



Roth IRA Conversions—New Rules New Opportunities for Tax-Free Growth: Your guide to a bright future.

Written by: **Denise Fries**

108 E. North Avenue, Bryan, TX 77801

Advantages of Converting Qualified Plans to a Roth IRA:

- Income taxes are likely to rise in future years
- Reduce taxable estate & overall taxes at death
- Trust planning
- Turn lemons into lemonade: convert depressed accounts
- Eliminate Required Minimum Distributions

As financial advisors it is part of our job to bring clarity to confusing financial transactions. Usually, if you are confused about something you won't act on it for fear of making a mistake. And then the real mistake may have been failing to act on a great opportunity. In all transactions there are pros and cons. The goal of this article is to help guide you through the new regulations and to decide if a Roth IRA conversion is right for you. We have read hundreds of pages of tax code, commentary and press releases and boiled it down into this document. The good news is that if you convert and then something changes that would have kept you from converting, there are liberal rules for putting things back the way they were.

Who Should Consider Converting to a Roth IRA?

Anyone who thinks income tax rates are going to go up.

Anyone who thinks they will have growth in their retirement accounts.

Anyone with a large net worth.

Anyone who has heirs who would benefit from inheriting an income tax free asset instead of an income taxable asset.

.....could it be you?

The Background

In 2010, taxpayers face opportunities and consequences as a result of upcoming changes in the federal income tax laws and notably, the *Sunset* of the "Economic Growth and Tax Relief Reconciliation Act of 2001" (EGTRRA). During the Bush Administration, there were many changes to the IRS Code beginning with EGTRRA. This act decreased income-tax rates and at the time, many critics argued the huge federal deficit would only be made worse by cutting individuals' tax liabilities. In a dual effort to placate these critics and satisfy existing legislation limiting such acts, a *Sunset Provision* was attached to revert automatically to the previous tax brackets after 10 years. Fast forward 10 years and the execution of the *Sunset Provision* on January 1, 2011 will mean the return of the top tax rate of 39.6% (currently at 35%), for high-income earners and will eliminate the bottom rate of 10% for low-income earners. The effects of the *Sunset Provision* will be most notable for high-income individuals. However, some new opportunities in the IRS Code present promising options to all taxpayers regarding their Qualified plans most commonly Traditional IRA's.

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TRADITIONAL IRA'S

- Contributions may be tax deductible
- Penalties for early withdrawal before age 59 ½
- Withdrawals without penalties may begin at 59 ½
- All amounts withdrawn are taxable
- RMD's begin at age 70½ and increase annually
- Accounts inherited are subject to income taxes

ROTH IRA'S

- Contributions are not tax deductible
- Withdrawals of profits may be made after five years for education or first time home purchase
- Contributions may be withdrawn for any reason, tax free and penalty free at any time
- All earnings and principle are 100% tax free after five years and after age 59½
- No Required Minimum Distributions
- Inherited Income-Tax Free.
- Owner may designate a trust as a beneficiary to fund a By Pass Trust or Family Trust

Features of tax qualified plans that can be converted

Beginning in 2010 all individuals may convert their *tax qualified retirement accounts* to Roth IRA's. There are many types of tax qualified retirement accounts and the new law allows you to convert most of them. For the purposes of this article the phrase "IRA" and "tax qualified retirement account" are used interchangeably and should cause you to think about ALL of your retirement accounts; however named. For all qualified accounts, EXCEPT Roth IRA's, funds withdrawn at retirement time are taxed as income at the then current tax rates. Additionally, withdrawals made before age 59 ½ are subject to income taxes and may be subject to a 10% penalty. With qualified accounts you are required to begin taking money out of the accounts even if you do not need the money. *Required Minimum Distributions (RMD)* from qualified accounts must begin at age 70 ½ and must be at least a minimum amount as computed using your life expectancy; otherwise costly tax penalties are incurred. The percentage required for withdrawal increases each year. Your legal spouse can inherit your IRA and must continue to take the *Required Minimum Distributions*. If your children or any other heirs inherit your tax-qualified accounts, they must pay income taxes on the balance which could be done in a lump sum if the account is liquidated or spread out over time if they exercise a "Stretch IRA" distribution. Any way that it is used, the money in a *tax-qualified account* is subject to income taxes even if the estate is small enough to avoid estate taxes.

