Roth IRA's - Beyond the Basics

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I. Background

a) First created in 1998 (Taxpayer Relief Act of 1997, IRC Sec. 408A)

b) Funded with After-tax dollars

c) Favorable Tax Treatment for "Qualifying Distributions"

d) No RMD's as Traditional IRA's

e) Qualifying Distributions

(1) 5 year "bake" period (ordering of distributions)

(a) Contributions - Jan 1st of taxable year in which first contribution made

(b) Conversions – Jan 1st of year of conversion

(2) After age 59 ½ (ex death, disability or 1st time home purchase)

f) Nonqualified Distributions

(1) Earnings taxed and may be subject to 10% premature distribution penalty

g) Qualified distributions do not affect AGI or tax on social security benefits

II. Funding a Roth IRA

a) Contributions:

(1) 2010 Limits $5,000 + $1,000 catch up if over age 50

(2) No age requirement

2010 IRA Contribution and Deduction Limits - Effect of Modified AGI on Roth IRA Contributions

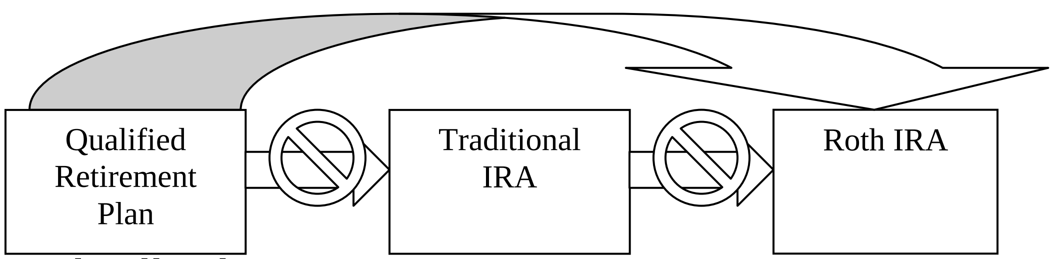
If You Have Taxable Compensation and Your Filing Status Is...	And Your Modified AGI Is...	Then...
married filing jointly or **qualifying widow(er)**	Less than $167,000	you can contribute up to the limit.
	at least $167,000	the amount you can

	but less than $177,000	contribute is reduced.
	$177,000 or more	you cannot contribute to a Roth IRA.
married filing separately and you lived with your spouse at any time during the year	zero (-0-)	you can contribute up to the limit.
	more than zero (-0-) but less than $10,000	the amount you can contribute is reduced.
	$10,000 or more	you cannot contribute to a Roth IRA.
single, **head of household**, or **married filing separately** and you did not live with your spouse at any time during the year	less than $105,000	you can contribute up to the limit.
	at least $105,000 but less than $120,000	the amount you can contribute is reduced.
	$120,000 or more	you cannot contribute to a Roth IRA.

http://www.irs.gov/retirement/participant/article/0,,id=188238,00.html

b) Conversion

c) Rollovers



III. Distributions

a) All Roth IRA's must be aggregated

b) Ordering Rules for Distributions from Roth IRA's

First	Annual Contributions	
Second	Conversions and Retirement Plan Rollovers (excluding rollover of designated Roth Accounts), subject to FIFO	a) Amounts taxed at conversion; then b) Non taxable portion at conversion
Third	Earnings	

Example of Ordering Rules:

Converted Traditional IRA of $35,000 to Roth IRA #1 in 2005, consists of
- $25,000 in pre-tax contributions
- $10,000 in after-tax contributions

Contribution of $5,000 to Roth IRA #2 in 2009
75% of account distributed in 2009 (total account value of $40,000 or $30,000 distribution)

