

## **A Primer on Roth IRA Conversion**

A Roth IRA conversion occurs when you distribute assets from a traditional IRA or an employer retirement plan and transfer/roll them directly into a Roth IRA. Through the conversion, the assets become after-tax assets that create tax-free retirement income for you and for your beneficiaries. However, the amount converted (excluding non-deductible contributions) becomes taxable income. Since it's generally better to defer taxation, why would someone opt to pay these taxes now? The answer is that withdrawals from a Roth IRA are NOT subject to federal income tax (provided it has been funded for five or more years and you are age 59½ or older, or you meet another exception). Also, unlike a traditional IRA, a Roth IRA does not require taking minimum distributions at age 70½. This allows Roth IRA assets to potentially keep compounding tax-free and then be passed to your beneficiaries income-tax-free. Basically, you pay the taxes now, before the assets grow, so you don't have to pay on the higher value later.

This may sound great but it doesn't make sense for everyone! Whether it's beneficial for you personally depends on a number of factors that will take some analysis. As a basic rule of thumb, the longer the time period between the conversion and withdrawal of assets, the more advantageous the conversion. In situations where a Roth IRA is being used as an estate planning tool, the extended time horizon makes the Roth IRA conversion and subsequent tax-free earnings that much more attractive.

You should also be aware that conversion is not an "all-or-nothing" proposition. Individuals may convert a portion or all of their traditional IRAs or other eligible retirement plans in a given year so you have the ability to put the conversion income in a tax year of your choosing. Recall that the ability to convert for high-income earners (over \$100,000 AGI) began in 2010, so anytime thereafter the decision is how much to convert, if anything, each year. Partial conversions are subject to the IRS's pro rata rules, which prevent investors from isolating and selecting only after-tax assets in order to avoid any conversion tax liability.

The best conversion candidates are a) high net worth individuals that have IRA assets they probably won't ever need to use themselves, b) pre-retirees at least 8+ years from retirement who have enough non-qualified money to pay the taxes, and c) younger people who have the long time horizon that allows investment compounding to overtake the negative effect of "pre-paying" the taxes on their IRA.

Remember, whatever amount you convert adds to your income and potentially increases your tax bracket. Medical, charitable and other income tax deductions may offset the income created by the conversion. If you convert in 2010, however, you can choose to spread

the tax liability over two years (2011 and 2012). All conversions made after 2010 will be subject to taxation in the year of conversion. NOTE: Current ordinary income tax rates are subject to sunset at the end of 2010. Therefore, individuals could find themselves in a higher tax bracket in 2011 and 2012 than they might be in 2010. This, and many other factors, are why you should speak with an advisor prior to taking any action.

(Article by Doug Haynes, Wealth Management Advisor, Merrill Lynch)

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