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WEALTH STRATEGIES

The Wealth Strategies team coordinates the delivery of wealth advisory information, strategies, and planning techniques for Silver Bridge Advisors. Working directly with clients and client advisors, the team develops customized solutions that integrate the estate, financial, and investment planning needs of our clients.

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Taxpayers: The Wait is Over! 2010 Brings New Opportunities For Roth IRA Conversions

January 12, 2010

The year 2010 will be one of the most exciting years for the Roth IRA account since its creation in 1997. On May 17, 2006, President Bush signed the **Tax Increase Prevention and Reconciliation Act of 2005** into law, which included a provision dealing with conversions of traditional IRAs to Roth IRAs. Starting in 2010, the existing $100,000 adjusted gross income (AGI) test for converting a traditional IRA to a Roth IRA will no longer apply.

Many of the basic rules and contribution limits have been sustained over the years, but the 2010 Roth IRA conversion is causing most of the hype. If you already have a Roth IRA, you are probably aware of its biggest benefit: the earnings grow tax free, provided you meet certain conditions. If you do not have a Roth IRA, you may want to consider one—and it may be easier for you to do just that in 2010.

Before we get into the reasons why 2010 may be your year to open or convert to a Roth IRA, let's look at some differences between traditional IRAs and Roth IRAs. If you own a traditional IRA, your contributions may be tax deductible, depending on your income level. Whether you can make deductible contributions or not, your earnings grow on a tax-deferred basis, unlike a regular investment account on which you pay income and capital gains taxes every year. Roth IRA contributions, on the other hand, are not tax deductible, but your earnings grow tax free, as long as you have held your account at least five years and you do not start taking withdrawals until you are at least age 59½.

Furthermore, unlike a traditional IRA, a Roth IRA does not require you to take mandatory distributions when you reach age 70½. Consequently, you will have more flexibility and freedom when it comes to making withdrawals.

If you have a traditional IRA, converting to a Roth IRA may seem like a good idea because tax free sounds better than tax deferred—and, all things being equal, tax free would indeed be better. However, it is not quite that simple. If you convert your traditional IRA to a Roth IRA, you will have to pay taxes on those traditional IRA earnings and contributions that had previously not been taxed. A conversion is usually reported as income for the tax year the conversion takes place. However, in 2010 only, your conversion amount will be split and reported as income for tax years 2011 and 2012 unless you elect to report the entire conversion amount on your 2010 tax return. You may find that spreading the tax over two years can make the conversion more affordable.

Expecting a vast majority to take advantage of these changes, the IRS has set up a special provision on how the tax will be paid. The IRS has granted individuals the option to claim 50% of the conversion amount as income in 2011 and the remaining 50% in 2012. Keep in

mind that this is only for conversions in 2010. After 2010, the taxes will all be paid in full the following year.

If you elect to pay the tax over the two-year period, keep in mind that the tax rate is determined for each of those two years. For example, in 2011 you will pay the tax based on your tax bracket for that year. Under current law, those rates are expected to increase to pre-2001 levels. If your income were to somehow skyrocket in 2012, then you will be paying more in taxes that year for the conversion.

If you do convert, we recommend that you use money held outside your IRA to pay the taxes. If you simply take money from your IRA, the value of your account will be lowered—and, if you are under age 59½, you may have to pay an additional 10% penalty on the amount you withdraw to pay the taxes.

Rolling Over a 401k

On August 17, 2006, President Bush signed into law the **Pension Protection Act of 2006**. This law made permanent increased contribution limits to IRAs (including Roth IRAs) that would otherwise have expired after 2010. It also made permanent the Roth 401k plan, which would otherwise not have been available after 2010.

Prior to 2010, it was difficult to convert a traditional 401k plan into a Roth IRA. First, you had to set up a traditional IRA and then roll the 401k into a traditional IRA. Next, you would have to open a Roth IRA account and complete the conversion paperwork. Once the conversion was complete, you would then close the Traditional IRA since it was no longer needed.

The rules have now changed. In 2010, you will be able to rollover and convert your 401k into a Roth IRA in one step, thereby bypassing the unnecessary middle step. In a direct rollover, there will still be taxes due on the conversion, similar to as if you had converted a traditional IRA to a Roth IRA. In addition, all traditional rollover rules apply to rollovers to a Roth, and you cannot rollover your current 401k plan until eligible (i.e., retirement, transfer to new employer/plan, death, etc.).

The Benefits of Converting Early

If you plan on converting your traditional IRAs and 401ks into Roth IRAs, we recommend you convert sooner rather than later for a few reasons: first, the market is still in a recovery phase and you could benefit from converting when your account balances are lower and pay less income tax.

Second, if that strategy backfires, you have the option to do a Roth IRA Recharacterization, better known as the conversion "take back." A recharacterization allows you to reverse the conversion completely. This could be the case if the market were to tank again or if you had an unexpected increase in income which would make your tax liability greater. You have until October 15th of the calendar year after the year you converted to recharacterize. For 2010, that would be October 15, 2011. This provides maximum flexibility and a built-in insurance policy if the strategy is not successful.

Third, under current law, the prevailing low tax rates are scheduled to expire at the end of 2010, and the default would be a return to pre-2001 levels, with rates as high as 39.6%. We believe that Congress and the President will likely pass new tax legislation in 2010, but if anything, we do not expect rates to be lowered from current levels. In light of the strong possibility of higher tax rates in 2011 and beyond, we recommend taking advantage of today's lower tax rates and paying greater than 50% of the tax liability due (if not the entire amount) for the taxable year 2010, and the

balance in the taxable year 2011. Again, if the strategy backfires you can elect the “take back” as described above.

The Advantages of Roth IRAs

Traditionally, a Roth IRA is used for saving for retirement, but many people do not know that there is a provision that allows you to withdraw from your Roth IRA to pay for “qualified higher education” expenses while avoiding the 10% early withdraw penalty. This pertains to the earnings; you can withdraw your contributions at any time. Individuals who are behind in saving for retirement may appreciate this strategy. Although the 529 college savings plan is often a better solution, the Roth IRA can provide similar savings while providing flexibility to use the funds for retirement or college.

Investors in alternative asset classes, specifically hedge funds, may also appreciate the tax-free planning the Roth IRA can offer, due to the large amount of taxable income generated by these types of investments. While the original “rollover” assets may not be hedge funds, you could strategically place “higher tax” hedge fund investments from your investment plan into your Roth IRA, thereby increasing the tax efficiency of your overall portfolio.

While a Roth IRA can be an excellent tool to help you save for your retirement, it can be one of the most powerful estate planning vehicles available, especially when you coordinate the Roth IRA with your overall planning documents. Due to its ability to shelter all future growth from income tax, as well as limited Required Minimum Distributions requirements, beneficiaries are much better off to receive tax free investments over traditional taxable investments.

To determine whether or not a Roth IRA meets your individual retirement and estate planning goals, please contact your Silver Bridge advisor, who can provide both a quantitative and qualitative analysis along with specific recommendations for your situation.■

This white paper is for informational and educational purposes only. Please consult with your tax advisor for more information and to determine the appropriate tax strategy to address your specific situation.

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