



“Jingle Roth” “Jingle Roth”



Many taxpayers continue to be “on the fence” deciding whether a 2010 Roth conversion is the right thing for them. A major concern is where the money will come from to pay the tax that will be due. As the clock winds down for the uncertain taxpayers, many individuals will find Roth Conversion tax planning more costly and less effective after December 2010. At this time, it appears that for 2011 the top federal income tax rates of 35% and 33% will rise to 39.6% and 36%, respectively. A Roth conversion can be a long-term gift to your family but it isn’t an easy decision.

By converting a traditional IRA to a Roth IRA in 2010 and including the conversion income in 2010, high-income taxpayers may pay tax at the lowest rates they are ever likely to see. Upon conversion, there will be no required minimum distributions (RMDs) and the account will grow income tax-free for the Roth IRA owner and any beneficiaries. Additionally, a Roth conversion can be recharacterized (undone) up to October 15th of the year after conversion. Following years of income limitations, Roth IRA conversions are now open to all taxpayers, including high-income taxpayers that stand to gain the most from such transactions. The potential tax benefit here is too big to ignore!







It is important to determine if you will benefit from a 2010 Roth conversion and take action now to plan and implement the most efficient and low-cost conversion possible. Taxpayers will owe income tax on pretax money moved from a traditional IRA or company plan to a Roth IRA, but may be able to spread the burden between 2011 and 2012 or pay all the tax in 2010. Still, the question is where will they get the money to pay the tax?

One option would be to pay the tax from the traditional IRA; however this is generally not a good idea since not all of the funds are working for you in the Roth IRA. Additionally, if you are under age 59½, you would be subject to the 10% early withdrawal penalty on any of the funds not converted (i.e., the funds used to pay the tax). Even if a taxpayer is 59½ years old or older, any funds used to pay the tax (not converted) cannot be recharacterized if the taxpayer later decides to undo the 2010 Roth conversion. Generally, if the taxpayer does not have non-IRA funds to pay the tax on a Roth conversion, the conversion won’t be worth it. In some cases converting

smaller amounts may be a good move. Over time, smaller annual conversions will still add up to big sums of tax-free money.

The most economical option is to find non-IRA cash to pay the tax on the Roth IRA conversion. This may require a review of assets by dividing them into four categories:

- 1) Cash; includes already taxed funds such as money market funds and bank accounts  (but not other tax deferred or IRA accounts). Withdrawals from these funds will not generate any tax, so all of the funds can be used to pay the Roth conversion tax.
- 2) Capital Gains Assets; includes stocks, bonds, mutual funds and real estate. You may  have paper profits on some of these assets and paper losses on others. The tax consequences will depend on your facts for 2010.
- 3) Tax-deferred Assets; this category includes IRAs and 401(k)s. Taxpayers taking money  from these accounts will owe income tax at ordinary income tax rates and perhaps a penalty, depending on their age. Not a good choice, as it would be very expensive.
- 4) Tax-free Assets; this is where Roth IRAs belong because they can generate tax-free  distributions, after the five year and age 59 ½ requirements are met. Life insurance proceeds are also included in this asset category. Eventually a Roth IRA allows the taxpayer easier access to the money, if needed.

It is generally best for taxpayers to take money from the first two categories (cash and capital gains assets) to pay any tax on the Roth IRA conversions in order to maximize the amount to be moved into the most desirable fourth category (a potentially tax-free Roth IRA).

Many financial advisors recommend that taxpayers hold from three to six months worth of cash for emergencies. As long as taxpayers are not holding their emergency cash in a tax-deferred retirement account, funds can be drawn out at any time without owing tax (such as an unexpected medical or legal bill). The cash reserves may be a potential source of funds to pay the tax on a Roth IRA conversion, especially if the taxpayer is holding more cash than actually needed for emergencies.



Think of your investment assets as separated into three “when needed” categories (1. now, 2. later and 3. never). When looking for the cash to pay the tax on the Roth conversion, you should focus on the “never” category. The “never” cash can be leveraged into either life insurance or Roth IRAs, both of which have the ability to turn the taxable money into tax-free

money. It is prudent in this environment of rising taxes for taxpayers to consider moving cash to tax-free territory for the long term.



The best place, other than cash, to look for money to pay the Roth IRA conversion tax is in taxable investment accounts. Due to the recent turmoil in the financial markets, many taxpayers may have significant unrealized losses. A sale of those “unrealized loss” assets can provide a bank of net capital losses which can then be offset by selling some appreciated capital assets (that can be sheltered from tax by the net losses). These transactions could generate cash for paying taxes on a Roth conversion. Since Roth conversion income is ordinary income and not capital gains income, capital losses can only offset Roth conversion income up to \$3,000 per year.

If you have long-term assets with both unrealized gains and unrealized losses, the losses can be utilized to offset the gains upon the sale of these assets. The sales proceeds can then be used to pay the Roth IRA conversion taxes.



For the taxpayer with unrealized gains but no capital losses, realized or unrealized, it might be that selling in 2010 with the 15% maximum tax rate on long-term gains still apply is the most efficient. The rate on long-term gains is increasing to 20% in 2011 and for those at higher income levels, will be exposed to the 3.8% healthcare tax in 2013. The use of capital assets for Roth IRA conversion taxes means amounts left in taxable accounts will be reduced and that could in turn mean less taxable investment income in the future and less exposure to the 3.8% surtax on unearned income in 2013.



Taxpayers who are eligible for the NUA (net unrealized appreciation in retirement plans that are attributable to employee contributions) tax break may also want to act in 2010 in order to use the 15% tax rate on capital gains for a portion of their distribution. These taxpayers would include those who have a highly appreciated employer stock inside an employee retirement plan. Typically the taxpayer must have left the company or be older than 59 ½ to utilize the NUA tax break as part of a qualifying lump sum distribution from the company retirement plan. Taxpayers who used the tax break in prior years and have not sold the NUA stock can sell some or all of that stock and pay at the 15% tax rate on the NUA – a fairly

inexpensive vehicle for the Roth conversion tax that also builds a good strategy for creating tax-free savings for the future.

It is a complicated decision, but think of it as a gift to your family. Consult your wealth transfer professionals for your 2010 tax planning opportunities.

