CLIENT **BULLETIN**

Independent Financial Advisors

SEPTEMBER 15, 2006

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Roth IRA Conversion News Flash

There's an intriguing planning strategy that has materialized from some recent Federal legislation. It may be of interest to anyone with income greater than $100,000. It allows such taxpayers, normally ineligible, to convert traditional IRAs to Roth IRAs in the year 2010.

Why would this be a desirable financial planning strategy? Well, Roth IRAs have several characteristics that make them superior, for some people, to the old style IRAs. Once the income tax has been paid (up front), Roths are income tax free forever. In addition, there are no lifetime required distribution (i.e. withdrawal) rules for them. That means that when you set up a Roth IRA, the funds inside the Roth can keep growing tax-exempt for your lifetime; at that point the Roth IRA can be passed on tax-free to your heirs.

The rules for heirs are not quite as generous, in the sense that they must take annual required minimum distributions. However, those distributions are tax-free as well. Most interestingly, the distributions can be stretched over the beneficiaries' lifetime(s), generating potentially huge tax-free compounding.

So Roth IRAs really have two main usages: a) as a terrific estate planning tool, if you don't need the money during your lifetime and b) as an investment vehicle for retirement, if you believe (as I do) that income tax rates will be higher in the future. Think of it this way: it may be beneficial to "bite the bullet" and pay income tax now during a Roth conversion, if you believe income tax rates will be significantly higher during your retirement. Rates are historically low right now, and with the high budget deficits, Congress in the future may be forced to raise income tax brackets.

With this particular legislation, there's an added advantage: when you do the conversion to a Roth IRA in 2010, there is no tax due in 2010 as is usually the case with a Roth conversion. Instead, the federal government wants your tax money so badly they're willing to wait two years to get paid, i.e. you're able to pay 50% of the tax in 2011 and the other 50% in 2012.

The greatest tax savings will be realized with the strategy if you have no IRAs currently, but it also works decently for current IRA holders as well. The specific course of action would be to open a non-deductible IRA account and sock away $5,000 per year ($4,000 if you're under 50) between now and 2010. Then in 2010, do the conversion of the IRA account to a Roth IRA, and the only tax due on the conversion will be the earnings between now and 2010. Assuming you earn 7% per year, earnings will total $5,766, so the tax bill will be small. Each spouse of a couple can follow this strategy, thereby accumulating a total of $40,000 to $50,000 to be converted to two Roth IRAs.

If you currently own regular IRAs, then something called the Pro-Rata Rule kicks in. Even though you may only want to convert the $50,000 in non-deductible IRAs to Roths, you must take into account all the rest of your IRAs. For example, if a couple holds $950,000 in deductible IRAs and $50,000 in non-deductible ones in 2010, they must pay income taxes on 95% of the $50,000. That's the proportion of deductible to non-deductible IRAs you hold that year. Put another way, the IRS will not let you just convert the non-deductible IRAs to Roth IRAs and pay no (or little) tax, unless, of course, you hold no regular IRAs.

Please contact me if you'd like to consider doing a Roth conversion. I'll help you think through the strategy for your particular circumstances and, if it makes sense, set up the non-deductible IRA accounts for you.