

Roth IRA Conversion Planning – A Key Opportunity to Create Wealth

If you have a traditional IRA, you may have the ability to take advantage of one of the more powerful financial and wealth transfer planning opportunities of converting a traditional IRA into a Roth IRA. And, in doing so, convert future taxable income into future tax-free income.

As you may be aware, beginning January 1, 2010, the \$100,000 adjusted gross income (AGI) limitation on Roth IRA conversions has been eliminated, making virtually all taxpayers eligible to convert to a Roth IRA. This presents an excellent opportunity for many taxpayers to shelter future income and appreciation from higher income taxes. Accordingly, please allow this letter to briefly summarize the benefits of converting to a Roth IRA and the other issues you need to consider prior to converting.

Looking forward over the next few years, it is highly likely that Congress will increase income tax rates, especially the two highest income tax rates, in an attempt to offset record deficits and to pay off the national debt. By converting to a Roth IRA today, at lower income tax rates, you, in all likelihood, will convert future income and appreciation within the IRA to tax-free income at a relatively low tax cost.

There are many factors associated with a Roth IRA conversion that need to be considered before the decision to convert is made. In order to arrive at the desirable Roth IRA conversion amount, one must prepare several spreadsheet analyses to determine which factors will have the greatest impact. In particular, the following factors have generally had the most impact on successful Roth IRA conversions:

1. Asset mix (i.e. qualified investments vs. non-qualified investments)
2. Size of traditional IRA
3. Time horizon
4. Current and future cash flow needs
5. Current income tax rates vs. projected future income tax rates
6. Wherewithal to pay the income tax with nonqualified investment funds

In addition to the above, it is important to point out that the tax law allows taxpayers to “recharacterize” (i.e., to undo) their Roth IRA conversions if either: (1) the taxpayer does not qualify to convert to a Roth IRA or (2) the conversion is not tax advantageous. In either case, if a taxpayer converts to a Roth IRA at any time during the current tax year, he/she will have until October 15 of the following tax year to recharacterize the previous year’s Roth IRA conversion. This provision within the tax law creates a unique opportunity by taking the risk out of the conversion by giving the taxpayer the benefit of hindsight.

For example, if a taxpayer converts \$500,000 to a Roth IRA on January 1, 2010, he/she has until October 15, 2011, to determine if he/she wants to keep all (or any portion) of the \$500,000 Roth IRA conversion. If the IRA has grown from \$500,000 to \$600,000, the taxpayer most likely will keep the Roth IRA conversion in that \$100,000 of growth has been shifted into a tax-free environment. Alternatively, if the IRA has declined in value from \$500,000 to \$350,000, the taxpayer most likely will recharacterize all of the \$500,000 conversion in order to eliminate paying income tax on \$150,000 of value which no longer exists.

If you are interested in learning more about Roth IRA conversions and/or believe this is a viable tax planning strategy for you, please call us to set up an appointment to meet in person.

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