What is a Roth IRA?

A Roth IRA differs from all of the other tax-qualified accounts because there is no tax deduction on the contributions in the year that they are made. All growth is tax free; not just tax deferred – but totally income tax free as long as you meet a few requirements. The Roth IRA owners must be age 59½ or older and they must have owned the Roth for at least five years to be able to make tax free, penalty-free withdrawals. Think of it this way: A farmer buys seeds and tax deducts the cost of the seed; but must pay income taxes when he sells his crop. This is like a Traditional IRA (tax deductible seeds = contributions; taxable crop=account value in the future). But with a Roth IRA the seed (contribution) is NOT tax deductible. The future crop (account value) is totally tax free. The longer you have to grow your funds the more potential tax-free income you could reap. There are restrictions as to who can contribute to Roth IRA's and up until 2010 high-income earners could not convert to a Roth IRA. With a Roth you may always withdraw 100% of your contributions income tax free and penalty free regardless of the need for the money. This type of retirement account is better for individuals who have a long time before they need all of the money and currently are in a lower income tax bracket than they expect to be in the future. (Don't forget that it is already known that taxes will increase in 2011 due to the *Sunset Provisions*). Some people wonder if those close to retirement should convert. Considering that a 65-year-old man has a projected life expectancy of more than 20 years it's logical to think that many "older" people will benefit from converting.

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Of particular benefit is that there is no Required Minimum Distributions at any time. Additionally, Roth IRA's pass to heirs outside of probate and withdrawals from them are income-tax-free. Thus, heirs pay no income taxes on inherited Roth IRA's. For all other Qualified Accounts, heirs will pay *Income Taxes*, irrespective of the size of the estate. Additionally, you can leave a Roth to a trust enabling you to use this asset to fund a By Pass Trust or Family Trust.

So what's not to love?

Over the past 12 years, individuals with modified adjusted gross income (MAGI) exceeding \$100,000 could not convert Tax Qualified accounts to Roth IRA's. Starting in 2010, the \$100,000 maximum MAGI is eliminated (unless changed by future tax laws), thus, making the conversion a tax planning opportunity for all taxpayers. **So why wouldn't everyone want to convert their tax qualified accounts to Roth IRA's?** Because any amount converted from a tax qualified plan to a Roth IRA must be included in your taxable income. If it is done in 2010 you have two options of how to pay: either pay 100% of the taxes in 2010 or divide it equally between your taxable income in 2011 and 2012.

Example: Bob and Rhonda have taxable income of \$145,000. If they convert their \$75,000 tax-qualified plans to a Roth IRA in 2010 they would have taxable income of:

Either: $\$145,000 + \$75,000 = \$220,000$ in 2010

OR $\$145,000 + \$37,500 = \$182,500$ in both 2011 and 2012.

Of serious consideration is the fact that converting Traditional IRA's could be advantageous in **2010** due to the difference in the marginal tax rates that would be applied if done at a later time. Compare these tax brackets to see the impact:

INCOME TAX COMPARISONS:

Current Taxes Compared to Post 2010

These charts examine ACTUAL TAXES DUE ON TAXABLE INCOME after all personal exemptions and standard deductions or, if greater, itemized deductions (assumes Married Filing Jointly).

Taxable Income	Taxes due on Income through 12/31/2010	Taxes due on Income beginning 1/01/2011	Difference
\$ 25,000	\$ 2,915	\$ 3,750	\$ 835
\$ 50,000	\$ 6,665	\$ 8,403	\$ 1,738
\$ 100,000	\$ 17,375	\$ 22,403	\$ 5,028
\$ 150,000	\$ 30,263	\$ 37,781	\$ 7,518
\$ 250,000	\$ 60,320	\$ 73,354	\$ 13,034
\$ 500,000	\$ 145,361	\$ 171,160	\$ 25,799
\$1,000,000	\$ 320,361	\$ 369,160	\$ 48,799

Any assets converted from a qualified plan to a Roth IRA are taxable, either in 2010 or divided between 2011 and 2012

Don't forget that you'll still have your personal exemptions and either standard deductions or itemized deductions.

