Converting to a Roth IRA: Beyond the Basics

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Outline

- Conversion Benefits and Costs
- Modeling Considerations
- Uncertainties (Risks) and Priorities
- Conclusions and Recommendations
- Practical Considerations
- Your Questions

Traditional versus Roth IRA

- “Traditional IRA”
  Funded with before-tax dollars.
  Tax on interest, dividends and gains is deferred.
  Distributions are taxed as ordinary income.

- “Roth IRA”
  Funded with after-tax dollars.
  Tax on interest, dividends and gains is deferred.
  Distributions are tax free.

An Alternative Paradigm

A traditional IRA is a joint venture.

- Governments' share is the unrealized tax.
- Your share is about 70%.
- Your share of a Roth IRA is 100%.

Your share of the investment earnings are tax-free

- About 70% of the earnings on a traditional IRA
- All of the earnings on a Roth IRA.

Buy-out Costs Are Paid from non IRA

Before Conversion

- $1MM traditional IRA plus $300,000 non IRA
- You receive earnings on $1MM (70% of IRA + non IRA)
- Your earnings from the IRA are tax-free
- Your earnings from the non IRA are taxed

After Conversion

- $1MM Roth IRA
- You receive earnings on $1MM, as before
- All earnings are from the IRA; all earnings are tax-free

Alternatively, the IRA is Partitioned

Before Conversion

- $1MM traditional IRA plus $300,000 non IRA
- You receive earnings on $1MM (70% of IRA + non IRA)

After Conversion

- $0.7MM Roth IRA plus $300,000 non IRA
- You receive earnings on $1MM, as before
- Your earnings from the IRA are tax-free
- Your earnings from the non IRA are taxed
- There are no tax savings

Other Considerations

- Roth IRAs are exempt from required minimum distributions before death.

  For those with surplus resources

  1. There is more time to accrue tax-free earnings.
  2. Inherited IRAs are larger.

- For those with surplus resources

  1. Estate tax may be reduced.
  2. Roth IRAs are better for funding a bypass trust.

- ERISA pensions provide better asset protection.

On the Other Hand,

Converting Generally Costs More

"Conversion Premium"

- 32% Costs (taxes, Medicare surcharges, other) if the IRA were converted today.
- 29% Costs (taxes, Medicare, other) if the IRA were distributed over the lives of owner and beneficiary.

It may be possible to reduce the conversion premium by converting gradually, by converting less and by converting in years of low income or high deductions.

Modeling Conversion Benefits

No Distributions from Traditional or Roth IRA

Net Benefit equals

- The value of Roth IRA

  $(1 + \text{Return})^{N}$

- Less the after-tax value of Traditional IRA

  $(1 - \text{Tax}) * (1 + \text{Return})^{N}$

- Less the after-tax value of Conversion Costs

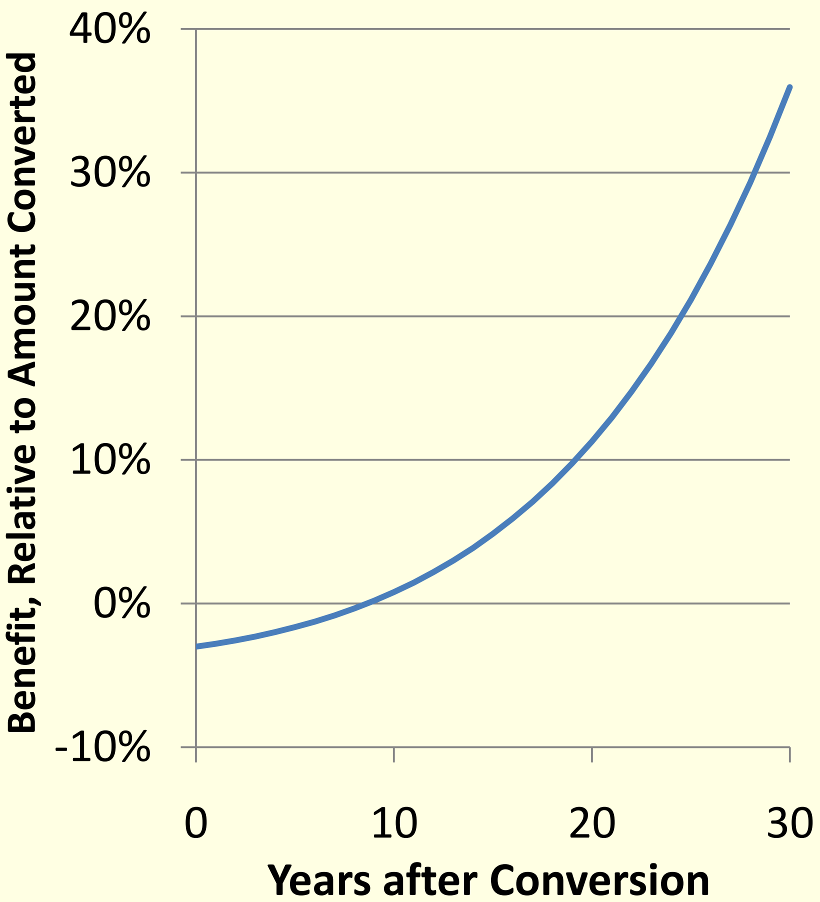
  $(1 + \text{AT Return})^{N}$

Modeling Conversion Benefits

No Distributions from Traditional or Roth IRA

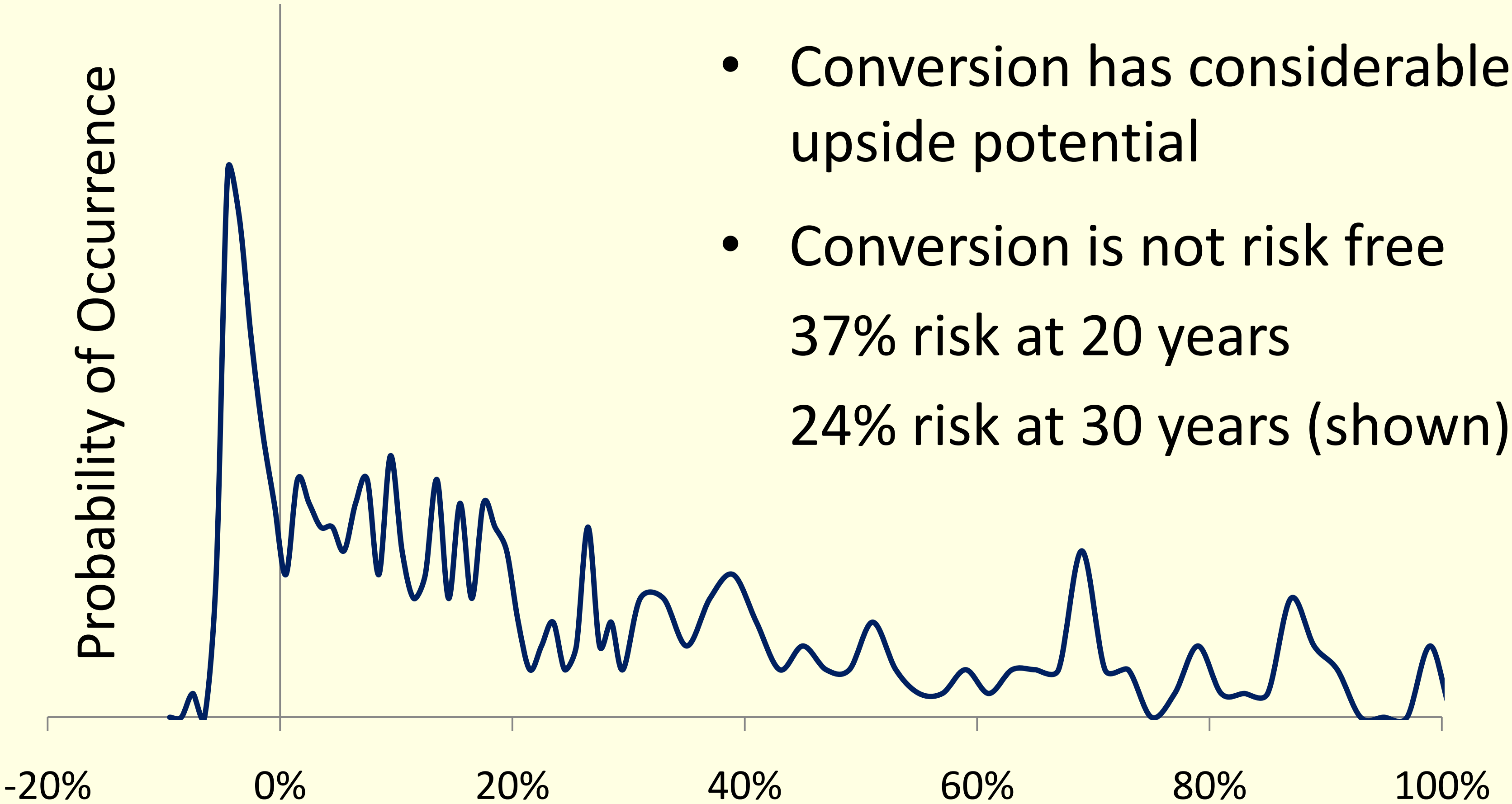
Illustration:

- 6% return net of inflation & expenses
- 32% Conversion Costs
- 29% Tax in Retirement
- 4.8% after-tax return on Conversion Costs
- Benefit is inflation-adjusted and after-tax



Modeling Conversion Benefits

No Distributions, 6% return, 16% standard deviation



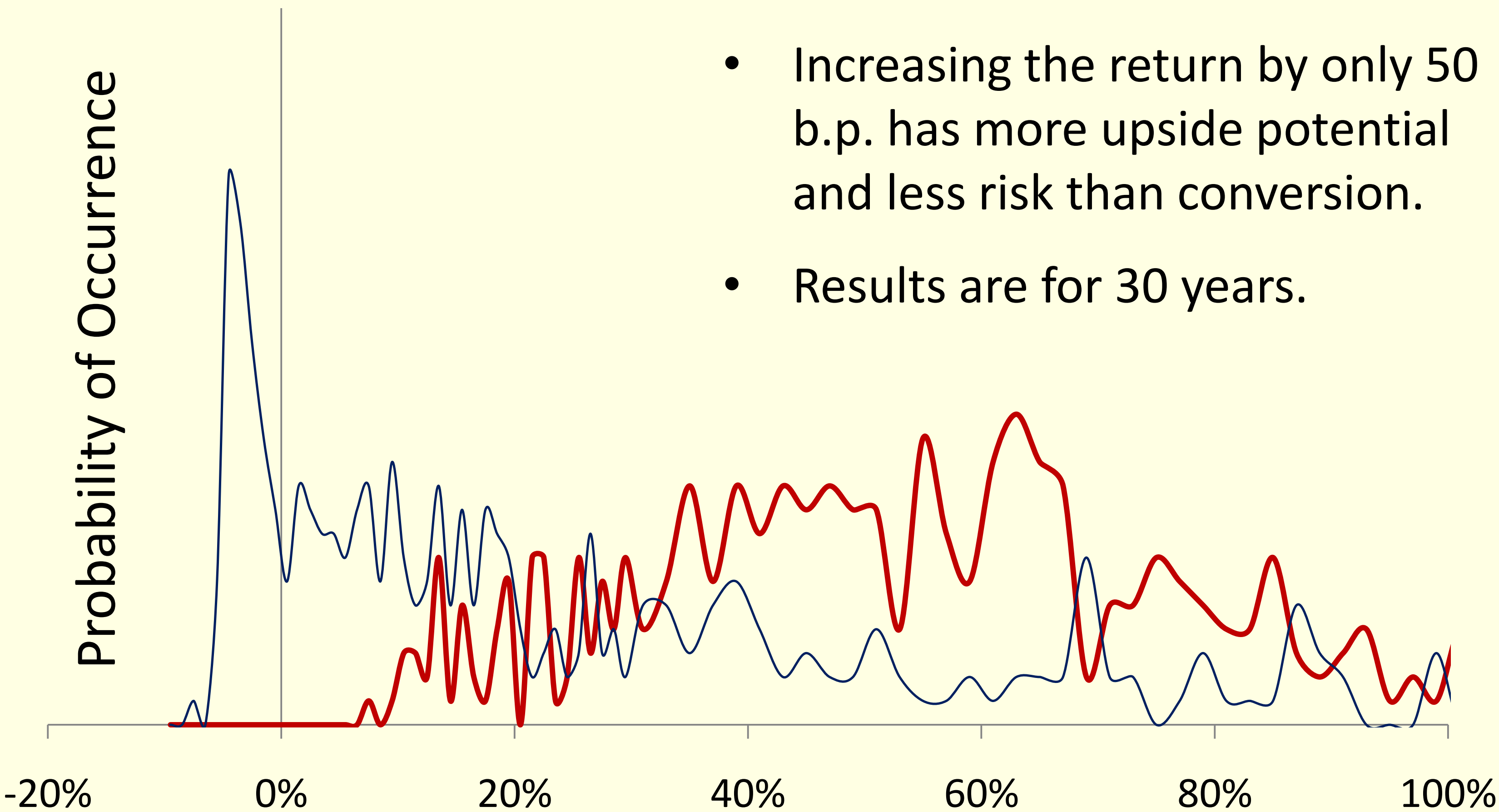
- Conversion has considerable upside potential
- Conversion is not risk free

  37% risk at 20 years

  24% risk at 30 years (shown)

Modeling Conversion Benefits

No Distributions, Enhanced Return



- Increasing the return by only 50 b.p. has more upside potential and less risk than conversion.
- Results are for 30 years.

Conversion by Younger Participants

- Considerable upside potential and some downside risk.
- Opportunity costs.
- Event risks.
- It is better to enhance returns; can do both!
- Consider delaying conversion.

Modeling Distributions as Annuities

"Roth IRA Conversion" by Wayne A. Thorp, Spreadsheet Corner, *Computerized Investing,* First Quarter 2010.

- Annuitize the traditional IRA, the conversion costs and the Roth IRA.
- Compare sum of the after-tax cash flows from traditional IRA and conversion cost annuities to the cash flow from the Roth IRA annuity.
- Annuities satisfy the minimum distribution requirements.

Example 1.

Annuity Model, Initial Year

Assumptions:

$400,000 traditional IRA

$128,000 conversion costs (32%)

28.75% tax on distributions

65 year old female (7% payout for life)

$28,000 spending

After-tax cash flow:

- Roth IRA: $28,000 per year
- Traditional IRA plus Conversion Costs: $28,129

Example 1.

Annuity Model, Later Years

Initially, $129 negative cash flow.

After recovery of basis, about twenty years:

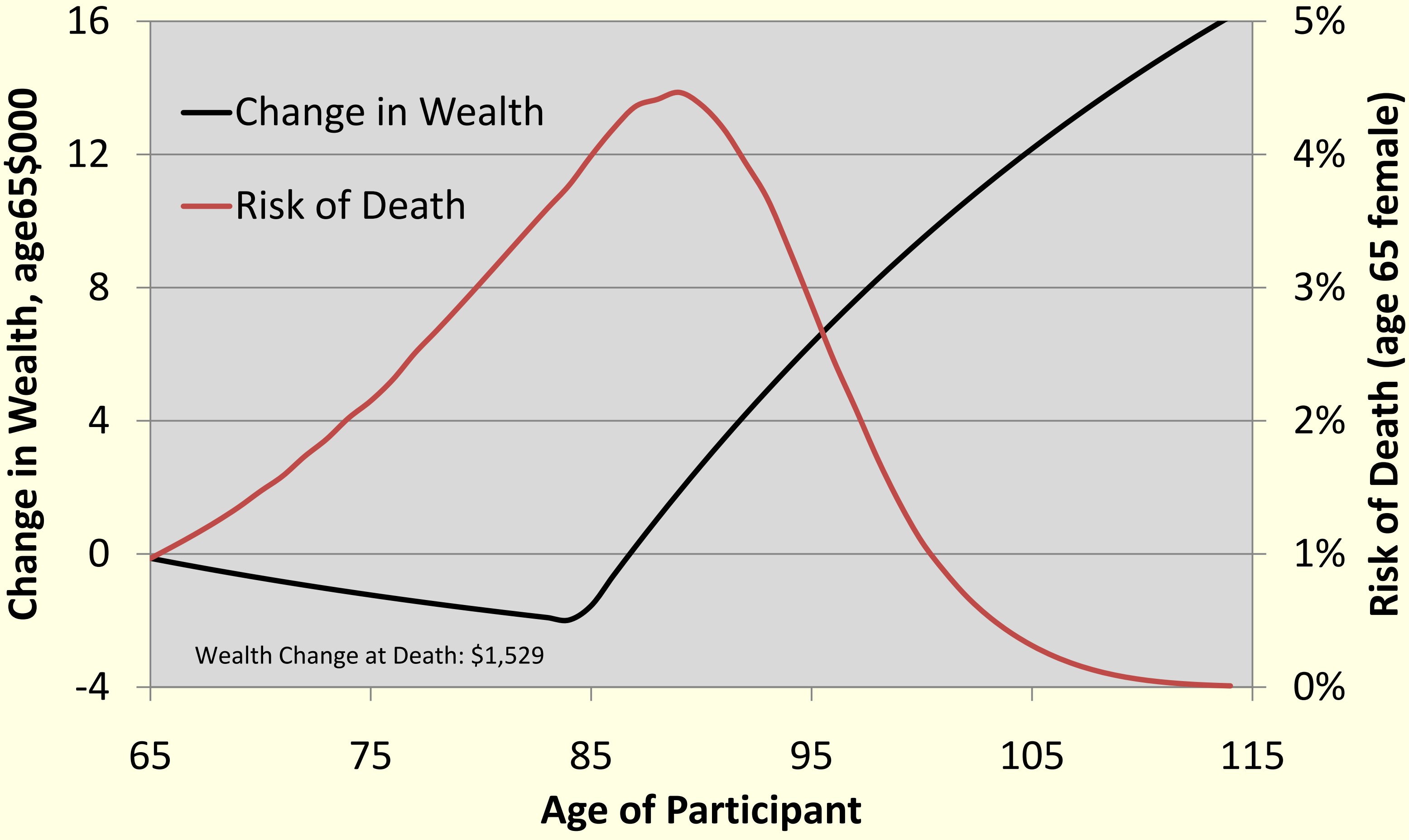
- Roth IRA: $28,000
- Traditional IRA plus Conversion Costs: $26,334
- $1,666 positive cash flow

Conversion might increase wealth at death.

- Discount cash flows before netting.

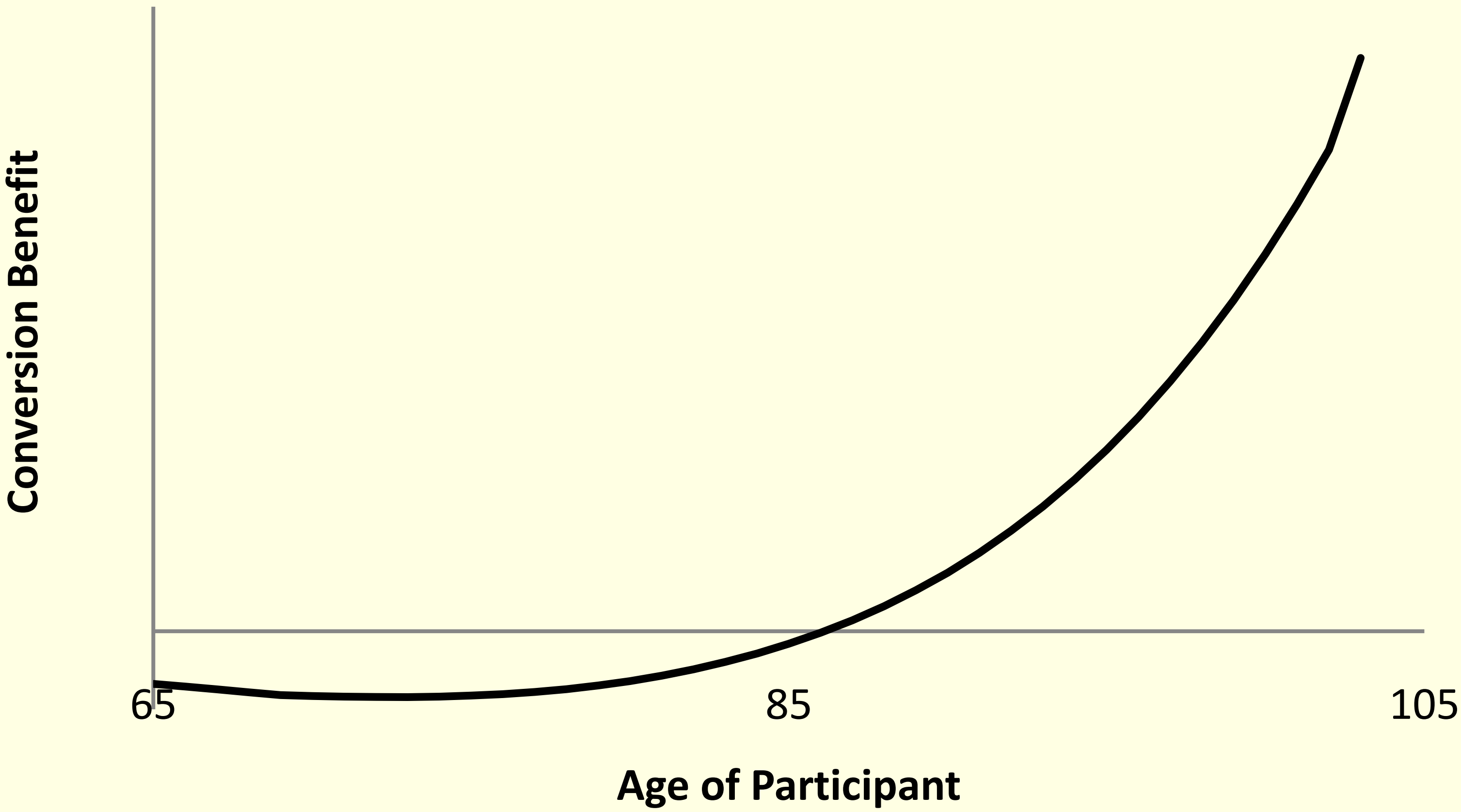
Wealth Benefit at Death

Sum of the change in wealth at each age weighted by the risk of death.



