

# Conversion to Tax-Free Roth IRA: Yes, No but Never Maybe



**Taxes**

*The Guide to Roth IRA Conversion*

*by Dr. Shelby Smith*

# Table of Contents

Overview.....	1
Can You Roth?.....	3
The Roth IRA “Mulligan” .....	4
The Main Reason You Want to Roth.....	5
Distributions and <i>The Five-Year Rule</i> .....	6
Estate Planning.....	6
The Silver Lining to Market Losses.....	7
Which Way are Taxes Headed?.....	8
Converting Retirement Money at Ex-Employers .....	10
The Time May be Ripe Now .....	12
You Can’t Roth if You Can’t Roll.....	14
Paying the Taxes on a Roth Conversion.....	16
Medicare Part B .....	17
Best Source for Tax Money .....	18
Creating a Tax-Free Defined Benefits Plan .....	18
What About Taxes on Social Security Benefits?.....	22
Required Minimum Distributions.....	24
More Reasons for the Roth Conversion.....	26
Summary .....	27
Case Study .....	29

## About the Author...

Shelby Smith has over three decades of hands-on experience working in financial and retirement services. Smith earned a Ph.D. in Economics from Iowa State University of Science and Technology in 1973 following Bachelors' and Masters' degrees in Economics from the University of Wyoming. During his professional careers Smith has been a college professor of finance, insurance and real estate; Chief Economist for a Federal Home Loan Bank; Chief Financial Officer of a large financial institution; Chairman & CEO of a large mortgage banking company; founder of a financial services company that specialized in serving banks; and consultant to insurance and brokerage firms. Smith is currently the President of BHC Marketing, Ltd. which is involved in insurance marketing nationwide, Internet Commerce and Sales Training Development. Smith also serves as the Executive Director of TheRetirementPros.com, an Internet-based public service organization providing retirement information to the general public.

Smith has written extensively in the financial services trade journals as well as speaking frequently to industry groups. He has held several NASD [now known as FINRA] and insurance licenses and routinely advises and coaches financial planners. Smith is a regular contributor of articles and seminar videos to consumer web sites and writes monthly Newsletters for both the retirement-minded and their financial advisors. Smith advocates a common sense approach to financial planning for retirement and encourages retirees to stay within their risk tolerances by learning as much as they can on their own before working with a financial planner. Smith resides in Houston, Texas.

Other retirement related reports by Shelby Smith:

*The Guide to Social Security: Higher Lifetime Benefits & Lower Lifetime Taxes*

*Is Your Annuity Good or Bad?*

*Understanding Your Mutual Fund*

*Tapping Into Your 401(k) Money Before Retirement*

*When Bank CDs Make Sense*

*Blueprint for 401(k) Recovery*

# The Guide to Roth IRA Conversion

## Overview

The ability to convert your retirement money to the Roth IRA is a generous gift to you from the federal government. The reasons for converting some or all of your retirement money to a Roth IRA are numerous. Among the most important reasons are:

- (a) once converted, there are no future income taxes on the amount converted or the earnings from the money;
- (b) there is no required minimum distribution [“RMD”] as is required for other non-Roth retirement accounts;
- (c) no RMD means you are not required to use the money during your lifetime;
- (d) a Roth IRA can be bequeathed tax-free to your spouse without the requirement that the money be withdrawn during his or her lifetime;
- (e) Roth IRA money can be left to a non-spouse beneficiary tax-free with all withdrawals, principal and earnings being free of income taxes forever;
- (f) the non-spouse beneficiary of a Roth IRA can “stretch” the tax-free payments over their expected lifetime;
- (g) income realized from a Roth IRA is not only tax-free but is not currently included in the income calculation that determines taxes on Social Security benefits or used to determine the price you will pay for Medicare Part B;
- (h) by reducing taxable income, you will obtain higher tax deductibility for itemized deductions, especially medical expenses;

Virtually any qualified retirement account can be converted to a Roth IRA, including 401(k), 403(b), 457, Thrift Savings Plan, IRA, SIMPLE IRA and all other tax-deferred retirement accounts covered by the Employees Retirement Income Security Act (“ERISA”) of 1974. There is no income, age or dollar volume catches: everyone with tax-deferred retirement money can convert all or some of it to a tax-free Roth IRA. While the process is simple, there are several details that need professional attention and it is generally best to convert to a tax-free Roth IRA with the help of a financial advisor. The Roth IRA law recently changed and the income limit for conversion was eliminated: *before 2010 you could not convert to a Roth IRA if your*

*adjusted annual gross income exceeded \$100,000 but this limit was removed at the beginning of 2010.* Many affluent among the retirement-minded are now convert to a tax-free Roth IRA as they think future tax rates will rise. These conversions are especially attractive when the stock market nosedives as was the case in August 2011.

