Clarity Wealth Advisors
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Roth Conversions IRAs

Hello!

With the uncertainty of where federal and state income tax rates are going to be in the future, Roth IRAs have become an increasingly popular tool for individuals to accumulate tax-free dollars for retirement. There are two types of Roth IRA accounts:

1. **Contributory Roth IRA** – an individual can contribute $5,000 ($6,000 if age 50 and over) for 2012 but there are two requirements, of which both must be met to qualify for a Roth IRA contribution to be made:

    - Earned Income
    - Adjusted Gross Income (AGI) – for 2012, AGI must be less than $110,000 for single and head of household filers to contribute the maximum amount, and $173,000 for joint filers.

2. **Roth IRA Conversion** – there are no restrictions regarding eligibility of converting retirement accounts (IRAs, SEP IRAs, 401(k) plans, 403(b) plans, etc.) to a Roth IRA. Prior to 2010, individuals with incomes over $100,000 were not eligible to partake in Roth IRA conversions.

In this newsletter, the topic of Roth IRA conversions will be highlighted.

How They Work

This strategy is one in which retirement accounts, such as traditional IRAs, SEP IRAs, 401(k) plans, 403(b) plans, government 457 plans, which generally are funded with pre-tax dollars, are converted to a Roth IRA. Individuals utilizing this strategy would rather pay the taxes now and have those assets grow tax-free versus continuing to have them grow tax-deferred and then be subject to ordinary income taxes when distributions are made during retirement. An individual can choose to convert all or some of their retirement assets to a Roth IRA. Depending on the size of the account, it may be more tax-efficient to convert smaller amounts over a number of years versus engaging in a lump sum conversion. There is no limit to the number of Roth IRA conversions one can do.

Since taxes are due on the pre-tax converted amounts, in most cases, it is best to pay this with after-tax dollars versus with funds from your pre-tax account. If you are under age 59½, the amount withdrawn to pay for the taxes as a result of the Roth IRA conversion may be a subject to a 10% penalty. Also, those amounts would then not get the benefit of future tax-deferred growth.

With respect to traditional IRAs, some individuals have a cost basis, i.e. they have funded them with after-tax dollars. If this is the case, it can be assumed that one can select which dollars to convert, and therefore would choose to convert the after-tax contribution amounts only so as to avoid any tax liability. This is not the case unless the individual only has one IRA that was entirely funded with after-tax contributions. In cases where an individual has both before- and after-tax contributions in an IRA (or multiple IRAs if applicable), the IRS requires that any conversions to a Roth IRA be calculated by looking at the ratio between those two amounts in order to determine what percentage of the conversion would be taxable. The IRS does not allow an individual to segregate which types of contributions they are going to convert to a Roth IRA. This results in the converted amount having a combination of before-tax and after-tax contributions. .

Five-Year Rule

With Roth IRA conversions, an individual has to keep the assets in the account for five years or until turning age 59½, whichever comes first, in order to take distributions without being subject to a penalty. In the event an individual has done multiple conversions over various tax years, each conversion contains its own five-year period.

For those age 59 ½ and over and deciding to convert assets to a Roth IRA, they can withdraw the amount converted at any time without incurring penalties, but any earnings have to remain in the account for five years.

Advantages & Disadvantages

As with any strategy, there are pros and cons. Here are some of the advantages and disadvantages of a Roth IRA conversion.

Advantages

- **Flexibility and Control** - It provides tax diversification of assets which results in more flexibility to manage income in retirement. An individual can choose what amounts to withdraw from taxable accounts, pre-tax accounts, and tax-free accounts and therefore, have better control of their tax liability.

- **No RMD** - There are no required minimum distributions (RMDs) after age 70½ with Roth IRAs as there are with other retirement accounts.

- **Accessibility** - There is accessibility to converted assets penalty-free before age 59½ once the five-year rule has been met.

- **Estate Planning** - It provides a way to transfer assets income tax-free to one's beneficiaries.

Disadvantages

- **Tax Liability** – In most cases, when an individual does a Roth IRA conversion, those assets are subject to ordinary income taxes and are due when the individual files their tax return.

- **Tax Rate Shift** – In doing a Roth IRA conversion, it may cause the individual's tax rate to increase given that the converted IRA assets are considered income.

- **Potential Lower Tax Bracket in Retirement** – In the event an individual anticipates being in a much lower tax bracket in retirement, it may not be as worthwhile to convert pre-tax assets and pay.

Items to Consider

In determining if converting retirement assets to a Roth IRA, there are a few items that must be taken into account prior to doing so:

- How will the income taxes due from the converted amount be paid?

- Will doing a Roth IRA conversion increase one's tax bracket?

- When does the individual start planning on withdrawing these funds?

- Does the individual plan on having a higher or lower tax bracket in the future?

Recharacterization

In the event an individual who had done a Roth IRA conversion decides later on, that they want to undo, it is an option. It could be due to being in a higher tax bracket than the individual had assumed and now, the taxes on the conversion amount would be higher than what was originally thought. The deadline for recharacterization is October 15th of the year following when the conversion was made.

Conclusion

Private foundations can be useful strategy for both charitable and estate planning purposes. Given the various requirements in setting up and administering these, it is highly recommended to consult with legal and tax professionals to ensure these are established correctly and are in accordance with current IRS rules.