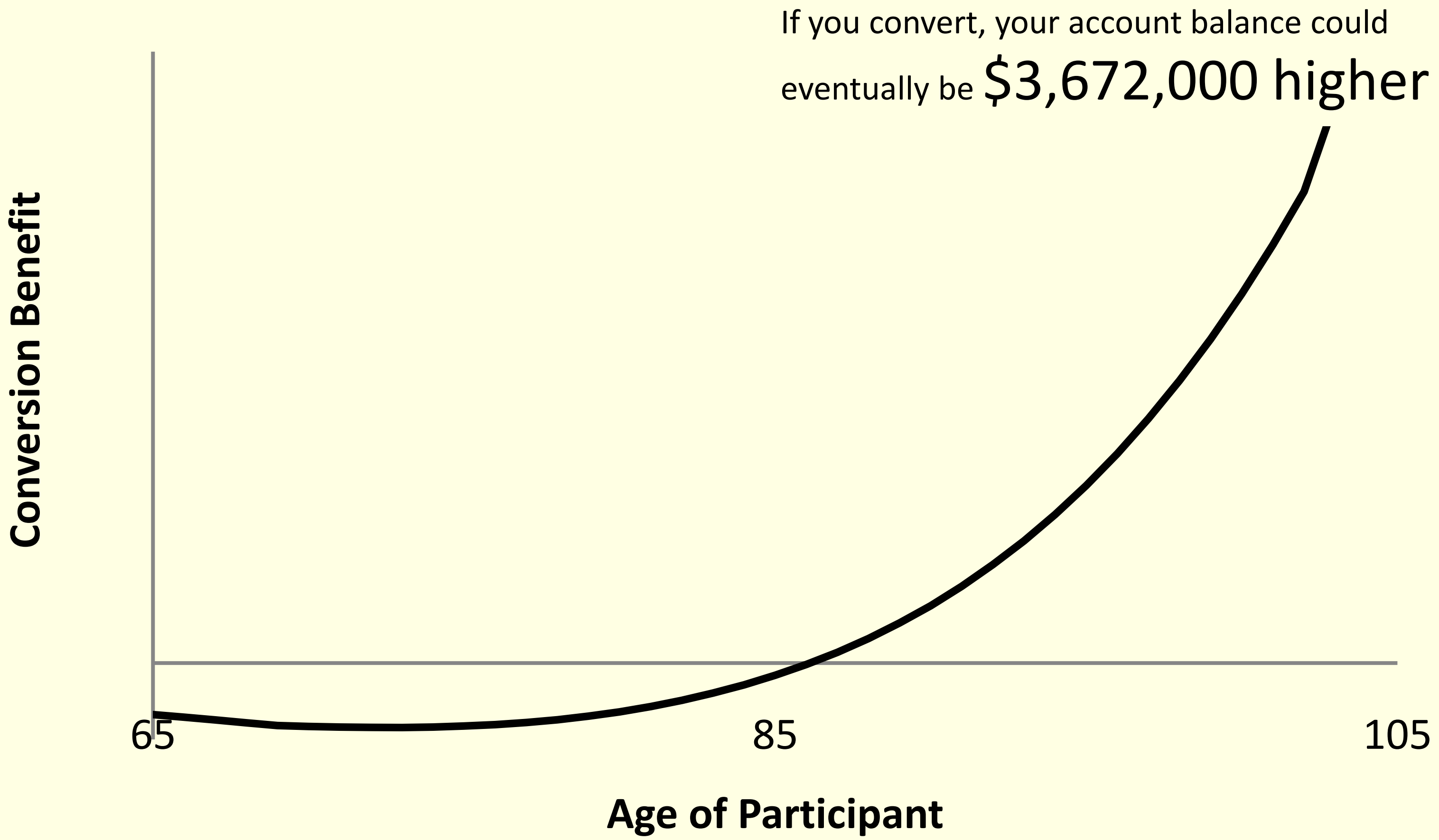
Brokerage Firm Calculator 5/28/2010

$1MM IRA, 4% premium, 30% tax, aged 65 female



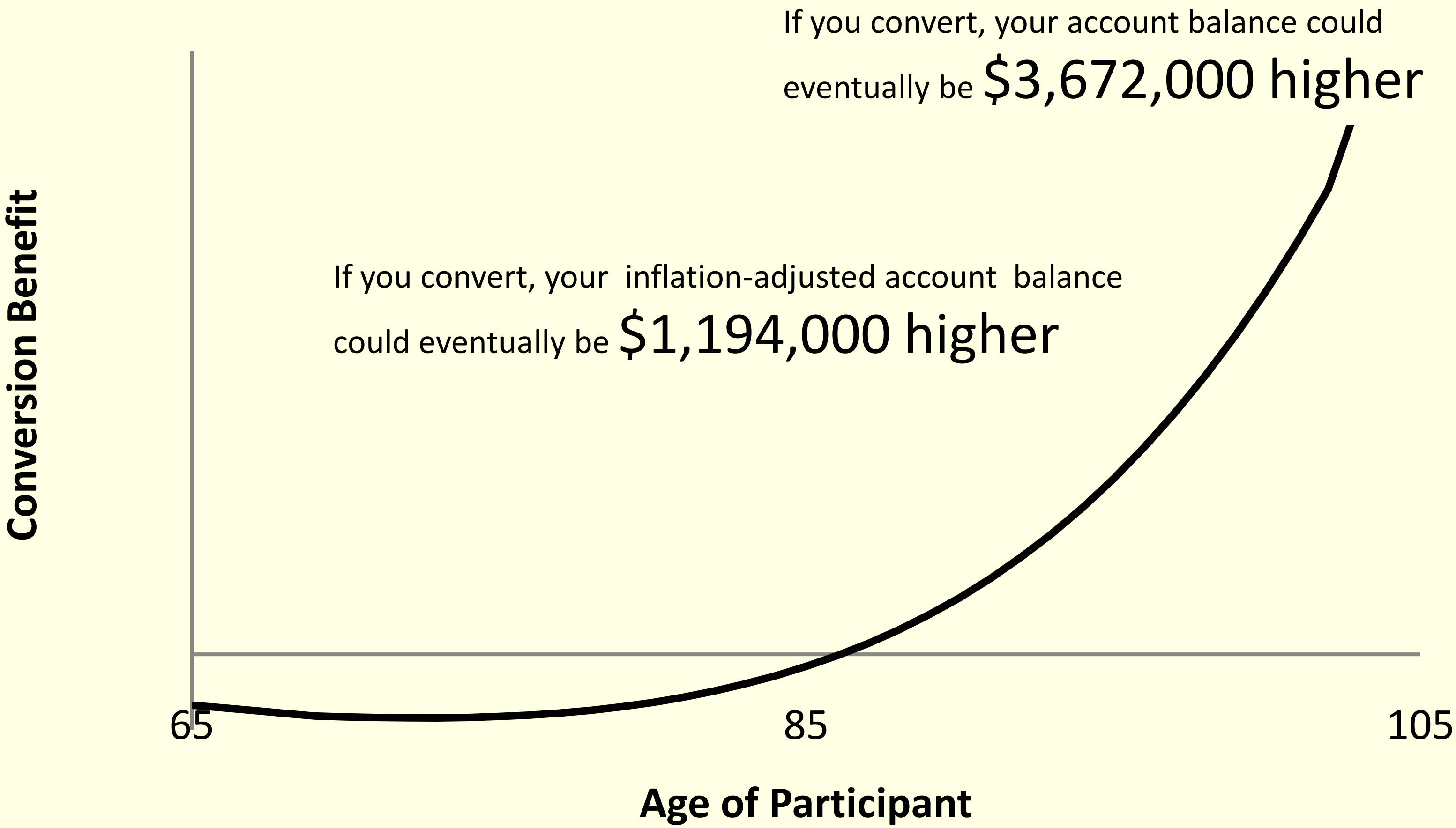
Brokerage Firm Calculator 5/28/2010

Benefit at age 103



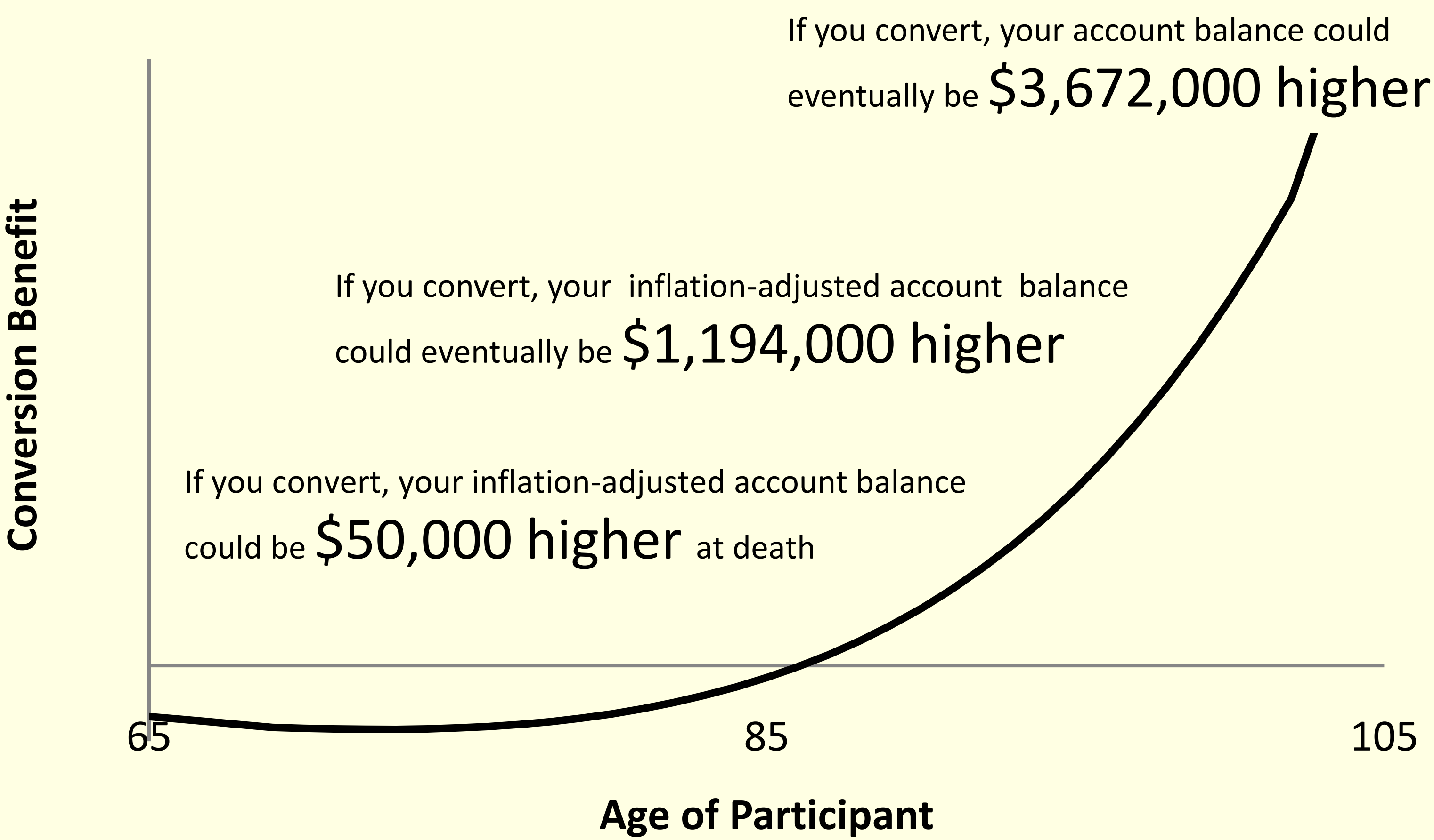
Brokerage Firm Calculator 5/28/2010

Inflation Discounting



Brokerage Firm Calculator 5/28/2010

Inflation Discounting and Mortality Weighting



Modeling Tax Rates

28.75% Marginal Tax Rate

- 25% federal marginal tax rate
- 5% state marginal tax rate
- State tax reduces federal taxable income
