

Bonanza or Bust?

Roth Conversions in 2010

by Richard F. Stolz



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It may be a seductive trap for some unwary taxpayers, and simply inappropriate for many of the rest, but the elimination of the income ceiling for Roth retirement account conversion eligibility next year is being hailed as a bonanza for financial planners. And indeed it is.

“This is huge. Every once in a while, the

government gives us something we can really go out and tell the public that might be attractive,” says Bryan M. Place, CFP®, CLU, ChFC, of Place Financial Advisors in Manlius, New York.

“I don’t think it’s overstating it to say that this is a once-in-a-lifetime opportunity,” adds Michael C. Slemmer, CFA, co-founder and principal of Advisors Trusted Advisor.

Exuberance aside, there is little doubt that even with ongoing financial media frenzy about Roth conversions during the final run-up to 2010, there is still a large public education job to be done—and who better to do it than planners?

A recent Fidelity Investments-sponsored poll of 800 individuals with household incomes exceeding \$100,000—that is,

those who will be newly eligible to exploit the Roth vehicle via conversions—suggested, surprisingly, that only 12 percent were even aware of the new conversion opportunity.

Moreover, while 56 percent of poll respondents reported confidence in their grasp of basic characteristics of Roth IRAs, “their actual knowledge . . . is lacking,” according to Fidelity. That conclusion was based on incorrect answers to follow-up poll questions on those tax fundamentals.

In the Works Since 2006

The Roth conversion opportunity has been in the works since 2006, when Congress enacted the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). That law did not change income-based restrictions on ongoing contributions to Roth IRAs. But by allowing anyone to shift all or some assets from conventional IRA, 401(k), and 403(b) accounts, in whole or in part, to an after-tax Roth vehicle in 2010, everybody can gain the benefit of tax-free post-age 59½ distributions for the rest of their lives or, significantly, the lives of anyone who inherits Roth assets.

There is, of course, a big catch: Any untaxed dollars that have accumulated in conventional IRAs, 401(k)s, or 403(b) accounts and shifted to a Roth vehicle next year (or thereafter) will be taxed upon conversion. It is not a matter of cynicism, but basic fiscal reality, that Congress’s motive for lifting the income ceiling on Roth conversions was to snag tax dollars sooner rather than later from the above-\$100,000 income crowd during the distribution phase of those conventional tax-deferred accounts.

“This was a revenue bill,” asserts Place.

More precisely, TIPRA was both a tax-cutting measure and a revenue-raising law. The Roth changes were among several other “revenue offsets” that helped “pay” for other TIPRA provisions, including a two-year extension of reduced tax rates on capital gains and dividends, and an exten-

sion of alternative minimum tax relief.

In addition to eliminating the income restriction on Roth conversion eligibility, TIPRA contained a provision intended to mitigate the effect of the tax hit for a taxpayer electing to convert in 2010. Specifically, the “income-splitting” rule allows taxpayers to shift half the tax liability attributable to 2010 conversions to 2011, and the other half to 2012. The income attributable to the conversion would simply be added to other taxable income in those years, and taxed at whatever marginal rate is applicable at that time.

Because that income-splitting opportunity is available only for 2010 conversions, there is some moderate time pressure for planners and their clients to determine whether it makes sense to take advantage of it. (Taxpayers don’t need to actually declare the conversion until the due date for their 2010 tax return.) Income-splitting may not

be the best approach for other reasons, however, even assuming that doing a Roth conversion that year makes sense (see “Income Splitting: Smart Move or Trap?” sidebar).

Many planners, looking ahead to 2010, have already been working with clients



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—Michael C. Slemmer, CFA

regularly to assess the pending Roth “opportunity.” In addition, of course, some planning clients have come under the \$100,000 modified adjusted gross income

Income Splitting: Smart Move or Trap?

Taxpayers who convert tax-deferred retirement accounts to Roth accounts in 2010 can elect to pay their tax liability in two installments, with their tax payments for their 2011 and 2012 years.

In theory, doing so could reduce the tax bite, or at least spread out the pain.

“But,” warns Michael E. Kitces, CFP®, CLU, ChFC, RHU, REBC, “under current law, our current tax rates sunset on December 31, 2010. When you wake up January 1, tax rates will be several points higher because we’ll go back to 2001 rates,” he says. “So for many clients, income spreading would be a free donation to Uncle Sam, which is exactly why Congress put it in in the first place.”