	Amount	Source	Taxes	Penalty
1	$5,000	Contribution	No Tax – contribution made with after tax dollars	No Penalty even though 5-yr bake period not expired
2	$25,000	Pre-tax Conversion assets	No Tax – Taxes paid at time of conversion	Penalty since within 5 years of conversion
3	$0	Non-deductible Conversion Assets	No Tax – After Tax dollars converted	No Penalty
4	$0	Earnings	Taxed	Penalty may apply, unless a qualified distribution or other exception applies

c) Accelerated Taxes on Distribution from 2010 Conversions

(1) Provision in TIPRA to discourage withdrawals on 2010 conversions prior to payment of taxes

	2011	**2012**
2010 Convert $200,000	Include $100,000 in income	Include $100,000 in income
Withdraw $50,000 in 2011	Include $150,000 in income	Include $50,000 in income

IV. Conversions

a) Tax Increase Prevention and Reconciliation Act of 2005 – Beginning in 2010 anyone can convert Traditional IRA to a Roth IRA. Previously:

(1) Modified AGI <$100,000; and

(2) Filing status = single or married filing jointly

b) Tax Consequences

(1) Taxes due on conversion dollars (except basis is converted tax free)

(2) 2010 conversions only - tax will be due in 2011 and 2012 tax year unless elect to be taxed 100% in 2010 – SUNSET PROVISIONS

Top 4 highest tax brackets for

1993 - 2000	2001	2002	2003 - 2010	2011?
28%	27.5%	27%	25%	28%
31%	30.5%	30%	28%	31%
36%	35.5%	35%	33%	36%
39.6%	39.1%	38.6%	35%	39.6%

(3) Conversions dollars included in income

(4) May affect taxation of Social Security benefits

(5) May put you in a higher tax bracket

(6) Tax calculated on a pro rata basis, aggregating all IRA accounts, for partial conversions.

Example:

Traditional IRA #1 = $150,000 (all pretax)
Traditional IRA #2 = $5,000 (all after-tax)

Tendency is to convert $5,000 Traditional IRA#2 to Roth IRA since all after tax dollars…this is not a tax-free conversion since all Traditional IRA's are aggregated.

Tax due on conversion of $5,000 will be calculated as follows:
$150,000/$155,000 = 97% of the conversion will be considered to be attributable to pre-tax dollars.
$5,000 x 97% = $4,850 is taxable income

c) Deductions….Deductions….Deductions in year taxes due

d) Best to use non-IRA sources to pay taxes to preserve the maximum available for tax free growth

e) 5 Year "bake" period for Conversions

(1) Begins in year of conversion

Simple Conversion Example:
Traditional IRA: $500,000, 7% growth rate
28% tax bracket at conversion
Taxable Account: $140,000 at time of conversion, 5.04% growth rate

	Traditional IRA		**Convert to Roth IRA & Pay Taxes with Separate Account**	
	Beginning Value	**Separate Account**	**Beginning Value**	**Separate Account**
Beginning Value	$500,000	$140,000	$500,000	$0
10 Years	$983,576	$228,915	$983,576	$0
15 Years	$1,379,516	$292,718	$1,379,516	$0
20 Years	$1,934,842	$374,302	$1,934,842	$0

25 Years	$2,713,716	$478,626	$2,713,716	$0
TOTAL	**$3,192,342**		**$2,713,716**	

Balance after 31% tax on full IRA withdrawal	$2,351,090	$2,713,716
Balance after 36% tax on full IRA withdrawal	$2,215,404	$2,713,716
Balance after 39.6% tax on full IRA withdrawal	$2,117,710	$2,713,716

V. Planning Considerations

a) When does it make Sense to Convert?

(1) Outside funds to pay taxes

(2) Future Tax Bracket in retirement years?

(3) No RMD's!