- No Medicare premium surcharge

Marginal tax rates are seldom valid for modeling because changes in conversion income are not small.

Example 1. Modeling Tax Rates

Single, $20,000 Social Security, $5,000 Other Income

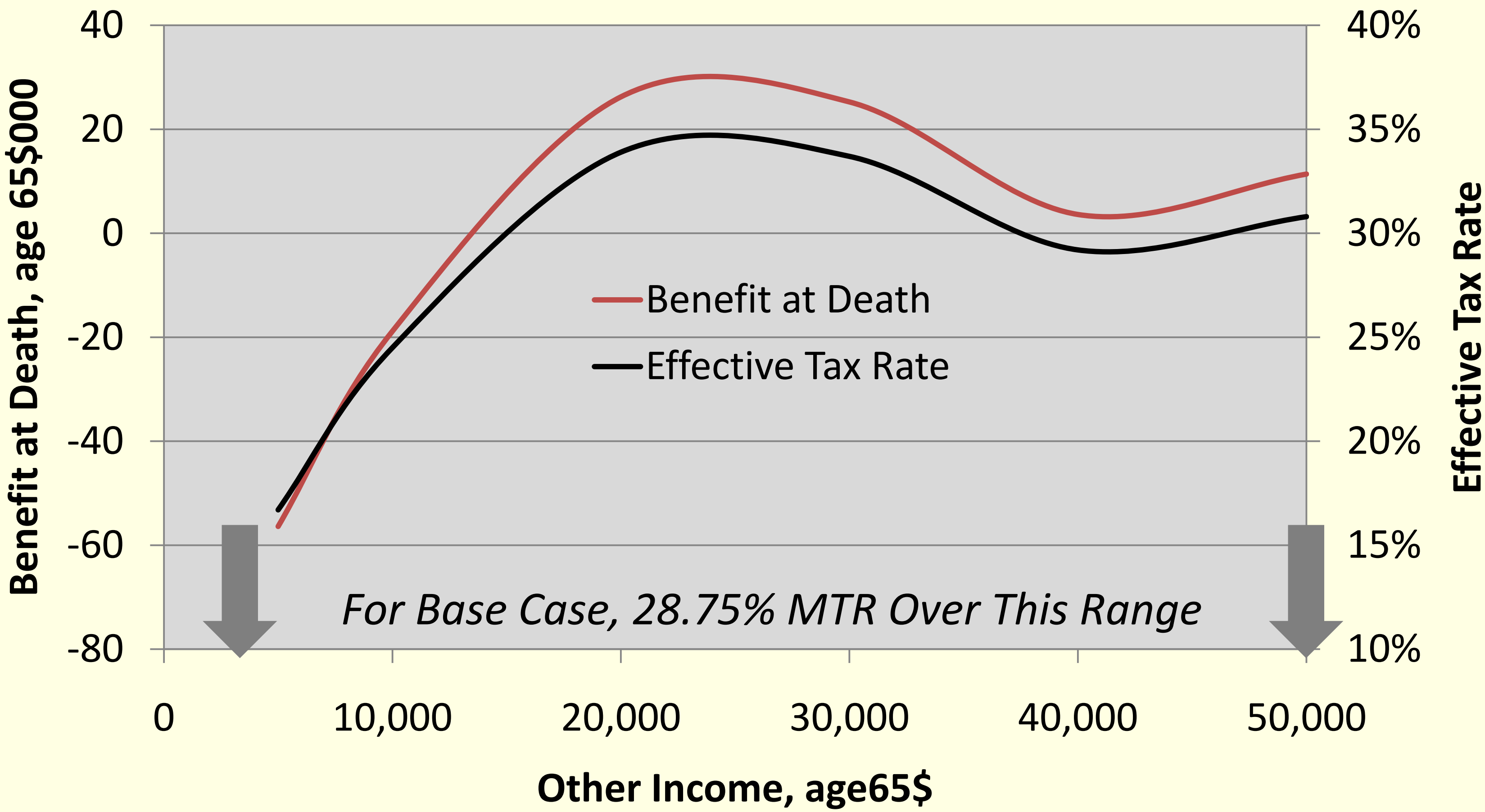
- The marginal tax rate is 28.75%.
- The effective tax rate is 22% in year 1

  Change in tax and Medicare Surcharge: $6,613

  Change in taxable annuity income: $30,715
- Effective tax rate declines because annuity income is fixed while tax brackets are inflation-adjusted.
- Survivorship weighted, average effective tax is 17%.