However, if the conversion amount would be large enough if not split in two to cause the taxpayer to “cross through several tax brackets,” Kitces says, splitting the income over two years might produce a better tax result, even with higher tax rates.

Of course, it is not yet clear whether Congress will actually allow tax rates to revert to 2001 levels in 2011. But the decision to elect income splitting for 2010 doesn’t have to be made until the taxpayer’s 2010 tax return is due in 2011. “Hopefully by January 2011, we’ll know what’s happening with 2011 tax rates,” Kitces says.

cap that limited participation in Roth plans, and thus have been the focus of planner attention.

“We work through this process each year anyway because it’s always a planning opportunity that needs to be explored,” says Michael E. Kitces, CFP®, CLU, ChFC, RHU, REBC, a planner, professional speaker, and financial educator based in Silver Spring, Maryland.



“In most cases, when you do the calculations, both for the living person’s benefit and the children’s, this may be one of the best wealth transfer strategies out there.”

—Will Rogers, CFP®, ChFC

Planting the Seed

Cassidy Burns, CFP®, of Riverbridge Partners in Minneapolis, Minnesota, adds: “We’ve been presenting it to a number of clients, whether or not there’s a perfect fit. We’re planting the seed, if not for now, then for next year.”

But would raising a prospective client’s expectations about potential benefits of a Roth conversion backfire if the analysis determines that a conversion would be ill-advised? Not at all, says Slemmer. “Ninety-nine times out of one hundred, people are going to appreciate the fact that someone is service-oriented enough to help them evaluate the opportunity.”

Besides, Burns adds, “if they’re at a cocktail party and somebody starts talking about it, they’ll know what it is,” and not wonder why their planner never told them about it.

Burns notes that the Roth conversion decision involves long-term goals and

assumptions, as well as estate planning considerations, and thus, isn’t a simple yes or no, or all-or-nothing proposition. “We’re positioning it as a planning opportunity within their life, as well as for the beneficiaries of their estate. This is a discussion that’s going to take time,” she says.

Naturally, planners seeking to expand their practices recognize the marketing potential of the Roth conversion issue.

“More assertive advisers will want to use this as a business-building opportunity,” notes Slemmer. “There are a number of reasons to complain these days about not having a good message for the marketplace—‘accounts are down, woe is me.’ The adviser [who will be successful is the one who] takes advantage of this and says to the marketplace, ‘Look, for those of you who aren’t with an adviser, or not with an adviser who is focusing on this, you should pay attention to it. I can do it. I have the expertise.’”

One such assertive adviser is Bryan Place, who is planning to deliver a client seminar covering Roth conversion basics. He’s encouraging his clients to bring their friends along as well. “Obviously there is a marketing aspect to this,” he says.

Cultivating CPAs

Place’s Roth conversion marketing efforts aren’t limited to consumers, however; he is also cultivating relationships with CPAs to build his client base. Place plans to offer some perspectives on the Roth conversion issue to CPAs “to get them to think about it, because there is a lot of potential for this within their clientele.”

Of course, most CPAs are well aware of that fact, and may already have deep technical expertise on the matter. Therefore, planners need to approach CPAs without

posing as know-it-alls, warns Will Rogers, CFP®, ChFC, a planner with Ameriprise Financial Services in Evans, Georgia. “I always prospect with accountants with the mindset that I am seeking information from them, and that there is a possibility that my knowledge and assumptions could be wrong, and that I’m trying to understand the nuances,” Rogers says.

In truth, he adds, “I may know this material backwards and forward, but there is always something new that I can learn.”

And indeed, CPAs should understand that the Roth conversion decision is much more than a simple tax compliance exercise, notes Slemmer. A basic accounting approach involves dealing with numbers “as they exist,” he says. But the Roth conversion decision “is so dependent on a person’s viewpoint about where tax rates are headed, where the market is headed, people’s income needs for the future, legacy concerns—it’s really about financial planning, not tax accounting.”

In other words, CPAs who focus narrowly on tax matters can indeed help their clients by making sure they are working with a planner who can assist them with incorporating all of these additional factors into their decision on whether to convert assets to a Roth account.

Some aspects of the analysis are purely mathematical, however. Kitces notes that the basic framework of the Roth vs. non-Roth decision as it relates to the conversion option is the same as the decision regarding contributing to a Roth vehicle or not on an ongoing basis. “Obviously, with conversions, we’re dealing with much bigger dollar amounts than one year’s contribution,” he says.

