior to 2010, an individual’s eligibility to convert to a Roth IRA conversion was dependent upon the individual’s modified adjusted gross income (MAGI) and his/her income tax filing status. Many taxpayers were not eligible to convert to a Roth IRA because of their MAGI exceeding \$100,000. However, as a result of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), starting in 2010, the \$100,000 MAGI limitation will no longer apply. Furthermore, Roth IRA conversions during the 2010 tax year will receive special tax treatment—the resulting taxable income may be spread over the 2011 and 2012 tax years. Alternatively, the taxable income can be reported entirely in 2010. For tax years after 2010, the taxable income is included in the year of the conversion.

In 2010, every IRA owner should be asking whether he/she should convert to a Roth IRA. In this introductory paper, we will review some of the tax and quantitative aspects of Roth IRA conversions, outline the general principles for deciding whether or not a conversion is prudent and, if so, how much should be converted.

## Benefits of Converting a Traditional IRA to a Roth IRA

There are numerous benefits associated with converting to a Roth IRA. First and foremost, Roth IRAs are afforded tax-free treatment for qualified distributions, which can include both lifetime and post-mortem distributions. With Roth IRAs, all income and growth within the Roth IRA are allowed to accumulate and compound tax free, allowing the wealth within the Roth IRA to accumulate faster than assets in a taxable investment account. Furthermore, the tax-free character of the Roth IRA distributions can result in significant income tax savings to the IRA owner and his/her future beneficiaries.

In addition to the benefit of tax-free growth and distributions, there are other benefits that can be achieved from a conversion to a Roth IRA. These benefits are as follows:

- To take advantage of favorable tax attributes (such as charitable deductions carryforwards, net operating loss carryforwards, investment tax credits, etc.).
- To benefit from the fact that there are no required minimum distribution (RMD) from a Roth IRA for an IRA owner and his/her spouse, if the spouse elects to treat an inherited Roth IRA as her/his own.
- To allow for greater wealth to be transferred to future generations (in part due to the fact that no income tax deduction is allowed for state death taxes levied on IRAs) from the payment of income tax prior to the imposition of estate tax.
- To achieve greater growth potential, to the extent that outside sources (e.g., taxable brokerage account) are used to pay for the taxes due on the Roth IRA conversion.
- To better utilize the IRA owner's unified credit applicable to estate and gift taxes.
- To effectively reduce the taxable estate of the IRA owner.
- To hedge against the projected increase in income tax rates after the first spouse dies.
- To hedge against possible increases in income tax rates and/or estate tax rates.
- To take advantage of short-term stock volatility (a decline in portfolio value expected to reverse soon), rotation in asset classes, and sector rotation.

## Factors in Deciding Whether to Convert

Many variables may affect the decision to carry out a Roth IRA conversion. In most cases a detailed mathematical analysis should be performed in order to confirm the benefits of a Roth IRA conversion in each individual case. Nevertheless, we generally have found that the following key factors need to be identified and addressed in order to best analyze whether a Roth IRA conversion is appropriate:

- Current marginal tax rate vs. projected future marginal tax rate
- Ability to pay the income tax with non-qualified funds
- Time horizon
- Asset mix
- Traditional IRA balance
- Current and future cash flow needs
- Estate planning objectives

An ideal conversion candidate is a person who: (1) possesses "outside funds" (e.g., funds from investments other than IRAs and qualified retirement plans) to pay the income 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 an income tax-free asset to his/her heirs.

Even if not meeting all of the requirements above, a very likely candidate is a person with certain tax attributes (such as charitable deductions carryforwards, net operating loss carryforwards, investment tax credits, etc.) that might expire unused or "underused."

Another strong candidate is one who fervently expects or carefully projects higher income rates at the time of IRA distribution than those rates applicable to the conversion.

## Mathematical Principles of Roth IRA Conversions

Certain mathematical principles derived from IRA analyses are important to understand. Some of those principles having the largest impact are listed below.

- A Roth IRA conversion within an IRA owner's same tax bracket, using funds from the IRA itself to pay the income tax on the conversion (and assuming no application of the 10% penalty for an early withdrawal from an IRA), is tax neutral. In other words, if tax rates don't change and other assumptions remain the same, there is no benefit (or detriment) from a Roth IRA conversion. However, other factors discussed above could suggest or dismiss a conversion.
- Paying the income tax liability on a Roth IRA conversion using funds from "outside funds" (i.e., from assets other than IRAs or qualified plans) is generally more tax favorable. Returns on taxable outside funds are reduced by a "tax drag," while those inside a Roth compound tax-free and are tax-free to the recipient, when received in qualified distributions.
- The longer the time horizon, the better is the economic result. Obviously, the more time funds can grow in a tax-deferred environment, the better the economic result. Even in cases when the IRA owner expects to be in a lower tax bracket in the future, if he/she has "outside funds" to pay the income tax on a Roth IRA conversion and has a long time horizon, it is possible that a Roth IRA conversion could be beneficial.
- Depending on the size of the IRA, the account owner's life expectancy and the ages of the beneficiaries, the total amount of additional wealth that could be created by converting to a Roth IRA and using it as a "legacy" asset for future generations can be impressive. Roth IRAs are not subject to lifetime RMDs for an IRA owner and his/her designated beneficiary spouse who elects to treat the inherited Roth IRA his/her own. Roth IRA distributions, like traditional IRA distributions, can be paid out over the life expectancy of other designated beneficiaries. However, Roth IRA distributions retain their tax-free character.

