ROTH CONVERSIONS

A closer look

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Have you considered converting your traditional IRA into a Roth IRA? Now that the tax law no longer places income or filing status restrictions on conversions, more individuals are finding they can take advantage of Roth IRAs. Simplified Employee Pension (SEP) IRAs and SIMPLE IRAs also can be converted.

A Roth IRA has several tax features you may find attractive in your planning. Of course, you'll want to carefully weigh the tradeoffs involved before making a decision about converting your IRA.

In this booklet, we answer questions you might have about Roth conversions and how they work. We also provide information that may help you decide if a Roth conversion is right for you.

What's the difference between a traditional IRA and a Roth IRA?

With a traditional IRA, your contributions are tax deductible if neither you nor your spouse is an active participant in an employer-sponsored retirement plan. If you (and/or your spouse) are considered an active participant in an employer's plan, IRA contributions are deductible only if your modified AGI is below a specified level. Income taxes generally are due on both deductible contributions and IRA investment earnings as withdrawals are made from the account.

With a Roth IRA, contributions are made on an after-tax basis and are not taxed when withdrawn. As with a traditional IRA, Roth IRA investment earnings accumulate without you having to pay current taxes on them. However, as opposed to a traditional IRA, withdrawals of Roth IRA earnings are *tax free* if the distribution is "qualified." Qualified distributions are those made: (1) after the five-tax-year period that begins with the first year for which a contribution is made to a Roth

IRA *and* (2) to an account owner who is age 59½ or older *or* on account of death or disability or for first-time home purchase expenses (up to a $10,000 lifetime limit).

Traditional IRA vs. Roth IRA

Feature	Traditional IRA	Roth IRA
Tax-deductible contributions	Yes*	No
Treatment of account earnings	Tax deferred	Tax free*
Tax-free distributions	No	Yes*
Required minimum distributions	Yes	No**

* Tax law requirements must be met.
** Minimum distribution rules are applicable after the account owner's death.

Why would I want to convert to a Roth IRA?

A Roth IRA can serve as a source of tax-free income after you retire. And, unlike distributions from a traditional IRA, qualified Roth distributions are not included in income for purposes of determining whether Social Security benefits are taxable.

Once you reach age 70½, you generally have to begin taking annual required minimum distributions (RMDs) from your traditional IRA. The RMDs are calculated using IRS tables based on life expectancy. You don't *have* to withdraw money from a Roth IRA unless you want to, since there are no mandatory minimum distribution requirements during your lifetime. Your beneficiaries *will* have to take RMDs from the Roth IRA, but those amounts won't be subject to income taxes as long as the five-year requirement has been met.

Are there any income-tax consequences to a Roth conversion?

Yes. When you convert a traditional IRA to a Roth IRA, any deductible contributions you made and any accumulated earnings in the traditional IRA become taxable. However, even if you're younger than age 59½, you won't be liable for the 10% early withdrawal penalty on the conversion. (Subsequent withdrawals of converted amounts may be subject to the 10% penalty if the withdrawal occurs within a five-year period, beginning with the conversion year.)

> ***Example:*** Kate, age 42, converts her $100,000 traditional IRA to a Roth IRA in 2011. The entire $100,000 balance is taxable, and Kate includes the full amount in her 2011 income. In her 35% tax bracket, the conversion costs Kate $35,000 of income tax. However, Kate will not owe an additional 10% penalty on the converted amount, even though she is under age 59½.

Do the income taxes on a Roth conversion have to be paid all at once?

Generally, yes. However, taxpayers who completed their conversions in 2010 could defer the income from a Roth conversion and spread it ratably over two years, *2011 and 2012*. The deferral and two-year spread are not available for post-2010 conversions.

Who should consider a Roth conversion?

Whether a Roth conversion is right for you depends on numerous factors. Everyone's situation is different. But, in general, a Roth IRA may be beneficial if you:

- Think you will be in the same or a higher tax bracket when you retire than you are now.
- Have some time until you plan to retire. The younger you are, the more you generally benefit.
- Currently have a low account balance but expect the value of your account assets to significantly appreciate in the future.

- Don’t think you’ll need to use all your retirement savings. Converting to a Roth IRA could allow you to provide your beneficiaries with a source of income-tax-free funds.
- Have the resources to pay income taxes on the conversion from non-IRA assets.

Why pay the conversion tax from non-IRA assets?

If you pay the tax from your traditional IRA, you’ll have fewer assets to convert, and you’ll lose the opportunity for those assets to grow tax free in the Roth IRA. Depending on the amount of the tax, the balance in your Roth IRA when you’re ready to retire could be significantly less than if you’d paid the tax from another source. In addition, you might have to pay the early withdrawal penalty on the traditional IRA assets you withdraw for your conversion tax payment if you are under age 59½.

