

Financial Advisory Services

Roth IRA Conversion

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The Roth IRA Conversion: Deal or No Deal?

Most financial pundits agree that Roth IRAs are a good thing. After all, it is hard to criticize a savings vehicle that allows income tax-free distributions during your retirement and continuing after death for your heirs. Roth IRAs also feature total control over the timing of your own distributions because they are not subject to the minimum distribution rules governing most other retirement accounts. The problem, however, for many investors looking to fund their own Roth IRA has been the restrictions on getting money into these accounts.

The two most common ways to move money into a Roth IRA are annual IRA contributions and/or converting an existing "Traditional" IRA balance. A common roadblock in taking advantage of these methods has been income limits imposed by current tax law. In 2008, if you are single and have income of over \$116,000 or married with income over \$169,000, you can forget any chance of making an annual contribution to a Roth IRA. In order to convert an existing traditional IRA, your income needs to fall below \$100,000 for the year of conversion (without including the converted amount). So while there may be a will to fund a Roth IRA, especially for those whose income exceeds these limits, there has not always been a way.

Enter the *Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)*

which was signed into law by President Bush on May 17, 2006. As part of an effort to increase revenue — estimated at \$6 billion over 10 years — this legislation allows the conversion of an existing traditional IRA balance without regard to income beginning in the year 2010. And with 2010 fast approaching, it is not too early to begin considering whether you should take up the government on its offer.

WHAT IS A ROTH IRA CONVERSION?

Remember when your parents were trying to teach you good time management and insisted that you get your homework done right after school so you could spend the rest of the evening doing the things you really wanted? Well, that's basically the concept at work here. You experience pain up-front in the form of income taxes for the promise of not having to deal with them again. Let's look at an example:

Jenny, who is single, left her job in 1998 and rolled-over her \$20,000 company retirement plan into a traditional IRA. Her IRA has grown and is now worth \$50,000 in 2008. Jenny currently has annual income of \$65,000 and decides to convert all of her traditional IRA balance to a Roth IRA. When Jenny goes to file her 2008 income tax return, the full \$50,000 will be added to her taxable income.

Inside:

- Is 2010 my only chance for a Roth conversion?
- What are "qualified" distributions from a Roth IRA?
- What's the difference between a Roth conversion and a Roth contribution?
- I've also heard about Roth 401(k) accounts. How do they work?
- Considerations before conversion



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The upside to Jenny: future “qualified” distributions from this account will not be subject to income taxes. Also, if Jenny were to name a beneficiary for her Roth IRA, the tax-free distributions could continue over the beneficiary’s lifetime.

IS 2010 MY ONLY CHANCE FOR A ROTH CONVERSION?

While you will be able to convert to a Roth IRA after 2010, there are special rules applicable only to conversions made in that year. The taxable income resulting from a conversion in 2010 can be spread pro-rata over the tax years 2011 and 2012. So a \$50,000 taxable conversion in 2010 would generate additional taxable income of \$25,000 in 2011 and 2012. Conversions made after the year 2010 require the taxpayer to include 100% of the income in the year of conversion.

Taking income over two future taxable years does carry some appeal as you can effectively defer the payment of tax, decrease the possibility of increasing your tax rate in the year of conversion, and start the clock on the five-year holding period (see below). But remember you are allowed to choose the amount to convert in any given year and there is no limit on the number of conversions so you do have the ability to elect an amount and a tax year that is advantageous.

WHAT ARE “QUALIFIED” DISTRIBUTIONS FROM A ROTH IRA?

In order for a distribution from a Roth IRA to be “qualified”, and in turn automatically excluded from both taxable income and the 10% early withdrawal penalty, certain requirements need to be met. First, the account must satisfy a five-year holding period **and** second, the distribution needs to be under one of the following circumstances:

- a. after the account holder reaches age 59½;
- b. after the account holder is disabled;
- c. to a beneficiary after the account holder’s death; or
- d. to pay for “qualified first-time home buyer expenses” (up to a lifetime amount of \$10,000 for yourself, child, grandchild, or ancestor).

The five-year holding period generally begins in the taxable year of the first contribution to a contributory Roth IRA even if subsequent contributions are made. Converted amounts, however, each have their own separately determined five-year holding period.

If a Roth distribution does not meet the criteria for a “qualified” distribution, a “non-qualified” distribution has occurred. Non-qualified distributions carry with them the possibility of income taxes and/or early withdrawal penalties. For instance, if an account holder dies 4½ years after converting a Traditional IRA, income taxes would be due on the earnings of the Roth IRA since the time of the conversion. In this case there would not be an early withdrawal penalty because distributions on account of death are exempted from the penalty tax.