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Types of Accounts That May Be Able To Be Converted:

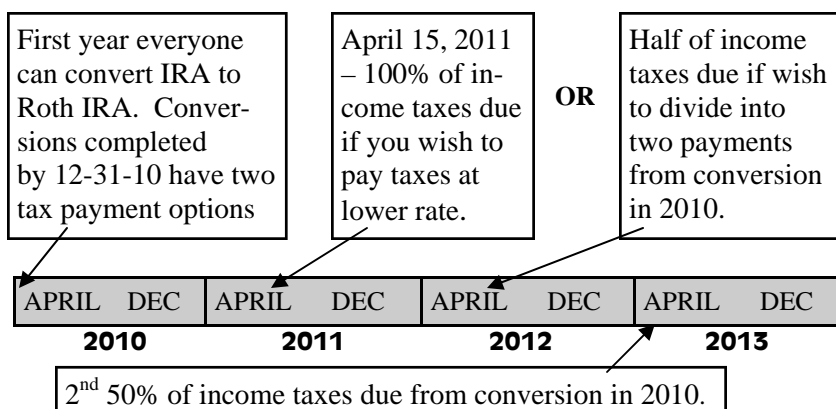
- **IRA - YES**
- **401(k)** – still employed - **Maybe, check with HR**
- **401 (k)** – retired - **YES**
- **Simple IRA - YES, after 2 years**
- **SEP / UNI-K - YES**
- **TSA – 403(b)** under age 59 ½ - **NO** unless no longer at that job
- **ORP** – any age still employed - **NO**
- **ORP** – any age – no longer employed at TAMU / Retired - **YES**

Wow! How would I come up with the money to pay the taxes?

- There are several ways to pay the taxes on the conversion. If you are **over 59 ½** one way to pay would be to have the money withheld out of the amount converted. This would simply be a withholding of some percentage (10%, 20%) thus reducing the size of the Roth IRA by the amount of the withholding. The amount withheld would be sent to the IRS and would be claimed as taxes paid when filing your 2010 tax return in April, 2011. Generally this option should not be exercised by people under age 59 ½ because it would result in a 10% penalty for early withdrawal on the amount of money withheld to pay the taxes.
- The ideal way to pay the taxes regardless of your age would be to convert the full amount of the IRA, with no withholding and pay the taxes from another source when the taxes are due in April 2011. If you have money in a CD checking or savings account, you are no doubt earning a very low interest rate on these funds. You would retain these funds until April, 2011 when your taxes are due.
- Another way: if you were making a monthly contribution to your investments you could stop the contribution and use the contribution toward the tax liability.
- Many advisors discuss using a home equity loan to pay the taxes. This would spread the liability over several years and the interest is low and tax deductible.

If you cannot come up with the money by April 2011, the IRS will allow you to pay the taxes over two years. This would allow you to claim half of the income in the tax year 2011 and the other half in 2012. Thus, the first payment is delayed until April 15, 2012 and the second payment is payable in April 2013- a full 3 years after the conversion.

TIME LINE FOR TAX PAYMENTS



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You must wait five tax years after converting to a Roth IRA to begin using those funds. "Old" Roths and converted Roths should not be combined.

**Over 65?
You may be able to reduce the taxability on your social security.**

Medicare Premiums are determined by each year's taxable income

Medicare Part B Premiums	Total Monthly Premium Amount
Less than \$170,000	\$110.50
\$170,001 to \$214,000	\$154.70
\$214,001 to \$320,000	\$221.00
\$300,001 to \$428,000	\$287.30
Greater than \$428,000	\$353.60

A RMD is still required in 2010 if you convert in 2010.