How can I convert my traditional IRA into a Roth IRA?

You have three choices for converting to a Roth IRA.

- One way is to leave your IRA with your current trustee and redesignate the traditional IRA as a Roth IRA.
- Another way is to have the trustee of your traditional IRA transfer the account funds directly to a Roth IRA with another trustee.
- The third way is to withdraw assets from your traditional IRA and deposit them in a Roth IRA within 60 days after receipt. Any taxable amounts of your traditional IRA that you don’t put into the Roth IRA will be taxable to you in the year withdrawn and subject to a 10% early withdrawal penalty (unless an exception applies) if you’re under age 59½.

Note for SIMPLE IRA owners: You cannot convert a SIMPLE IRA to a Roth IRA within the first two years after first participating in the plan.

Can I convert part of my traditional IRA?

You can, but you can't choose to convert only your nondeductible contributions so that you won't be liable for income taxes on the conversion. If you have made both deductible and nondeductible contributions to your traditional IRA, the amount you convert will be considered to come partly from nondeductible contributions and partly from deductible contributions and earnings.

What if I convert my traditional IRA and the value of my account drops?

Should the value of your account drop after your conversion, you could end up paying income tax on money you no longer have. If this happens, you can *undo* the Roth conversion by *recharacterizing* the transaction, thus changing the account back to a traditional IRA. You'd no longer owe tax on the conversion if you meet certain tax law requirements. As long as you timely file your income-tax return for the year in which you make the conversion to a Roth IRA, you have until October 15 of the following year to recharacterize your converted IRA.

Example: Darryl's traditional deductible IRA was worth $120,000 at the beginning of the year when he converted it to a Roth IRA. By year-end, the value had dropped to $100,000. Darryl is faced with paying tax on $20,000 of the IRA value that he no longer has. He decides to recharacterize the account as a traditional deductible IRA. Darryl has until as late as October 15 of the next year to complete the recharacterization.

What if I change my mind and want to reconvert my traditional IRA to a Roth IRA to take advantage of the lower taxes that would be due on its decreased value?

You can reconvert the account to a Roth IRA. But special timing rules apply. Professional guidance is recommended.

Can I convert my 401(k) plan or other employer-sponsored plan accounts to a Roth IRA?

If otherwise eligible, you can roll over distributions from employer-sponsored plans, such as 401(k), 403(b) annuity, and 457 governmental plans, into a Roth IRA, regardless of your income. When you roll over from an employer plan to a Roth IRA, you must report the resulting income for tax purposes.

What are the possible estate planning benefits of a Roth conversion?

If you are reasonably sure that you won't need the money in your traditional IRA during your lifetime, converting to a Roth IRA may be advantageous for your family. Because *you* are not required to take minimum distributions from a Roth IRA during your lifetime, all of your IRA assets can continue to grow income-tax free. You can leave your beneficiaries more assets — assets they can withdraw tax free over their lifetimes. (Your Roth IRA will be subject to minimum distribution rules after your death.)

The value of the Roth IRA is included in your gross estate for federal estate-tax purposes. However, the amount of income tax you pay on the conversion will reduce your gross estate, which could result in federal estate-tax savings if your estate is large enough to be subject to tax.

What else should I consider before converting?

You will want to weigh the effect that including the taxable conversion amount in your gross income will have on your tax situation. Some tax deductions and credits can be claimed only if your AGI is below a set threshold for that particular tax item. While it's contrary to conventional tax planning, if the conversion will put you over a threshold for a particular deduction or credit, you may want to see if you can delay paying the expense until the next tax year. Check with your tax advisor for more guidance.

You also should be aware of the estimated tax requirements if you decide to convert. Normally, when you receive income on which no tax is withheld — such as the income realized in a Roth conversion — you must prepay taxes in the form of estimated taxes or have enough withholding from other income sources to cover the tax. If you don't, you may be subject to an underpayment penalty.

After I've converted my traditional IRA, can I make annual contributions to the Roth IRA?

You can make annual contributions to your Roth IRA for 2011 only if your modified AGI is less than $122,000 for single taxpayers and heads of household, $179,000 for married couples filing jointly, and $10,000 for married persons filing separately. (These limits may be adjusted for inflation in the future.) But if your income is greater, you still have an opportunity to build your Roth assets. Here's how. Create a traditional nondeductible IRA and contribute the maximum amount allowed for the year. Then, convert the traditional IRA to a Roth IRA. The next year, make your maximum nondeductible contribution again and convert, and so on. Time will tell if this "loophole" will be closed in the future.

How do I find out more?

Talk to us. Our knowledge and experience make us an excellent source of the information you need to take a closer look at Roth conversions and make the right decision for you. We can work with you to explore all of your retirement planning options.

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