

December 30, 2009

## Have Too Much Income to Convert to a ROTH IRA?

If you are frustrated because your income has disallowed you from converting your Traditional IRA to a Roth IRA, there is a special opportunity for you in 2010. We recommend you take advantage of this as early as possible in 2010 if converting to a Roth IRA is part of your retirement income strategy. Waiting until the end of the year may cost more in taxes than an early conversion.

Why convert retirement accounts to Roth accounts? What is the big deal anyway? The big deal is how they are taxed – or not taxed. First let's review how traditional retirement accounts work. Usually, when you contribute money to an individual retirement account (IRA) or an employer sponsored account such as a 401(k) or a 403(b), the amount of money you contribute to the account reduces the amount of income you report on your tax return and pay taxes on. This is an incentive to invest money into these accounts. These accounts also have several special features. Generally they are protected from creditors and bankruptcy courts. In addition, the money earned in these accounts is usually not taxed - until it is time to take the money out of the account. Another important feature is that the money cannot be taken out of the account without a penalty until you reach nearly 60 years of age (59½). Although there are exceptions to this rule, the purpose of these accounts is to help people save money for retirement.

In theory, these accounts are designed to encourage you to save money toward retirement when you are earning the most (and paying taxes at the highest rates). Traditional IRAs generally provide a deduction from your income and reduce your taxes while you are in the higher tax brackets. Later during your retirement you pay taxes on these savings in the IRA as you take distributions from the account. It is presumed you will be in a lower tax bracket than when you saved the money, so you will be paying less tax overall.

There are two factors which complicate this theory. First, we don't really know what our future tax rates will be, so we don't know if we will be in a lower bracket in retirement than we are in right now. The other factor is that it is not just the money you put into the account that you pay taxes on when you make withdrawals. You will pay taxes on both the amount you put into the account, and the investment earnings the account has accumulated over the years. All of us hope that this is a substantial amount of money. Another factor with these accounts is that if you don't need to take the money out of the account to live on, you may only leave it in the account until age 70½, at which point you are required to take out distributions based on your age and life expectancy tables. Ultimately, because of these required distributions and unknown tax rates, maybe the tax you pay won't be less over all.

How is the Roth account different? The Roth IRA is different because you don't get a tax deduction when you contribute money to the account. It is also different because you

### MAIN

1419 Coit Avenue N.E.  
Grand Rapids, MI 49505  
(616) 456-6464  
Fax: (616) 456-6442

www.cwccpas.com  
cwccpa@cwccpas.com

### SOUTH

901 Gezon Pkwy, Ste D  
Wyoming, MI 49509  
(616) 257-1099  
Fax: (616) 988-2069

generally don't pay taxes on what you take out of the account, if you wait until you are at least 59½ years of age. This means that all of the investment earnings are not taxed at all. This is a great opportunity, especially if you are thinking that tax rates will be increasing in the future to pay for the government's addiction to spending, and a future shrinking of the work force.

There are other advantages to a Roth IRA. The biggest one may be greater flexibility in making withdrawals. The people with the most to gain from a Roth IRA are probably young people with many years to allow their investments to grow before retirement. This is often the group of people that is also trying to reach other goals such as purchasing a home or eventually, paying for their children's education. Although other retirement accounts allow limited withdrawals for these and various other reasons without penalties before age 59½, the Roth IRA allows you to withdraw the amount you contributed without a penalty. In addition, you can withdraw rollover contributions without a penalty once the rollover is 5 years old. This is an important safety net for young families. (Remember, these withdrawals are not taxed either – no tax and no penalty.)

Another advantage of the Roth IRA is you are never required to take money out of the account, no matter what your age. This creates a tool which can be used to pass assets down to your heirs, providing them with a tax-free source of income.

Roth IRAs have been limited ever since Congress introduced them. An income limit of \$100,000 has been a part of the definition of who was eligible to roll funds from a traditional IRA to a Roth IRA. This has kept people with an income level above \$100,000, and those married who file separate, from being able to use this tool. Beginning in 2010, the income limits are removed, allowing anybody to convert their IRA to a Roth IRA.

In addition to traditional IRAs, a SEP-IRA and a SIMPLE IRA can be converted to a Roth IRA. But please be aware that with a SIMPLE IRA, there is a two-year period of minimum participation you must meet before you make the conversion. Conversions can be made by rolling over a distribution from a traditional IRA within 60 days of the distribution, by having the trustee of the traditional IRA transfer an amount to the trustee of the Roth IRA, or by having the trustee of the traditional IRA transfer an amount to a Roth IRA.

When you convert a retirement account to a Roth IRA, you include the value of the account (or portion of the account) converted in your income when you file your tax return, and pay taxes on that income. For many people, this would create a large tax bill, and the money to pay the tax cannot be taken out of the IRA without a penalty unless you are 59½ years of age or meet one of the other penalty exceptions. (Remember, the five year aging rules mentioned above.)

For 2010 only there is a special incentive. Conversions of Traditional IRAs to Roth IRAs in 2010 are not taxed in 2010. Instead, half of the converted value is included in income and taxed in 2011, and the other half in 2012. This provides more time to prepare for the tax bill that will come. It also may lower the amount of tax paid because you are climbing the tax brackets twice.

If you decide that you are going to make this conversion, we recommend you make the conversion in January of 2010, instead of waiting until December. If you don't make the conversion in January, we recommend you make it happen as early in the year as possible. The goal is to reduce the amount of tax you have to pay by making the conversion when the value of the account is at its lowest level. All of us hope and anticipate our accounts will increase in value as the year progresses, but that doesn't always hold true. We suggest that you make the conversion in January, when, we hope, the value of the account is at its lowest point. This will create tax, but less tax than later if the account has grown in value. If the value of the account drops and does not recover by the end of the year, you can change your mind and 're-characterize' the account back into a regular IRA. This will cause the first

conversion to no longer be taxable. Once you have made this re-characterization, you must wait until the next tax year (but not less than 30 days) to convert that account to a Roth IRA again. This strategy takes the risk of early conversion and a subsequent drop in the value of the accounts out of the picture.

We want to suggest an advanced strategy using this re-characterization tool to help you make your conversions to a Roth IRA as tax efficient as possible. Let's assume you decide to convert your IRA account of \$200,000 to an Roth IRA over a period of 5 years, including approximately \$40,000 of income each year, rather than \$200,000 all in one year. (You might be trying to use the tax brackets over several years to reduce your tax from the higher amount it would be if all the income was recognized in one year.) Let's also assume you have diversified your investments so you have five different types of stock, mutual funds or other investments each worth approximately \$40,000. You realize that by waiting to convert some of the funds until another year means the value of the investment will likely grow, which means you will have to include more money in your income in future years – creating additional tax. You would like to convert the portion of your portfolio that will increase the most the first year, then the portion that will grow 2<sup>nd</sup> most, the second year, and so forth in order to minimize the future tax cost of the delay in your conversions. Since it is impossible to know in advance which accounts will grow the most each year, use the re-characterization tool to review the year. You can do this by converting the IRA to five separate Roth IRAs, converting the entire \$200,000. At the end of the year, review the performance of each account, and re-characterize the four accounts that did not have the highest performance. After a 30 day wait and as long as you are in the new tax year, you can re-convert the four IRAs back to Roth IRAs to start the process for year 2.

The decision to make this conversion involves evaluating several complex issues, calculations, and assumptions about uncertain future economic conditions. Your financial/ investment adviser and your tax adviser at Culver, Wood & Culver CPAs can work together to organize the information you need to make a decision about whether or not you should convert your IRAs and which strategy will work best for you. Please call to schedule time to plan this piece of your financial future.