(Even though the \$100,000 modified AGI income test will still constrain ongoing Roth IRA contributions after 2009, the 2006 liberalization of Roth rules that provided for Roth 401(k)s and Roth 403(b)s without income restrictions has given many higher earners the ability to make substantial annual Roth-type contributions. In 2009, people over age 50, with access to a Roth 401(k) or 403(b),

regardless of income, could salt away \$22,000 in those plans.)

Analytical Framework

Kitces summarizes the basic framework for Roth conversion decision-making as follows: “If my tax rate never changes, I do not create nor destroy a single dollar by doing a conversion. It doesn’t matter what my growth rate is, nor my time horizon.”

William Reichenstein, Ph.D., CFA, a professor in the finance department at Baylor University’s Hankamer School of Business in Waco, Texas, illustrates the same point with basic mathematical equations. “It’s not a time value of money issue,” he emphasizes. “It’s purely a matter of whether your tax rate is going to be higher [when the conversion is done] or when you take the money out.”

That fact is sometimes lost on financial planners, however. Dennis M. Gurtz,

CFP®, CFA, CPA, a planner based in Bethesda, Maryland, recalls a recent conversation with another planner who, he says, “isn’t stupid,” but “didn’t get it.”

“It’s a mathematical identity,” Gurtz says, “if you have the same tax rate now as later.”

“The key,” he adds, “is knowing what your tax rates are going to be” in retirement, or the tax rates of heirs who could inherit a Roth account and enjoy the tax-free income it can produce.

Actually, Gurtz, Reichenstein, and others are quick to concede that the analyt-

ical plot thickens beyond a future marginal tax rate prediction exercise. For example, Roth IRAs aren’t covered by the required



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minimum distribution (RMD) rules applicable to conventional IRAs. “That means, with a Roth I get to keep a little bit more between age 70½, and whenever I pass away,” notes Kitces. “But I’d have to live

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Is the Roth Conversion Opportunity Being Scrutinized Adequately?

Edward F. McQuarrie, Ph.D., a professor at Santa Clara University's Leavey School of Business, is an unabashed Roth conversion skeptic. It's not that he believes conversions *never* make sense. Rather, McQuarrie thinks the opportunity is often over-sold, or simply misunderstood.

For starters, McQuarrie believes some planners are too quick to assume that many clients will find themselves in a higher tax bracket in retirement—or even the same tax bracket they were in during their prime earning years. This frequently false assumption, he says, stems from two misconceptions or oversights.

The first, he says, is the effect of the inflation indexing of tax brackets.

"To get into the highest (35 percent) marginal bracket today," he says, "you have to have family income of about \$350,000." If inflation-adjusted, that income threshold will nearly have doubled in 20 years, assuming a 3 percent inflation rate. That is, a taxpayer may need to have an income approaching \$700,000 to be in the top bracket.

But that's only half of the analysis required, McQuarrie says. What also must be assessed is the taxpayer's *effective* tax rate in retirement, based on the weighted average of different rates applied to each layer of income.

When that analysis is applied, McQuarrie says, "you'd probably have to be looking at an income of around \$1.5 million in 2029, even with the tax rate increases that everybody expects, for the Roth conversion to make sense" for a top marginal tax-bracket earner today.

"The heart of the misconception," McQuarrie maintains, "is people don't understand the difference between upper middle-class professionals and the true upper crust."

McQuarrie also believes people need to be more skeptical about the assertion that Roth account dollars, when withdrawn, will truly be "tax free."

"The idea that Congress will never change today's Roth provisions for the worse, for the rest of your life and the life of your heirs, requires more faith than reason, and a naïveté that would be touching if it wasn't so dangerous to your financial well-being," he warned two years ago, in an article published in *Barron's*.

In that March 5, 2007, article, titled "Breaking Faith in Savings Is Very Easy," he enumerated a variety of subtle ways that Congress could nibble away at Roth's tax-free status—especially for high net worth taxpayers, while granting itself political cover with the general public.

He suggested, for example, that Congress could impose a tax on what it would deem "excess" Roth accumulations. "Congress could look voters in the eye and say, 'we're not taxing your Roth—all you have to do is take a big enough tax-free distribution each year to keep your account balance below the excise tax threshold.' This trick is easy to envision," he wrote.

way beyond 70½ for it to have a material impact," he adds. If the client's goal is to pass that Roth account on to heirs, the lack of RMDs could make a "material" difference to those heirs if the taxpayer did live well beyond age 70½.

