The Roth IRA Conversion - On Sale NOW! Less than 4 Months left!

September 01, 2010

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InsuranceNewsNet

Sept. 1, 2010 -- Since Jan 1, 2010, the buzz about the Roth IRA conversion has grown louder by the day. Jan. 1 was the blast-off date for IRA owners who have incomes more than $100,000 to be eligible to convert their traditional IRAs to the Roth IRA and everyone is getting into the game. I just did Google search for Roth IRA Conversion and found 1,460,000 websites, many of them encouraging IRA owners to convert their IRAs to a Roth IRA with their firm. Many of us in the financial services industry are receiving dozens of e-blasts weekly from financial marketing firms touting they can teach us how to take advantage of the “Roth Conversion Bonanza."

So what’s the buzz all about and why are so many financial firms gearing up to get their share of Roth conversion bonanza? One reason might be because the fees, loads and commissions associated with managing the trillions of dollars of qualified assets in America is big business. The value of the nation’s retirement savings is $11 trillion, according to the U.S. Treasury Department. Beginning this year, much of that savings became eligible to be converted to a Roth IRA. Before we begin the wholesale conversion of tradition IRAs and eligible 401(k) plans to the Roth IRA, let’s examine the facts.

The Advisor Bonanza
The Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 allows individuals with incomes exceeding $100,000 to convert their traditional IRAs to a Roth IRA beginning Jan. 1. Those who choose to convert in 2010 will be able to report half of the conversion income in 2011 and the remaining half in 2012. Those who convert after 2010 will pay all of the conversion tax in the following year.

There is an INCOME TAX SALE. We are currently in historically low tax brackets so those who convert now will pay no more than 35 percent federal income tax on the amount converted. It is widely anticipated that income taxes will increase by 2011.

For many traditional IRA owners, the Roth conversion offers a number of advantages. Roth IRA owners and spouses are not forced to take distributions while they are living and any growth and future distributions to their heirs will be income tax free. This can allow them to pass more money to their children and grandchildren income-tax free. For example: A 60-year-old who has a traditional IRA balance of $300K, must begin taking required minimum distributions by April 1 of the year following the year he turns age 70½. Assuming it grows at the rate of 5 percent, the IRA will be worth $488,668 when he turns 70. If the account continued to earn 5 percent and the owner took only his required minimum distributions and died at age 85 there would be $491,306 of taxable money left to be passed on to the heirs.

Converting to a Roth – Tax paid out of the IRA
If the same IRA owner converted to a Roth now, and paid conversion tax at the rate of 33 percent out of the IRA there would be $200,000 left in the account. But now the owner will not be required to take any distributions during his lifetime. If no distributions are taken and the account continued to grow at 5 percent, there will be $677,270 of income tax free money left for the heirs. ($200,000 X 5% X 25 years = $677,270). That means the heirs will inherit $185,964 more and it will all be income tax free. What happened in this case is the owner lived long enough (25 years) after the conversion to recoup the taxes paid at the time of the conversion and then some. If the IRA owner didn’t need or want to take distributions and the goal was to pass as much to the heirs as possible converting to a Roth makes sense. The heirs would inherit more and the income from the inherited Roth IRA will be income tax free.

Converting to a Roth – Tax paid from Non-IRA Funds
If the owner was in a position to pay the conversion tax from Non-IRA funds he then would have a $300,000 Roth IRA and the amount of tax free money passed on to the heirs would have increased to $1,015,906. ($300,000 X 5% X 25 years = $1,015,906). That’s $338,636 more than they would have inherited if the owner had chosen to pay the conversion tax from the IRA. Additionally for some IRA owners, converting to a Roth will reduce their future taxable income and could reduce or eliminate the

taxation of their Social Security Benefits.
Annuities are a great vehicle for the Roth conversion because they are not subject to Market fluctuations and have historically yielded 5 percent or better over the long run. For annuity producers, the Roth conversion can truly be a bonanza.

The Advisor Minefield
What looks attractive today is not guaranteed for tomorrow. In 1934 President Franklin D. Roosevelt made a promise to the American people. No income tax on your Social Security Benefits. In 1983, Congress broke that promise and today many retired Americans are paying income tax on 85 percent of their Social Security Benefits. Could this happen to the tax free income benefits of the Roth IRA? Of course it could!
Older IRA owners and those who die prematurely may not have enough time to recoup the tax paid on the converted IRA. In this case the heirs could wind up with less inheritance than they would have had the owner chosen not to convert.

Current and future tax brackets of the IRA owner and their beneficiaries could impact the value of converting to a Roth.

Annuities can be a great solution for the Roth conversion but this must be done properly. If you transfer all of your client's traditional IRA to an annuity today and later convert it to a Roth, the outcome could be disastrous. If the IRA owner doesn't have sufficient non-IRA money to pay the tax on the conversion, where will the tax dollars come from? If they remove the needed tax money from the annuity, they will likely pay an unwanted surrender penalty. The best approach is to leave a portion of the IRA equal to the estimated conversion tax in a short term liquid account and transfer the balance to the annuity. When the conversion to the Roth occurs, a 1099 will be generated by the insurance company. The money will be readily available to pay the conversion tax. Converting to a Roth can be like paying the tax on the seed and saving the tax on the crop. It can be a positive financial move depending on when the crop will be harvested. Now that we know the ground rules, let's look at the characteristics of the ideal prospect and the wrong prospect for the Roth conversion.

Six Signs of the Ideal Prospect for the Roth Conversion
1. Owner doesn't plan to take distributions within five years after the conversion and is 59½ or older.
2. Expected to live long enough to recoup the conversion tax.
3. Has non-qualified funds to pay the conversion tax
4. Believes their or the heirs' tax brackets will be higher in the future.
5. Desires to pass more onto heirs income tax free.
6. Fully understands all positive and negative tax consequences of converting to a Roth.

Six Signs of the Wrong Prospect for the Roth Conversion
1. The owner will need to take distributions within five years after conversion and is under age 59½.
2. The owner is at an advanced age or in poor health.
3. The conversion tax will need to be paid out of the IRA (under 59½).
4. Believe their tax bracket will be similar or lower in the future.
5. Conversion will raise their marginal tax bracket (consider a partial conversion).
6. Does not understand All positive and negative tax consequences of converting to a Roth.

Consumer Awareness
This is a strong indication that the majority of IRA owners are not up to speed on the new Roth conversion rules and may not be aware that those with incomes over $100,000 now have the opportunity to convert their traditional IRAs to a Roth IRA . The best cure for lack of awareness is the highly trained Financial Advisor. TIPRA and the Roth conversion can be a blessing for some IRA owners and the wrong move for others.
Somewhere between the Ideal prospect and the Wrong prospect for Roth IRA conversion there is the great gray area where the majority of IRA owners can be found. For many of these IRA owners a partial Roth conversion may be the best solution. Only highly educated advisors who are well trained in all of the IRA and Roth IRA distribution rules will be in a position to make the difference. So is this the Roth IRA Bonanza or a Minefield?

I suggest it is both!

For more information on David F. Royer and IRA planning, visit www.KeystotheIRAKingdom.com.