(4) Tax-free legacy to heirs, especially is beneficiaries are young (i.e., tax-free lifetime investing)

Example:
Traditional IRA holder age 70 has IRA valued at $100,000
Growth Rate 7%
Converts to Roth IRA before RMD's begin and names 40 year old daughter beneficiary
Dies at age 86, distributions to beneficiary begin
Total tax-free distributions be beneficiary $1,004,313.79

(5) Income from retirement accounts not needed to fund your lifestyle

(6) Significant charitable deduction carry forward or other credits/net operating losses which will reduce your taxable income in year of conversion

(7) Eligible to take a distribution from a qualified plan

(8) Direct conversions for participants and beneficiaries: Thanks PPA 2006!

(9) Net Unrealized Appreciation on employer stock in a qualified plan (loophole closed?)

(10) Real (or perceived) undervalued assets at time of conversion

b) When Does is Make Sense to Recharacterize - take a "Mulligan"?

(1) Tax bracket changes

(2) Made a Roth contribution in error

(3) Market losses after conversion

(4) Keep in mind the following when you take your Mulligan

(a) Generally, cannot do a partial recharacterization cherry picking those assets in which performed the worse

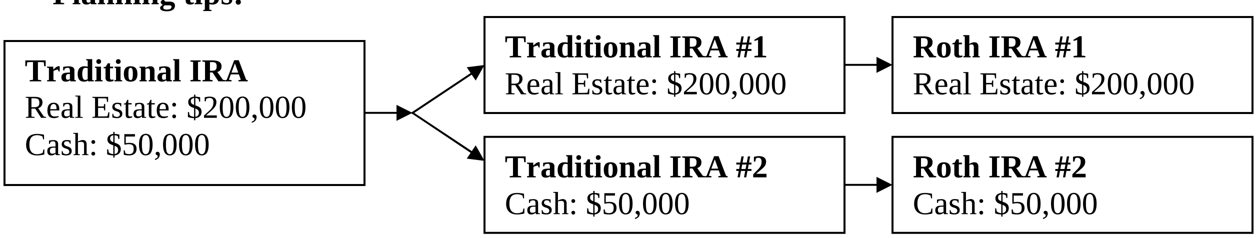
(b) Earnings/Losses must be prorated among the entire account to determine how much can be recharacterized (see worksheet attached)

(c) Consider employing multiple IRA's

Example:

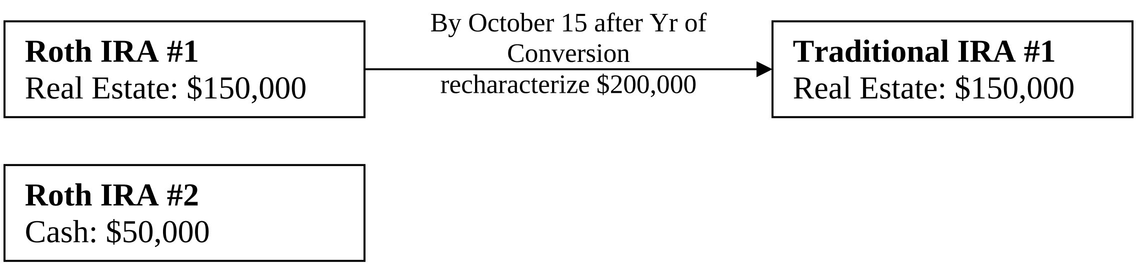
Traditional IRA converted to Roth IRA - value $250,000
Real Estate $200,000
Cash $50,000
Roth IRA continued to decline as real estate prices dropped further – value $200,000
Real Estate $150,000
Cash $50,000
Tendency is to take your mulligan on just the real estate and keep the cash in Roth IRA – OK, but recharacterization will be valued at $160,000 not $200,000 (loss is prorated among all assets)

Planning tips:



Tax Due on Two Traditional IRA Conversions totaling $250,000

(5) "Mulligan" must be completed by tax return deadline, with extension (Oct 15th for filers by April 15th) – Full or partial



(6) OOPS…your "Mulligan" was worse than your first shot…Reconvert back to Roth IRA on Jan 1st after year of original conversion or 30 days after "Mulligan," whichever later

VI. Future of the Roth IRA?