For some situations there are no advantages to converting your tax-qualified account to a Roth IRA. If you have a large pension (TRS, Civil Service or private company pension) that always keeps you in the highest marginal tax rates (earning above \$250,000 annually) there may be smaller marginal income tax benefits to the conversion for you. However, it would still be better for your heirs, and it would eliminate Required Minimum Distributions.

And remember that you must wait five tax years from the time that you convert your tax qualified account to a Roth to begin withdrawals from that account or the amount that was withdrawn before five years would be subject to a 10% penalty. Part of the planning process would be to determine how much income was needed from your investments during those five years and ensure there was plenty to meet your needs. You may still use your previously established Roths on their own 5-year time frame.

Those individuals that are over age 63 should also be aware that this conversion may affect their future Medicare premiums and cause them to pay a higher premium for one year since those premiums are based on your income looking back up to two years. It could be two years of higher premiums if you spread the tax bill out in 2011 and 2012.

Other items for consideration:

- Distributions from a Roth IRA are not included in income for purposes of determining whether social security benefits are taxable. This further reduces your gross adjusted income in retirement and may reduce your taxable income because may cause your social security check to not be included in your taxable income. For Married Filing Jointly if your total income, including tax exempt income and 1/2 of social security is below \$32,000, then your social security is not subject to income taxes.

If you are 70 ½ or older:

- If you convert on January 1 you still have to take a full Required Minimum Distribution for the conversion year. Many people will use these funds to pay all or part of the taxes for the conversion.

For High Net Worth individuals:

- Estate Tax laws are expected to change following their *Sunset* provision. Assuming that estate taxes will be imposed on more estates it is wise to consider converting large qualified accounts to Roth IRA's to reduce estate taxes. A smaller estate means a smaller estate tax and then the inherited Roth IRA is free of income taxes when inherited. A tax advisor can provide specific projections for your circumstances.

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Changed your mind?

**You can undo a
Roth
Conversion.**

Ready for Action?

**Call us.
We can help.**



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Did you make non-deductible contributions to IRA's?

- If you made IRA contributions that were not tax deductible in the year you made them you can convert those funds tax free assuming you convert 100% of the IRA balance. For example, if you convert half the IRA you only get to use half of the nondeductible credit. The tax free conversion amount is proportionate to the amount converted.

And Finally:

- A taxpayer who converts an IRA to a Roth IRA can undo all or part of the conversion by doing a trustee to trustee transfer of funds from a Roth IRA to a Traditional IRA no later than the due date, including the 6 month extension, for the tax return for the year the conversion originally occurred. This is called recharacterization." Recharacterizing the transfer no later than the extended due date of the return (October 15) is available regardless of whether the taxpayer actually extends his tax return, as long as the return is timely filed. The number of reconversions is limited: A person who converts a Traditional IRA to a Roth IRA and then undoes the conversion cannot then reconvert the Traditional IRA to a Roth IRA again until the beginning of the tax year following the year of the original Roth IRA conversion.

There are many factors to consider to determine if an IRA conversion in 2010 (or any year for that matter) is the right decision for you. But for many people it will provide an excellent opportunity to earn tax free income for themselves and their heirs. Securities America and its representatives do not provide tax or legal advice. Any tax or legal information provided here is merely a summary of our understanding and interpretation of some of the current income tax regulations and is not exhaustive. Therefore it is important to coordinate with your tax advisor regarding your specific situation.

What's Next?

- We will help you determine which qualified accounts are candidates for conversion.
- We will help you determine if a Roth IRA conversion is in your best interest and if so, how much should be converted.
- We will work with you, your tax professional or refer you to a tax professional to help determine the taxations issues.
- We will work with you to identify existing funds to pay the taxes due and / or develop a plan to create them by specified due dates.
- We will process all paperwork to convert existing accounts with Fries Financial Services or bring new funds into Fries Financial Services.

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• (979) 846-8395 • (800) 324-4875 • Fax (979) 846-2607 • Email: service@friesfinancial.com