KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

Roth IRA Conversions

Effective January 1, 2010, high-income individuals will have an opportunity to convert their existing IRA funds (or a portion of these funds) into a Roth IRA, in the process triggering (and accelerating) tax due on their traditional IRA balances. Prior law limited conversion to those with gross income of less than $100,000. While both traditional IRAs and Roth IRAs allow for assets to grow tax-free within the account, the fundamental differences between the two involves whether, and when, taxes must be paid. For traditional IRAs, taxes are imposed when funds are distributed, with mandatory distributions beginning once the account owner turns 70 ½ years old. Roth IRA accounts on the other hand are *never* subject to future taxation (under current law) and have *no required minimum distribution* ("RMD") amount at any point during the account owner's lifetime. These differences can result in a significant potential benefit to the Roth IRA owner and his heirs that only increases with time, without an appreciable economic downside.

An election to convert funds to a Roth IRA seems contrary to one of the fundamental rules of tax planning - that it is advisable to defer payment of taxes when possible (especially if it is expected that withdrawals will be taxed at a lower rate since there is less income in retirement). For many high income and high net worth individuals who will have substantial taxable income in retirement, a reduced income tax bracket is not likely and not therefore the determining factor. Nonetheless, why accelerate the taxable event? *Because of the potential benefit of the Roth tax-free growth period, particularly with regard to maximizing transfer of wealth to one's heirs*. A Roth IRA does not require any distributions to be taken during the owner's lifetime, which, when coupled with a future beneficiary's ability to take RMDs as calculated over their own lifetime, allows for a potential period of considerable length in which the assets can continue to grow tax-free (not merely tax-deferred). RMDs for a traditional IRA on the other hand, are calculated based on the account owner's life expectancy, and, as a result, significant funds must be distributed from the account each year after the owner turns 70 ½, at which time distributions will be taxed. By electing to convert to a Roth and paying tax currently, the IRA owner is choosing a potentially extended tax-free growth period over a shorter tax-deferment period.

When a taxpayer converts a traditional IRA to a Roth in 2010, the converted amounts are included in computing taxable income. The taxpayer may elect to have the income taxed fully in 2010, or choose to defer the tax and include 50% of the income in 2011 and the remaining 50% in the 2012 tax year. Taxpayers currently in the highest tax bracket will likely experience an increase in Federal tax rates in 2011 (from 35% to 39.6%) assuming no intervening Congressional action. All else being equal, we recommend that the tax be paid in 2010.

Another factor favoring a Roth conversion election is the ability to "undo" a conversion at any point up until October 15th of the year following conversion, should the assets suffer a significant decline. If a Roth conversion occurs in February of 2010, the owner would have over 20 months of market exposure before a decision is required to accept the conversion and pay the tax or undo the conversion and pay no tax, as if the transaction never took place. Another attempt at conversion can be made as early as January 1st of the following tax year.

To maximize the benefits of the Roth conversion, payment of income tax triggered by the conversion should be made from general assets instead of retirement assets. This allows more of the assets in the tax favored Roth account to continue to grow tax-free during the life of the account. Additionally, if IRA funds were used to pay the tax on conversion, taxpayers under the age of 59 ½ would incur a 10% penalty on these early retirement distributions, as the rules only waive this penalty on early distributions for amounts converted to a Roth, not for amounts used to pay the taxes due upon conversion. As Roth funds cannot be withdrawn without penalty until five years after the conversion date (with limited exceptions) the appropriate conversion candidate will have no need to access the Roth funds for the foreseeable future. Further, the ideal candidate will have sufficient assets and liquidity to reasonably conclude they will never have to access the Roth account for the remainder of their lives.

While the thought of making a tax payment before its required date seems counterintuitive, and the risk of lower income tax rates (in general or to encourage IRA withdrawals) in the future cannot be ruled out, the significant potential benefit of tax-free growth for the account owner's lifetime and the greater part of a beneficiary's lifetime make the Roth conversion an attractive one for many of our clients. Please consult with your KLS Managing Director regarding the best course of action given your particular circumstances.

February 2010