Another variable that must be thrown into the analytical mix, Kitces says, "is the extent to which I have outside dollars available to pay the tax" upon conversion. That's because, "all else being equal, simply having a fully preferred Roth account is better than having a big traditional IRA and a taxable side account that's going to get dinged by taxes annually for interest, dividends, and capital gains." Kitces adds, however, that the tax efficiency of that side account must also be factored into the analysis.

So when can planners recommend substantial Roth conversions with confidence? The "overwhelming driving factor," Kitces says, is the anticipated tax rate differential. "If you are 100 percent certain that your tax rates aren't moving anyplace," he says, "there is a little bit of a tailwind for the Roth simply because you can avoid RMDs," assuming "you have outside dollars to pay the tax."

And given the "overwhelming" importance of that tax rate differential, a Roth conversion would be a no-brainer if one could safely assume that one would be in a higher tax bracket during the distribution phase. But casual predictions about higher (or even un-changed) tax rates in retirement, perhaps based on the current political or economic environment, may be ill-founded and costly (see "Is the Roth Conversion Opportunity Being Scrutinized Adequately?" sidebar).

The Roth Inheritance

Another case in which a large Roth conversion might be clearly indicated, according to Scott Ditman, CPA, a tax partner with Berdon LLP in New York, involves "someone who is not going to need the IRA money at all to live on, and can leave it as an asset that's growing tax-free to their

children or grandchildren.” This approach may be particularly beneficial if the children or grandchildren who inherit the Roth are in a high tax bracket when they receive the inheritance.

Adds Rogers: “In most cases, when you do the calculations, both for the living person’s benefit and the children’s, this may be one of the best wealth transfer strategies out there.”

Ditman notes that a Roth IRA, just like a conventional IRA, will be included in the estate and subject to estate taxes—a key factor that needs to be considered in the conversion analysis. And Gurtz points out that assets used to pay income taxes attributable to the Roth conversion prior to the taxpayer’s death are, of course, no longer in the estate, and thus not subject to estate tax. Heirs are required to begin withdrawing inherited Roth IRA assets from the account at a schedule based on their life expectancies.

Another relatively straightforward scenario for a Roth conversion involves clients with IRAs that have been funded with non-deductible contributions. Converting such an IRA to a Roth, depending on the amount of un-taxed capital gains and investment income that have accumulated in the account, could be very tax-efficient.



“If I wait until retirement to convert, all of it is going to be taxed at future rates. If I convert some of it now, some will be taxed at the current tax rate, some at a future tax rate. And since nobody knows for sure what future tax rates will be, that would favor a partial conversion.”

—William Reichenstein, Ph.D., CFA

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accounts using different kinds of assets, watching their performance, and for any accounts that sustain losses, re-characterizing them back to conventional IRA status to avoid wasting a tax benefit.

However, IRS rules could limit the benefits of converting nondeductible IRAs to Roth status if clients already have conventional IRAs with substantial un-taxed balances, Place warns. “You have to aggregate



“I have not had one person, after we’ve gone through the analysis, who has wanted to do the conversion.”

—Scott Ditman, CPA

all of the IRA assets when you convert” for purposes of determining the tax liability on the amount of IRA assets being converted to a Roth account. “It’s a pro-rata conversion across all accounts,” he says.

Partial Conversions

If Roth conversions were an all-or-nothing proposition, they probably would not be prudent under many scenarios, given the uncertainties, planners say. “I don’t think we have any clients [who are] considering doing it with their entire IRA,” says Burns. Adds Place: “With most clients, you’re going to find that there are little things that are happening in their life where a partial conversion might make sense.”

For example, Place suggests the case of a business owner whose tax bracket is typically higher than it’s likely to be in retirement, who has a net operating loss one year. “We would want to take advantage of that loss” and do a partial conversion at the lower income tax rate for that year, he says. “Or maybe it’s an older client who has had substantial health issues to deal with this

year” and has reduced his or her taxable income to a lower bracket through substantial medical expense deductions.

Yet another partial conversion scenario: Determining the amount of additional taxable income the client could take through a conversion to “use up” his or her current tax bracket, without pushing any income into the next higher bracket.

And even if income from a partial conversion would be taxed in a high tax bracket, it might make sense to convert a nominal amount to a Roth to satisfy the requirement that Roth accounts be created at least five years before withdrawals can begin tax free.

“This way,” Place says, “if something happens in the future and [the client’s] income is substantially lower and a bigger conversion makes sense, you have already started that five-year clock.”