WHAT’S THE DIFFERENCE BETWEEN A ROTH CONVERSION AND A ROTH CONTRIBUTION?

A Roth Conversion involves taking an existing Traditional IRA balance, paying income tax on the amount converted and moving those dollars into a Roth IRA. Beginning in 2008, individuals may also consider rolling over funds directly from an employer retirement plan to a Roth IRA. The same pre-2010 eligibility rules apply whether the conversion comes from a Traditional IRA or an employer retirement plan.

A Roth Contribution is an annual amount of after-tax dollars that can be contributed from, say, your checking account to your Roth IRA. A full contribution is allowed if your income is below \$159,000 for a joint tax return and \$101,000 for a single tax return in 2008. The maximum amount that can be contributed in 2008 is \$5,000 with an additional \$1,000 available for those over age 50. Earned income is required up to at least the amount of the contribution in that particular year. Roth contributions may also be made on behalf of a non-working spouse assuming the wage earner makes enough to cover both contributions.

I’VE ALSO HEARD ABOUT ROTH 401(k) ACCOUNTS. HOW DO THEY WORK?

Beginning in 2006, both 401(k) and 403(b) retirement plans may allow employees to make after-tax salary deferrals (up to \$15,500 in 2007) to be designated into a Roth 401(k) or Roth 403(b) account. These salary deferral contributions replace those that would normally be made on a pre-tax basis. Not all employers have made this change to their retirement plans so check with your employer’s plan administrator to see if this is an option.



Considerations before Conversion

The carrot of pulling money out of an account tax-free during your retirement does come with a stick. The stick is paying income taxes today and there is little that goes against human nature more than paying taxes sooner than required. The question is simple: Will you end up paying fewer tax dollars by paying now or by deferring to the future?

Like most financial projections involving long-term periods of time, the answer to our question has much to do with individual circumstance and is radically changed by differing assumptions. There are, however, several patterns we have noted in exploring this question for our clients.


1. The additional tax created by the Roth conversion should be met from a ready source other than the converted IRA or other tax-deferred accounts. In our example of Jenny's \$50,000 IRA conversion, she may need to pay upwards of \$15,000 in additional taxes. Obviously the larger the conversion and the higher your tax bracket, the greater the need for access to cash to pay the tax bill.

2. Longer time-frames before distributions will favor a conversion. Because Roth IRAs grow tax-deferred and the growth is never taxed when withdrawn as a "qualified distribution", knowing when you intend to make account distributions becomes critical. Remember Roth IRAs are not subject to minimum distribution rules until they are passed on to a beneficiary, so withdrawals can be completely discretionary during retirement. Best case scenario is when a retiree can earmark Roth IRA funds either as an account of last resort or specifically for their heirs. The power of compounding tax-free generally starts to overtake the immediate cost of paying taxes up-front when looking at time-frames of 20+ years.

3. Similar or higher future income tax rates will favor a conversion. An impressive argument can be made that we are currently in a historically low income tax environment with a top marginal tax rate at 35%. Will this be the tax rate in 2010? How about in 2020 and beyond? In the end what really matters is the tax you will pay in the year of conversion versus what tax you would have paid if you had not converted and the timing of those tax payments. The tax you pay in the future will depend not only on tax rates but also on your entire financial picture in

retirement — your sources of income and deductions. If you are in your prime earning years today and you truly expect your tax rate to go down dramatically in retirement, consider holding off on a conversion until you hit those low tax years or perhaps bring in taxable IRA distributions to fill-up lower tax brackets.

4. Is your balance sheet dominated by tax-deferred accounts? The decline of the traditional pension plan has shifted the retirement savings burden from employer to employee. As a result, many employees are accumulating the bulk of their retirement stash in tax-deferred retirement plans. A Roth conversion with at least a portion of those assets may offer you more flexibility down the road to meet lifestyle and estate planning objectives without triggering income taxes with every withdrawal. You are in essence diversifying the tax attributes of your retirement resources.

5. Roth IRAs offer appealing gifts to heirs. If Roth IRAs can be maintained and passed to heirs, you have literally left the gift that keeps giving. Distributions from a Roth IRA in the hands of your heirs can be spread over their lifetime — and still without income taxes upon withdrawal. When the tax on the converted Roth amount is paid, you have made a tax-free gift of future growth. How valuable that gift will be depends on how long the account is allowed to grow both in your hands and in the hands of your heirs. Taking time to work with a financial advisor on this issue can prove beneficial as you consider what of your current balance sheet you may be able to earmark for heirs. 



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