Taxes Estimated from Income Forecast

Example 1, $20,000 Social Security plus Other Income



Modeling Surplus Resources

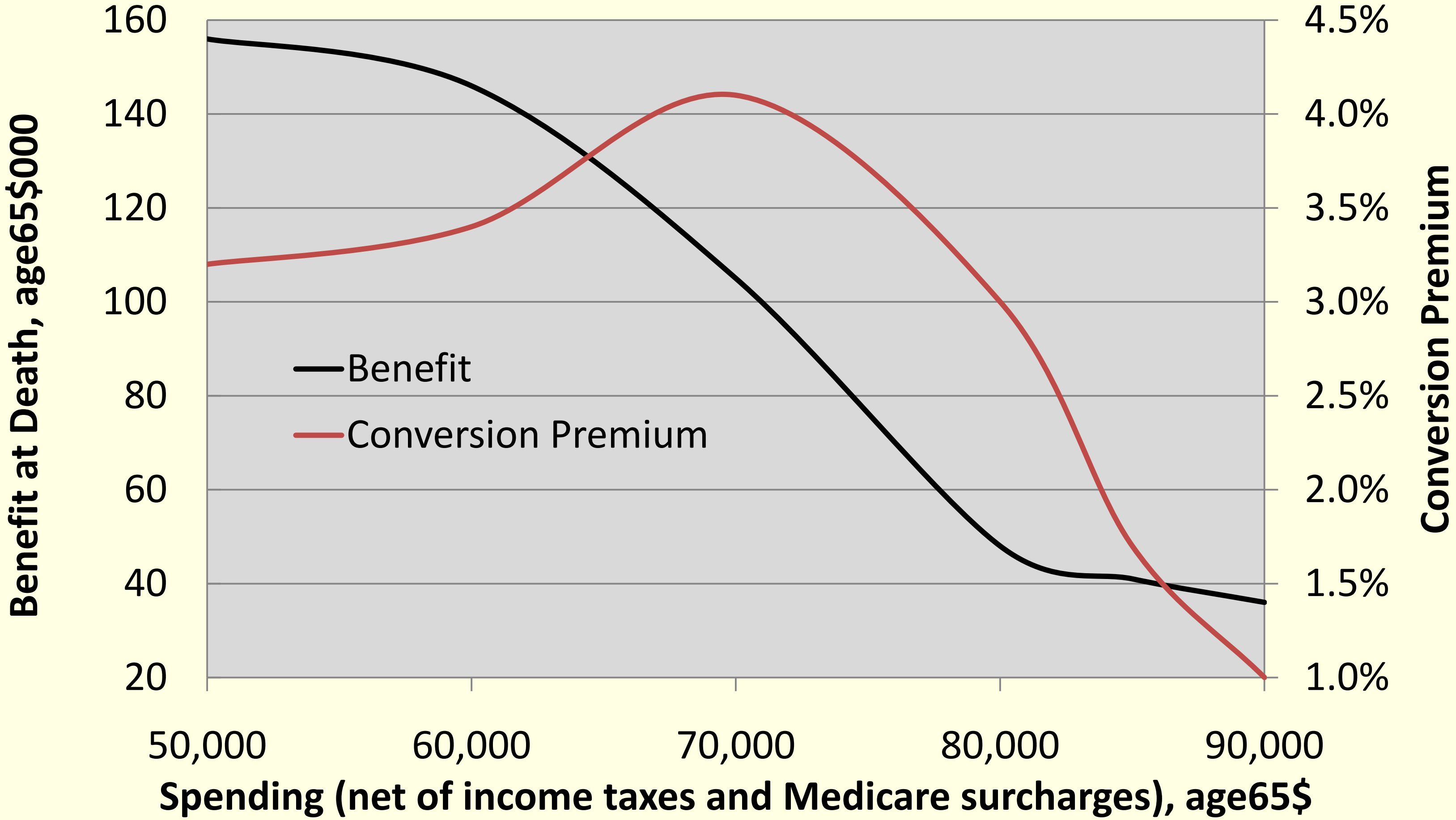
- When there are surplus resources
  - Prioritize cash flows, taking money first from taxable account
  - Delay distributions from traditional IRA to age 70½
  - Minimize distributions from Roth IRA
- Measure conversion benefits as the mortality weighted difference between two scenarios, one with and the other without conversion.
- Spending, net of income taxes and Medicare premium surcharges, is the same in both scenarios.

Example 1a. Modeling Surplus Resources.

Assumptions

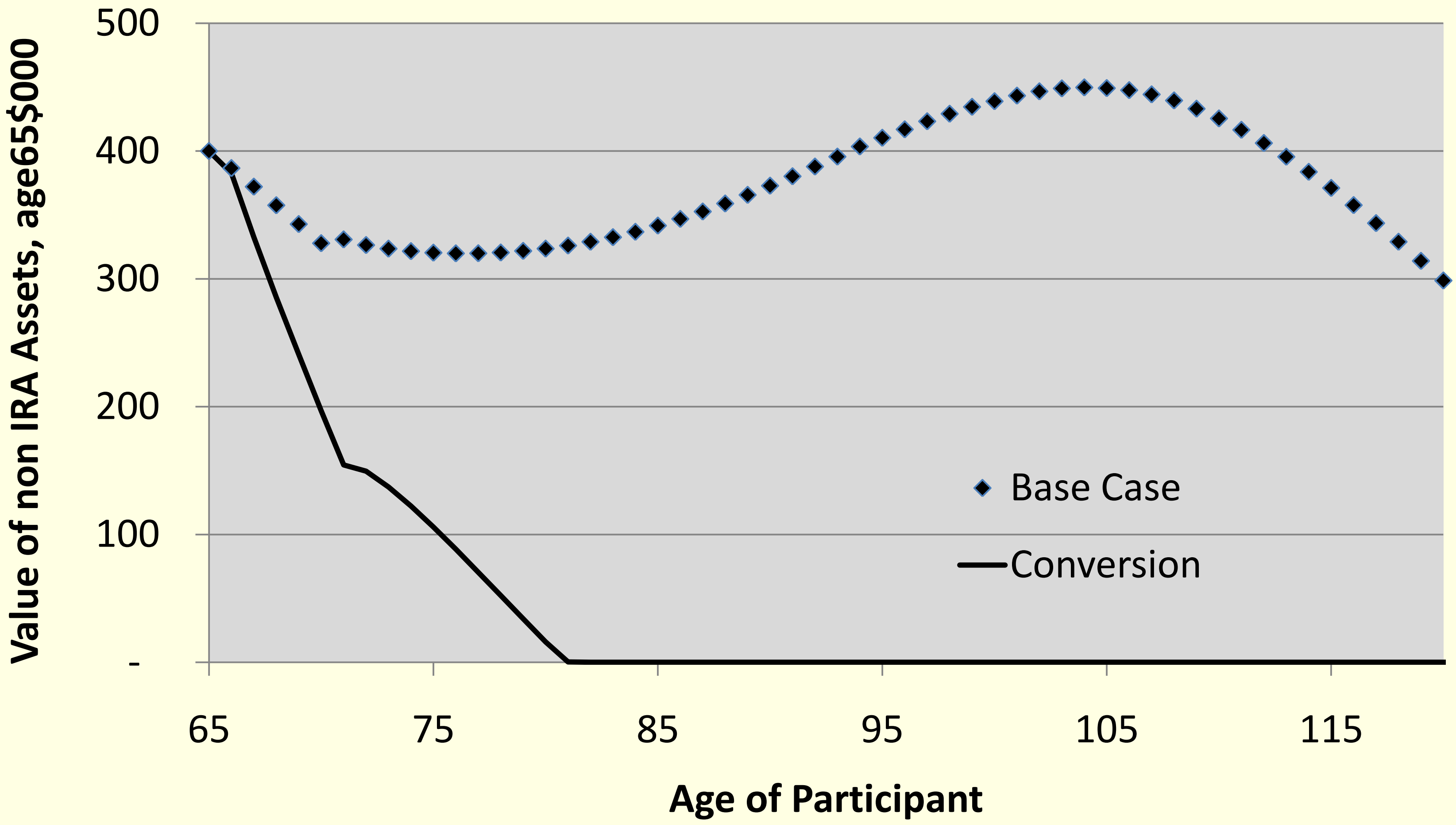
- Age 65 female.
- $20,000 Social Security and $30,000 other income.
- Income and spending are cost of living adjusted.
- Estimate taxes, Medicare surcharges from income.
- 4% return, net of inflation and expenses.
- $400,000 traditional IRA; $400,000 non IRA.
- Convert $80,000 annually at ages 65 through 69. (Conversion cost is 32%.)
- RMD rules apply to traditional IRA from age 70.