Finally, partial conversions today can be regarded simply as a form of “tax diversification,” according to Reichenstein. “If I wait until retirement to convert, all of it is going to be taxed at future rates. If I convert some of it now, some will be taxed at the current tax rate, some at a future tax rate. And since nobody knows for sure what future tax rates will be, that would favor a partial conversion,” he reasons.

Rogers considers tax diversification akin to investment portfolio diversification. “We diversify clients’ assets between stocks, bonds, and other assets. I believe it is also appropriate to diversify clients’ tax holdings between taxable, tax-deferred, and tax free.”

But planners should be mindful of the limits of tax diversification, warns Edward F. McQuarrie, Ph.D., a professor and associate dean for assessment at Santa Clara University’s Leavey School of Business. “All future taxes are subject to future Con-

gresses,” he says. McQuarrie believes planners and their clients need to think skeptically about the ultimate prospects for a lifetime of “tax free” Roth income (see “Is the Roth Conversion Opportunity Being Scrutinized Adequately?” sidebar).

With all of the variables at play in the Roth conversion analysis, financial planning software makers have developed elaborate tools to help with the number crunching. Burns uses one that generates a report for clients replete with tables, graphs, and charts highlighting account balances and spendable income under varying scenarios. “It gives clients a way to experience it and see the benefits” of conversion, she says.

Scott Ditman, CPA, reports that his firm has developed a homemade Excel spreadsheet to help analyze the implications of Roth conversions for taxpayers while living, the estate tax considerations, and the after-tax benefits for their heirs.

Limits of Software

Ditman understands that even the most sophisticated software is only as good as the assumptions upon which its projections are based. It cannot, for example, anticipate that a client who had planned to retire where he had always lived—New York City, where state and municipal taxes add 12.6 percent to the taxpayer’s federal income tax tab—later decides instead to retire in Florida, which does not tax income. “If I did the conversion when I’m in New York, I’m paying a tax I wouldn’t be subject to in the future,” he says.

Also hard to predict is the effect of tax planning opportunities in retirement that may allow taxpayers to keep their tax rates relatively low, notes Reichenstein. For example, taxpayers who reach retirement with substantial taxable accounts intact may be able to defer withdrawing fully taxable IRA funds by instead living off of those taxable accounts, which may consist of assets whose liquidation would not trigger a significant tax liability. Or a retired

couple might find their taxable income reduced because of significant tax-deductible medical or nursing home expenses, he adds.

Of course, financial planning always involves grappling with unknowns, and, when a decision must be made, sometimes just going with one's gut. How are clients reacting to the Roth conversion idea so far?

Client Reluctance

"I have not had one person, after we've gone through the analysis, who has wanted to do the conversion," says Ditman. "Once they hear they're going to have to come up

objective dollars-and-cents analysis would suggest otherwise.

Even Roth conversion skeptic McQuarrie agrees there are times when emotional considerations may override financial analysis, and lead to a decision to convert some assets. "There is a species of American that has a visceral repulsion from paying taxes. Never underestimate the seductive appeal of 'tax-free forever'" to such people, he says.

"If you're a financial planner, you know you can't justify the time it would take laying out all the scenarios for a client when he's sitting there, frothing at the mouth about taxes," McQuarrie says. But



“Every time you have an opportunity to talk to clients about something, it strengthens the relationship.”

—Cassidy Burns, CFP®

with [a substantial amount of money] now to pay the tax, for a perceived benefit they're going to get 10 or 20 years down the road, or that their kids are going to get," clients balk, he reports.

"My tax rate is going to go down," is the prediction Cassidy Burns says she typically gets from her clients, as the basis for choosing not to do a conversion.

These advisers' experience may be typical. The Fidelity Investments survey found that only 7 percent of those polled expect to do a Roth conversion.

But some clients may be emotionally predisposed to take advantage of such opportunities. One such type of client is what Bryan Place calls the "angry RMD guy." "There are a lot of people who are just flat-out angry that they've got to take that RMD. For them, it may be appropriate to look, at a minimum, at a partial conversion," he says, perhaps even if an

that doesn't mean planners shouldn't do their best to offer objective advice on the issue, he adds.

Still, it is also possible for planners themselves to get "too caught up in the numbers," says Place. "We have to strike a balance between what makes sense on paper and what helps clients sleep at night," he says.

And even if the planner is inclined to believe a Roth conversion doesn't make sense, that doesn't mean the topic should be avoided. Says Burns, "Every time you have an opportunity to talk to clients about something, it strengthens the relationship."



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