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Retirement Income Planning

Roth Conversions 2010

A Once-in-a-Lifetime Opportunity

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Coming on January 1, 2010 is a "once-in-a-lifetime" opportunity for every person in the United States who has retirement money saved in traditional IRAs or other qualified plans. Without earnings limits they can convert to a Roth IRA.

This conversion opportunity allows for tax-free growth of their retirement investment dollars while spreading their tax liabilities across 2011 and 2012. Yet, when considering whether your clients should convert traditional IRA dollars to Roth IRA dollars, it is really all about tax rates.

If taxes are high, there is one major advantage with the traditional IRA, or any other type of pre-tax retirement savings plan. The money is tax-sheltered from those high rates. When the money is withdrawn and the rates are low, income taxes are paid at the lower rate. The inverse is true if the rates are currently low, but increase in the future. Retirement savings invested in a Roth IRA at today's low tax rates are immune from future income tax rate increases, forever.

CLUES TO INDICATE RISING TAX RATES

How does one know if tax rates will go up or down in the future? As people approach retirement, or are already in retirement, what clues might indicate that tax rates could be on the rise in the near future?

CLUE 1

The 35 percent top marginal tax bracket today is the lowest since Ronald Reagan was president and just a little higher than the rates in effect when Calvin Coolidge was in office. The sunset provisions in the current tax law, with no Congressional votes needed, will force the rates to revert to those effective in 2000. The 2000 top bracket rate was 39.6 percent. Today, a married couple earning $200,000, filing jointly under the existing 35 percent rate structure, would pay an estimated $44,264 in federal income tax. That same couple, filing jointly after the sunset of the Bush tax cuts, would pay an estimated $55,049 on the same $200,000 of earned income. What appears to be a small tax rate increase of only 4.6 percent actually results in a whopping tax payment increase of 24.3 percent.

CLUE 2

The bias in the tax code between married couples filing jointly and single tax payers has never gone away. Assuming that the Bush tax cuts do sunset, a single tax payer would pay $60,051 or $5,002 more than a married couple. In retirement planning, it is important to remember that eventually all joint-filing tax payers will become single-filing tax payers.

CLUE 3

The following Federal Budget items have been well documented in the national press over the past few months:

- The cost of the war since 2001, based on rough estimates, is over $904 billion dollars
- The "Cash for Clunkers" program cost $3 billion in just two months
- The "Detroit Bailout" cost $39 billion over the past year
- The Federal bailout of Wall Street, TARP Program, cost $700 billion

CLUE 4

The top marginal tax bracket during the Kennedy administration was an eye-popping 91 percent. The top marginal income tax brackets have traditionally averaged above 60 percent in the United States.

CLUE 5

In 2009, the amount of the federal deficit will approach $2 trillion dollars. The deficit in 2009 is the largest in the history of this country.

THE HIGHER-INCOME TAXPAYER PARADOX

Lori Montgomery, in her Washington Post article dated September 9, 2009, quoted Timothy Geithner in a statement on ABC News: "We have to bring these deficits down very dramatically

and that's going to require some very hard choices."

In the Washington world of political rhetoric, when it comes to taxes, "hard choices" usually mean that tax rates are going up. When you look at the clues, and these clues do not even consider the impact of health insurance reform, it is virtually impossible to believe that the current 35 percent top bracket will last into the foreseeable future. The people who are going to be paying those tax increases are those with high incomes. The people with high incomes have a target painted on their chests that will invite a series of unwelcome visits from Uncle Sam.

This leads to something called the "Higher-Income Taxpayer Paradox." This paradox assumes that wealthy people who have saved money in qualified plans at low tax rates will, at retirement, take money out of qualified plans at high tax rates. This great strategy for the government is not a very good strategy for higher income retirees.

The best solution to this tax-rate savings paradox is the Roth IRA. The Roth IRA requires that taxes be paid up-front, and for this up-front payment, the Roth IRA offers great flexibility to the taxpayer. With the Roth IRA, there are no required minimum distributions at age 70½, and the money in the Roth IRA grows tax-free. Generally, there is no income tax on the withdrawals from a Roth IRA. Plus, there are no IRD taxes imposed on beneficiaries of Roth IRAs. In addition, contributions can be made to a Roth IRA after age 70½ when there is still earned income. Ideally, Roth IRA contributions are made when taxes are low, and withdrawn tax-free during retirement when taxes are higher.

On January 1, 2010 the $100,000 MAGI restriction for Roth Conversions is eliminated. All taxpayers can convert their existing Traditional IRA accounts, their 401(k) plan balances, and their 403(b) plan balances into Roth IRAs. Although new contributions to Roth accounts are still subject to earned income limits, for the higher income taxpayers, this new conversion opportunity may be the only way to get into the Roth arena.

In a word, the Roth IRA is a great deal. It is such a great deal that higher income retirement savers were prohibited from participation by the government. If individuals had modified adjusted gross income (MAGI) of over $100,000, participation in the Roth world was either restricted or not available at all. The legislative thinking was that the very liberal, tax-friendly, Roth tax-advantaged savings plans should only be extended to lower-income wage earners.

2010 ROTH CONVERSION EVENT OPPORTUNITY

Here is the good news. On January 1, 2010 the $100,000 MAGI restriction for Roth Conversions is eliminated. All taxpayers can convert their existing Traditional IRA accounts, their 401(k) plan balances, and their 403(b) plan balances into Roth IRAs. Although new contributions to Roth accounts are still subject to earned income limits, for the higher income taxpayers, this new conversion opportunity may be the only way to get into the Roth arena.

What's the catch? The catch is that income tax must be paid on the withdrawals from traditional tax-qualified accounts to make the conversion. The good news is that the tax on conversions in 2010 may be at one of the lowest tax rates in recent history. The better news is that the tax burden created by the withdrawals in 2010 can be spread over 2011 and 2012 equally. The government is here to help, after all, or is it? There might be some urgency to pay all of the tax due in 2010. The downside to spreading the tax over two years is that the tax rates could be incrementally higher in those years than they are now.

The Roth conversion is a tax-diversification strategy that injects flexibility into a retirement plan. The Roth conversion creates an excellent pool of capital that can be passed along to children or grandchildren, income-tax-free. Unfortunately, according to an online study of investors made by Fidelity between August 14th and August 28th, 2009, most people were not aware that the Roth IRA would be available to them in 2010. Of the 800 participants in the study, 88 percent said that they were unaware of the conversion opportunity and 34 percent did not understand the tax implications of the Roth IRA conversion.

As attractive as Roth conversions are for wealthy tax payers, the personal circumstances of each tax payer will ultimately determine if making a Roth conversion is a good idea. And, that's when the assistance of a qualified financial professional is critical to investors. When it comes to making this type of decision, it is helpful for financial professionals to "model" the conversions for their clients using software tools. A good software analysis model should project three scenarios:

- What happens if you do nothing and taxes increase, decrease or remain the same?
- What happens if you make a Roth conversion and pay the tax due with assets not in the qualified plan?
- What happens if you make a Roth conversion and pay the tax due with funds from the qualified plan itself?

If your clients hold assets in traditional tax-qualified accounts and you think that tax rates are going to rise, the time for action is now. An analysis based on these three scenarios will show if this conversion strategy is a fit for any of your clients. For those clients, you should begin to educate them today about the new rules which will position you to hit the ground running on January 2. Helping clients improve their retirement financial plan by making a Roth conversion is a "once-in-a-lifetime" opportunity that should not be missed.❖