Benefit Increase is NOT Associated with a Lower Conversion Premium



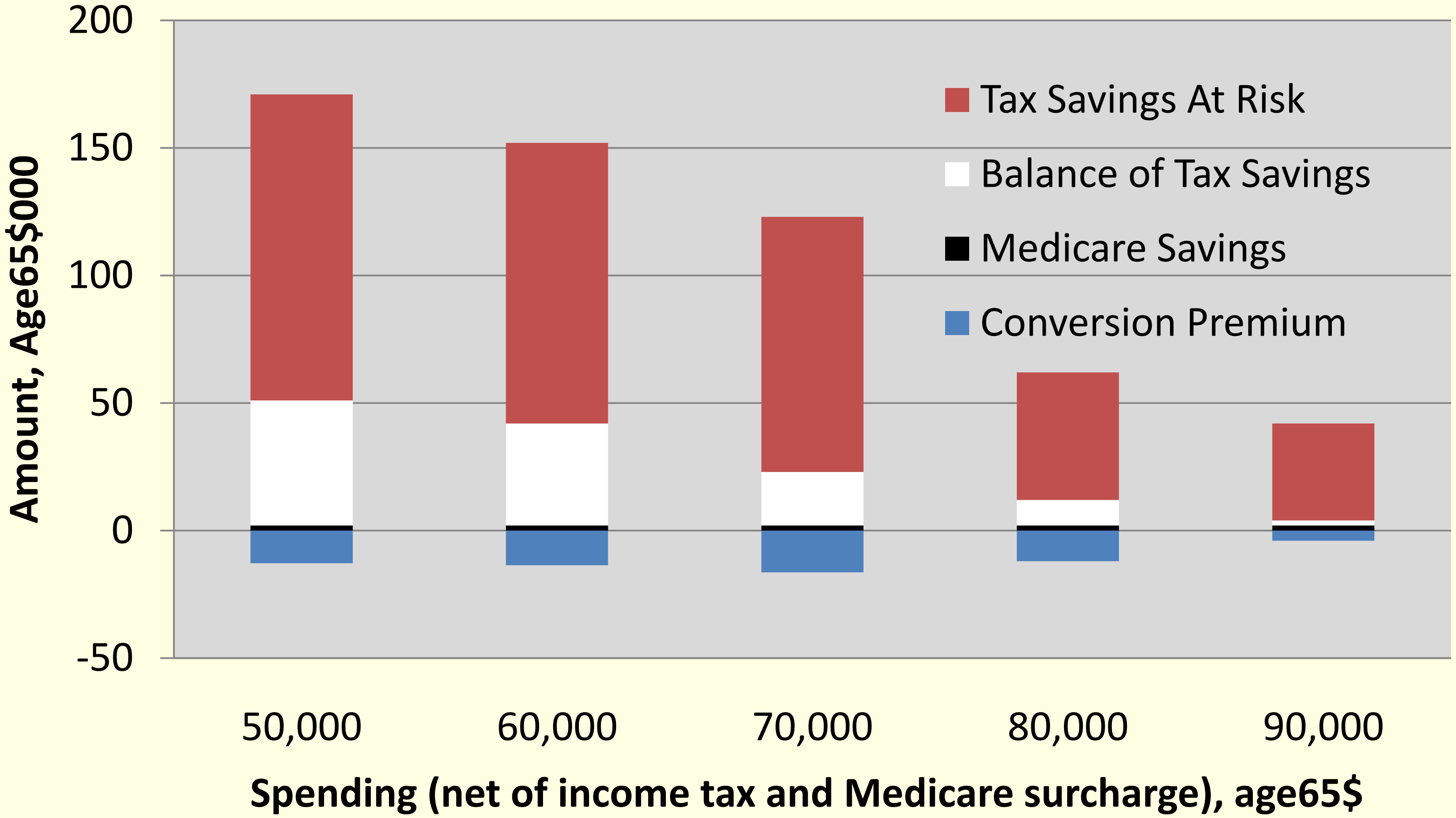
Taxable Assets (Taxable Income)

Example 1, Spending $65,000



What is at Risk if RMD Policy Changes?

Example 1. $20,000 Social Security, $30,000 pension



Example 1a. Conclusions.

Investment return: 4% mean, 10% standard deviation

If spending is more than about $80,000 a year,

There is a significant risk of running out of money.

Consider the purchase of a life annuity.

If spending is $70,000 a year or less,

Risk of running out of money is low.

Risk of having less after conversion is also low.

Conversion is likely beneficial if spending $70,000 or less. Amount of benefit is uncertain.

How Might Tax Policies Change?

Test the impacts of what you fear might change.

Policy	Traditional IRA	Roth IRA	Possible Change
Tax-Exempt Earnings	Yes, for your share of IRA	Yes	Reclassify earnings as AMT preference income
Contribution Limits	Nominal	Nominal	Equalize after-tax
• Required Distributions • Social Security taxation • Medicare surcharge	Yes	Exempt	Apply the same rules to Roth IRAs
Stretch IRA after death	Yes	Yes	Distribute within 5 years
Limits on Size of IRA	No	No	Excess accumulation tax

Available Calculators Have Limitations

	Brokerage Firm - free	CCH Roth IRA Conversion Evaluator $595	Brentmark Retirement Plan Analyzer $595
Deflate cash flows	No	No?	No
Mortality weighting	No	No	No
Estimate tax from income	No	No	No
Spending and income	Yes	Yes	No
Return variation	No	No	No
Policy changes	No	No	No
Capabilities determined	5/28/2010	Review	Demo version

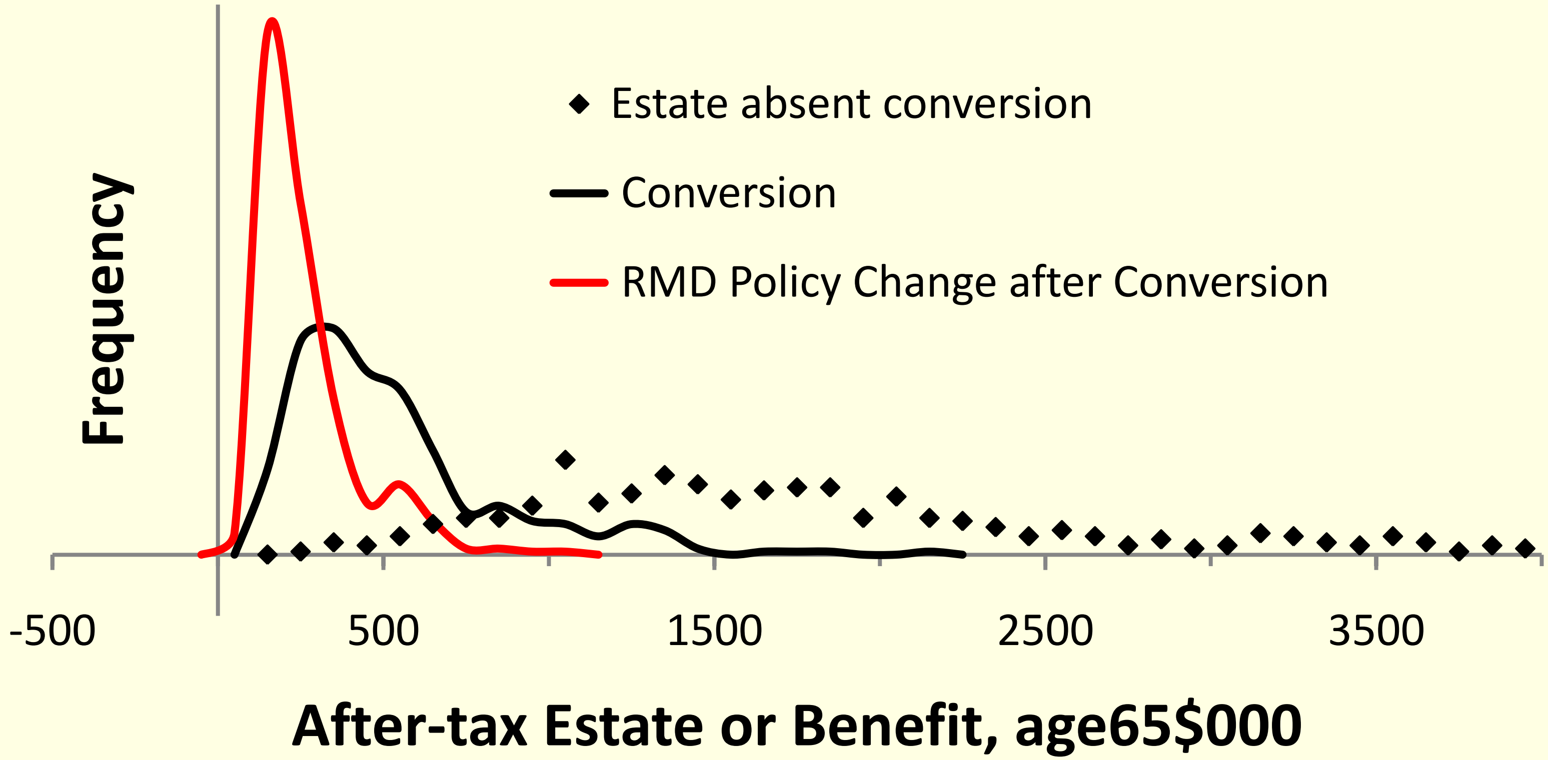
Example 2. $1 million IRA, $1 million non IRA

$20,000 Social Security plus $30,000 COLA income
Spending is $90,000 plus taxes and Medicare surcharges
65 year old single female; investment return: 4% ± 10%

- The deterministic value at death is $1.7 million.
- Converting $1 million in 2010 increases the value at death by $400,000, 40% of the amount converted.
- Conversion increases the after-tax value of the residual IRA several fold – which could be great news for the heirs.
- Estate tax savings?