### Determining the Proper Amount to Convert

After concluding that a Roth IRA conversion would be beneficial, an IRA owner must then determine how much of the traditional IRA to convert and when to do the conversion. Although there is no bright line rule or "optimum" conversion amount, there are several general rules of thumb to follow when executing a Roth IRA conversion. These include:

- To the extent that the IRA owner's current marginal income tax rate is equivalent to or lower than his/her projected future marginal income tax rate, there is little harm in making a Roth IRA conversion.
- Convert an amount that will allow as much of the conversion income as possible to remain in the IRA owner's current marginal income tax brackets. The more the taxpayer's marginal

income tax bracket increases due to the conversion, the less favorable the conversion may be.

- The ability to utilize funds from outside of the IRA to finance the conversion will allow a more beneficial result. If at all possible, avoid having to use the IRA funds to pay the income tax liability on the conversion.
- In summary, although there is an interplay of factors affecting the decision of whether to convert to a Roth IRA and the amount of the traditional IRA to convert, the driving factors are generally the IRA owner's current and projected future marginal income tax rates and the ability to finance the conversion with funds from outside of the IRA.

### **Roth IRA Recharacterizations**

A person executing a Roth IRA conversion is provided broad relief under the tax law to "recharacterize" (i.e., undo) part or all of a Roth IRA conversion. A recharacterization provides an IRA owner with the option of transferring assets from the Roth IRA back into the traditional IRA, and in doing so, eliminate the income tax liability associated with the conversion. Alternatively, in appropriate cases, the IRA owner can accomplish the same result by simply instructing the fiduciary to recharacterize the Roth IRA to a traditional IRA.

An individual may recharacterize a current year Roth IRA conversion on or before the extended filing date of the current year's income tax return. Thus, an IRA owner is able make the final recharacterization decision with the benefit of hindsight. For example, the IRA owner may execute a Roth IRA conversion early in the year, wait to determine the effect the market will have on the Roth IRA, and then make a final recharacterization decision late in the following year. In this scenario, the IRA owner may have more than nine months after the year in which the conversion takes place (potentially 21 months after the conversion takes place) to make the final recharacterization decision.

Some factors that weigh heavily in considering a recharacterization include a drop in value of the assets in the converted IRA occurring after conversion and before the recharacterization deadline; a change in the circumstances of the IRA owner, including impairment of funds to pay the conversion tax; or just cold feet.

### **IRA Reconversions**

After an IRA owner effects a recharacterization, he/she may reconvert that now-traditional IRA to a Roth IRA at the later of (1) the year following the original conversion or (2) 31 days after the recharacterization.

## Roth IRA Segregated Conversion, Recharacterization, and Reconversion Strategy

Once a Roth IRA conversion has been completed, it is possible that before the recharacterization deadline some of the investments within the Roth IRA will have increased in value while some of the investments will have decreased in value. In determining whether to recharacterize a Roth IRA conversion, the most favorable approach would be to recharacterize only those assets that have declined in value since conversion.

Unfortunately, however, the IRS has explicitly prohibited a strategy of “cherry picking” assets within a single Roth IRA to recharacterize. See Notice 2000-39, 2000-2 CB 132. All gains and losses within the Roth IRA must be prorated over the entire IRA instead of on an asset-by-asset basis, regardless of the actual assets recharacterized. Nevertheless, with careful planning and the application of the “Roth IRA Segregated Conversion, Recharacterization, and Reconversion Strategy,” a taxpayer may be able to avoid the application of the “anti-cherry picking rules” and permanently reduce the taxes incurred to effect the desired conversion.

The strategy involves specifically identifying assets to be transferred to newly established Roth IRAs and using a separate Roth IRA for each grouping of assets. Typically, the grouping of assets would be a particular fund, particular stock, or particular grouping of stocks within a market sector. Assets with high correlations to each other would be placed in the same IRA, while assets with low or negative correlations to each other would be placed into separate IRAs. Consequently, if the investment performance of one Roth IRA investment is poor, it is possible to recharacterize 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.

If the IRA owner wishes to have all the original Roth IRA holdings in a Roth IRA, he can then reconvert the recharacterized IRA with the depressed investments (expecting a relatively quick recovery), thus converting the original IRAs and incurring lower total taxable income than generated in the first conversion.

### EXAMPLE

Assume conversion on 1/2/10

Recharacterize on 10/15/11

Reconvert on 11/15/11 (Year after conversion and 31 days)

#### ***Account values at conversion date (and assume no after-tax contributions to IRA)***

Large-Cap Value Fund	\$300,000
Mid-Cap Growth Fund	<u>\$300,000</u>
Total	\$600,000

#### ***Account values at recharacterization deadline***

Large-Cap Value Fund	\$450,000
Mid-Cap Growth Fund	<u>\$200,000</u>
Total	\$650,000

If both funds are in the same Roth IRA account, you will not recharacterize, since the account has increased in value. What if you established separate Roth IRAs for each fund upon conversion?

Assume that you reconverted on 11/15/11 and the Mid-Cap Growth fund had not yet recovered in value.

**Values on conversion**

Large-Cap Value Fund	\$300,000
Mid-Cap Growth Fund	<u>\$200,000</u>
Total	\$500,000

Through a recharacterization and a reconversion, you save taxes on \$100,000 of income - a permanent savings.

**Conclusion**

Roth conversion planning is very complex. Most cases require significant mathematical analysis. Also, there are a number of considerations we have not addressed in this introductory paper, including, among other topics, estate planning considerations, retirement cash flow planning and portfolio considerations, uses of trusts in Roth IRA conversion strategies, and asset protection matters. An IRA owner must work with his/her team of professional advisors - CPA, financial advisor, and estate planning attorney (with knowledge of or access to asset protection matters) to determine whether a Roth IRA conversion is desirable and, if so, what portion of the IRA should be converted. In many cases, the factors that support some level of Roth IRA conversion generally outweigh the factors that favor no conversion.

If you have questions about whether a Roth IRA conversion might benefit you, please contact your HM&M executive.

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