Roth IRA Conversion: A Roundtable Discussion

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In order to gain a better understanding of the issues surrounding the conversion of an IRA into a Roth IRA and why an individual may want to consider such a conversion, we have brought together a roundtable of tax, estate planning and investment professionals to provide their insights on this topic. These participants include: ***James D. Stuckey****, CPA, Partner, Clifton Gunderson LLC; Attorney* ***David L. Higgs****, Partner, Husch Blackwell Sanders LLP; and* ***Todd M. Sheridan****, CFA, Vice President, David Vaughan Investments, Inc.*

Why is everyone talking about Roth IRA conversion strategies?
Stuckey: The easy answer is that there has been a change in the tax law. Effective for 2010, there is no longer an income limitation on the ability to convert a traditional IRA into a Roth. Prior to that time frame, the income limitation precluded individuals with modified adjusted gross incomes in excess of $100,000 from converting.

Is 2010 then the only opportunity?
Stuckey: No, the ability to convert regardless of income is a change effective in 2010, but the opportunity continues on for subsequent years. The only distinction with 2010 is the fact that in 2010, the individual can elect to spread the income from the conversion into two tax years—2011 and 2012.

Is there any reason that you would pay the tax in 2010 rather than spreading it out?
Stuckey: The recommendation that I am making to many of my clients is to pay the entire tax in 2010. For those people in the top tax bracket now at 35 percent, it's very likely that they're going to be in the 39.6 percent or higher bracket in 2011 and 2012. That bracket change is going to be more costly than the loss of the opportunity of investing the tax money for another two years.

Sheridan: If you have a taxpayer who has carry-forwards from charitable deductions or other losses that could offset the income from conversion, this could also impact the decision.

With the status of the estate tax currently unknown, are there certain estate tax factors we can count on more than others, and, if so, how does that impact the Roth conversion decision?
Higgs: It certainly seems that even though there is discussion of estate tax reform in Congress, there will continue to be a federal estate tax now and into the future. And to the extent that people are impacted by estate tax, the Roth conversion can provide some useful estate planning opportunities. One opportunity is in the form of allowing for an easier, more efficient funding of credit shelter trusts. Another opportunity is the reduction of a taxable estate and ultimate reduction of estate tax due to the payment of income tax associated with a conversion.

Does the age of the designated beneficiary have an impact on the success of the Roth conversion?
Higgs: Sure. When the owner of the Roth IRA dies, required minimum distributions must commence at that point in time, and this distribution is based on the age of that designated beneficiary. The younger that designated beneficiary, the smaller the distributions, and thus, the longer the period of distribution. The exception to this is if the spouse is named the beneficiary. The designated spouse can treat the rollover of the Roth as his or her own, and as such, is not subject to required minimum distributions.

So under best-case circumstances, would you want to name a child or grandchild as a beneficiary?

Higgs: Fundamentally it's going to be a matter of who you want the benefits to go to. Typically, a spouse is going to be named first. Certainly, people are still going to identify children and grandchildren if that's a fit. A concern with a young grandchild, however, may be the owner of the IRA may not have full confidence as to how that person is going to turn out. You may need to use a trust solution for them. There may be other complications with that, but the stretch out part of it is certainly beneficial.

Would you manage the investments held in a Roth IRA any differently than a taxable portfolio?
Sheridan: The Roth in this kind of a situation would become the most valuable account, assuming the existence of other taxable accounts. You would definitely want to take advantage of utilizing the Roth to locate your most tax-inefficient investments, and also simultaneously ensure that you did everything possible to preserve value in the Roth above and beyond all of the other accounts in the client's portfolio.

What is recharacterization, and how does that all work in light of an overall portfolio strategy?
Sheridan: *Recharacterization* is the ability to basically undo a Roth conversion. Several reasons could drive this consideration, such as changes in tax rates, income or a decline in value of the converted assets. Recharacterization would put the assets back in the original IRA and eliminate the ordinary income tax consequence. It is a powerful tool to be able to back your way out, if it is to your advantage. It is also a valuable option due to the long window available to a recharacterization—as long as six months after the tax filing deadline, assuming full extensions. So a conversion in January 2010 could be reversed potentially as late as October 2011 if circumstances change.

How important is it to fund the tax liability associated with the conversion with assets outside the IRA?
Sheridan: It is extremely important. Assuming income tax rates stay constant in the future, a Roth IRA will produce the same after-tax future value as a traditional IRA. However, if you are able to fund the tax liability from conversion with post-tax dollars outside of the IRA, you are basically concentrating more of your total portfolio in the tax shelter of the Roth. That is where the real power in this conversion opportunity really comes from.

What are the potential risks or downsides to implementing a conversion strategy?
Stuckey: Well, taxpayers considering a Roth conversion would have to recognize that predicting future income tax rates in retirement years is very difficult, particularly when the timeframe can be 20 or 30 years into the future. There's always a possibility that a future Congress can convert our present tax system to a value-added or national sales tax system, in which case, conversion today could be a strategic error. So there's certainly some risk here.

In closing, what would you consider the best-case fact pattern to take advantage of a Roth IRA conversion strategy?
Stuckey: Well, keep in mind each individual situation can be different and unique, but as a general rule, first, an individual who expects to be in the same or a higher tax bracket in the future, and second, an individual who does not need to take withdrawals to meet annual living expenses in the future would be good candidates. Since under the Roth you are not required to take those withdrawals, the longer you leave the money in there, the more compounding and benefit you receive. Third, an individual who can pay the tax at the time of the conversion with funds held outside of the IRA is a good candidate. Fourth, as Dave was mentioning earlier, if we are dealing with a taxable estate, the payment of the income tax due to conversion would reduce the size of the estate and hence the estate tax. And fifth, the younger the individual, the better the opportunity for conversion because of the long time period the money can be in the Roth since there's no required withdrawal during that life. This increases the opportunity to compound and earn a fair return without taxation. All of those issues point to the possibility of a beneficial conversion.

Thank you, gentlemen, for your time and perspectives. **iBi**

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