Example 2. Return and Policy Risks

The Benefit is Uncertain but the Risks are Low.



Example 2. Conclusions.

$1MM IRA; $1MM non IRA

Conversion is attractive.

- Low risk of running out of money.
- Low investment and RMD policy risks.
- Conversion benefit is uncertain.
- Estate tax savings and stretch benefits may provide upside.

Example 3. Costs Paid from IRA

$1.8 million IRA, $100,000 non IRA assets

Full conversion at age 65

- Conversion premium is 4%
- Value at death is $1.4 million (unchanged)
- Possible estate tax savings, stretch benefits
- No risk to her personal financial security.

Not attractive because there is a 50% risk of passing less to the heirs with little upside.

Example 3. Costs Paid from IRA

$1.8 million IRA, $100,000 non IRA assets

Converting $75,000 at ages 65 – 69

- Conversion premium is minus 5% (favorable).
- $130,000 deterministic benefit (35% of amount converted).
- Possible estate tax and stretch benefits.
- 16% risk of leaving less to heirs.
- Never a significant risk of penury.

Example 3. Costs Paid from IRA

$1.8 million IRA, $100,000 non IRA assets

Increase average return from 4 to 4.5%

- $200,000 deterministic benefit
- No return risk; no RMD policy risk.
- Partial conversion benefit is increased and the risk of passing less to the heirs is decreased.

Enhancing the investment return is advantageous, with or without conversion.

Example 3. Conclusions

Full conversion at age 65 is not attractive because of the 50% risk of passing less to the heirs.

Partial conversion over five years

- Could provide attractive benefits
- A change in RMD policy halves the benefit but does not increase overall risk.
- There is no risk of penury but a 16% risk of passing less to the heirs.

Enhancing the return should take priority.

Example 4. Residual IRA to Charity

As Example 2 but with no tax on the residual IRA.

- Although the conversion premium is 20%, the charity is likely to receive more after conversion.
- There is a significant risk that the charity receives less. There is always less if RMD policy changes.
- Increasing the investment return without conversion always provides more for charity.

Second-to-Die Life Insurance

Kelly Greene, *The Wall Street Journal*, March 20, 2010

60 year old couple with a $500,000 traditional IRA plus $200,000 to pay conversion costs.

- Conversion ~ Insurance if return ~ 4.5%.
- Insurance is free of mortality, investment and RMD policy risks.
- There is no estate tax (under current policies!) if insurance is owned inside an ILIT.

Priorities

- Are you sacrificing your standard of living to make your children rich or *alma mater* proud?
- Have you considered gifting surplus assets to family or to charity during life?
- Root out unnecessary investment expenses and optimize asset allocations.
- Confirm IRA beneficiary designations and estate planning documents.
- Consider conversion.

Conclusions and Recommendations

1. It is better to pay conversion costs from non IRA assets.
2. It can be advantageous to reduce the conversion premium.
3. Early conversions may be advantageous.
4. Estimate taxes from income; discount for inflation and incorporate mortality risk.

Conclusions and Recommendations

5. Evaluate policy and investment risks.
6. Benefits can be attractive for those with surplus resources, especially when conversion costs are paid from non IRA assets.
7. Comparable benefits can likely be achieved with lower risk. Prioritize accordingly.
8. Seek competent advice.

Practical Considerations
Conversion in 2010 Might Cost Less

For "high earners"

- Federal income tax rates may increase from 2011
- There is a new 3.8% Medicare tax from 2013
- Combined federal taxes might be

2010	2011	2013 (IRA)	2013 (non IRA)
33%	36%	36%	40%
35%	40%	40%	44%
15%	20%		24%

Practical Considerations
Reporting 2010 Conversion Income

- Can defer half of conversion income to 2011 and half to 2012 or can elect to report all income in 2010.
- Consult with your tax adviser about what is best in your circumstances.
- Decision can be delayed to October 2011.

Practical Considerations
Recharacterization

- A Roth conversion can be undone for any reason. The option to recharacterize reduces risk.
- Must recharacterize earnings.
- The deadline is October of the year after the conversion, assuming a timely filed return.

  An extension request must include a bona fide and reasonable estimate of the tax liability based on all information available at the time of the request.

Practical Considerations

Timing of Federal Tax Payments

First Conversion Year

- Avoid interest on underpayment by paying 100/110% of the prior year's tax in equal quarterly estimates.
- Delaying full tax payment to October costs about 5% in interest and penalties, absent recharacterization.

  Penalties are avoided by paying at least 90% of the tax liability by April 15th.

Year After Conversion

- Avoid interest on underpayment by paying 90% of the current year's tax in equal quarterly estimates.

Practical Considerations

Inherited IRAs

- A beneficiary must distribute a traditional or Roth IRA within five years of death; or

  Begin distributions within one year of death. Annual required distribution are <u>usually</u> based on the beneficiary's life expectancy.

- A beneficiary cannot convert an inherited traditional IRA to an inherited Roth IRA.

- A spouse can finesse these rules by electing to be treated as the owner rather than as the beneficiary.

Practical Considerations

Income Taxation of Distributions from Roth IRAs

- Distributions are taken, in order, from the amounts contributed, amounts converted and from earnings.
- Amounts contributed or converted are tax-free.
- Earnings are tax-free after age 59½ and five years

  After the initial contribution to <u>any</u> Roth IRA; or

  After the initial contribution to the <u>specific</u> Roth designated pension account.
- This tax treatment applies to inherited Roth IRAs.

Practical Considerations

Taxation of Traditional IRAs and Pensions

- Basis in traditional IRAs is aggregated.

  IRA1: $100,000 with $15,000 basis
  IRA2: $50,000 with no basis
  10% of any distribution from either IRA is basis.

- Basis in a California IRA may be larger than federal basis. Extra California basis is recovered first.

- Basis in a pension is recovered uniformly over a period determined by the "Simplified General Rule."

Practical Considerations

Moving Basis Between Traditional Pensions and IRAs

Basis moves from QP/TSA to the IRA *pro rata*

Cannot move basis from an IRA to QP/TSA

A strategy for tax-free conversion of basis:

- Roll the taxable portions of all traditional IRAs to a QP/TSA.
- Since the residual IRAs are now entirely basis, immediate conversion would be tax-free.

Practical Considerations

Premature Distribution Penalties (12½%)

Roth IRAs

- Contributions are recovered penalty-free.
- Conversions are penalty-free after the earlier of

  Age 59½; or

  Five years after the specific conversion.
- Earnings are penalized if distributed before age 59½.

Traditional IRAs and Pensions (except SIMPLE)

- Conversions to Roth IRAs are penalty-free.
- Distributions to pay conversion costs could be penalized.

Practical Considerations

Mechanics of Conversion

- Converting to a Roth IRA with the same custodian has the least risk.
- Converting to a Roth IRA with a new custodian should be satisfactory.
- Rolling a distribution from a traditional IRA over to a Roth IRA within 60 days is not recommended.
- Do not consolidate accounts or close the traditional IRA until after the recharacterization deadline.
- Consider separate conversions of each asset class.

For More Information

- Publication 590 “Individual Retirement Arrangements,” www.irs.gov
- “Life and Death Planning for Retirement Benefits,” Natalie Choate, www.ataxplan.com
- “Converting to a Roth IRA: Beyond the Basics,” www.lingane.com/tax/beyondbasics.pdf