If your retirement account has lost value in the recent market decline and turbulence, you have an excellent opportunity to save taxes. Every owner of a retirement account on which taxes have not been paid has a silent partner: Uncle Sam. Isn't it better to buy out your partner [pay the deferred taxes] at a time when market losses have lowered the account value? This represents a massive "tax sale" by the government! If you wait until the market has recovered – if it recovers – you'll pay more in taxes; however, if you convert to a Roth now, all future market gains will be tax-free. As you'll see later, you can even change your mind and undo the Roth conversion if the market moves opposite your expectation, or you simply change your mind about the Roth conversion. Also, if you agree with the majority that future income tax rates will rise, it is best to pay the taxes now before the rates rise. Since taxes are a major drain on your retirement money, converting to a Roth IRA to avoid higher taxes later makes a great deal of sense for many retirees and working Americans of all ages. Also, by paying the taxes associated with the Roth conversion from other money, you can actually boost the amount of money you've sheltered tax-free for your retirement. Some smart retirees use the Roth IRA conversion to prepay estate taxes or as part of their estate planning.

There are some minor drawbacks in converting to a Roth IRA, including the taxes that must be paid with the tax return filed for the year of the conversion. Also, there is a five-year restriction on withdrawing the money penalty free if you are under age 59½. Of course, converting to a Roth IRA does not make sense for everyone, but if you're in a high-income bracket, do not plan to use all your retirement money near-term or will be passing retirement money to a beneficiary, converting to a Roth IRA is an option that deserves consideration. It is always best to obtain professional advice before making major investment or retirement decisions, and converting to a Roth IRA is no exception. In what follows, we will discuss the merits, and drawbacks, of converting retirement money to a Roth IRA.

## **Can You Roth?**

There are currently no limitations or restrictions on converting your tax-deferred retirement accounts to a Roth IRA; however, this does not mean that everyone can benefit by doing a Roth conversion of their traditional qualified retirement money. Nonetheless, everyone with retirement money on which they have not yet paid the federal income taxes should investigate the feasibility of the Roth IRA. If converting to a tax-free Roth IRA is suitable for you and your family, it could mean more money for retirement, a larger legacy for your loved ones and/or the wiser use of other assets you have earmarked for retirement use.

There is no age or dollar amount limit on the amount of retirement money you can convert to a Roth IRA. For example, let's look at a hypothetical married couple both aged 80 that have traditional IRAs but have no immediate need for the money they are now being forced to annually withdraw from their accounts as Required Minimum Distributions ["RMD"]. They could convert their traditional IRAs to Roth IRAs at any time if such is suitable. The taxes must be paid when taxes are filed for the year of conversion. Once the account is converted, there are no further income taxes on the amount converted or the earnings thereon and there are no requirements to withdraw money from the Roth during their lifetime.

By converting to a Roth IRA, our hypothetical couple might enjoy a substantial tax savings on their Social Security benefits and pay less for Medicare Part B. The amount of tax paid on SS benefits is determined by provisional income [also called combined income]. This measure of income is defined as the sum of adjusted gross income [from Line 37 of IRS Form 1040], interest from tax-exempt municipal bonds, one-half of Social Security benefits plus several other minor items. Provisional income does not include withdrawals from a Roth IRA; thus, converting non-Roth retirement money to Roth IRAs can lessen the tax-bite on SS benefits.

Medicare Part B payments are determined by total annual taxable income, and if converting to a Roth IRA lowers taxable income, Medicare Part B coverage can be reduced. These will be discussed in greater detail below.

## **The Roth IRA “Mulligan”**

In golf we call a mulligan a “do over”. If you shank the ball off the tee and are golfing with friends and the wager is small, they’ll likely give you a “mulligan”. You’ll get another try without adding a stroke to your score. If you convert to a Roth IRA and later decide it was a mistake, you can undo and return everything to its previous status. The Roth “mulligan” is called “recharacterization” and is available to you until you file your final tax return, including extensions, for the year of conversion. For example, if you convert in 2011, you have until October 15, 2012 to change your mind, go back to your former position and avoid paying taxes on the conversion. There are some limitations on using the mulligan, e.g., if you convert 401(k) money to a Roth IRA and later use your mulligan, you may have to return to a traditional IRA rather than the 401(k). This could present complications if you are near or at age 70½ and still working. If you have extenuating circumstances, you’ll want to discuss the options with your financial advisor, and this is best done before converting to a Roth IRA.

If you do over the Roth IRA [use the mulligan] in the same year of the conversion, you cannot later convert the same account again to a Roth during the same calendar year, because only one Roth conversion per account per year is allowed. You could, however, re-convert the same money to a Roth the following year. If you use your mulligan in the year after the year of conversion, you must wait thirty days before you can again convert the same money to a Roth IRA. If you have multiple retirement accounts, it is generally best to convert each to a separate Roth IRA account rather than aggregate them in one Roth IRA account. This multiple account approach is a great way to segregate different investment options and existing separate retirement accounts into unique Roth IRAs that can later be individually recharacterized if you have a change of mind.

Let’s say you convert \$100,000 of your traditional IRA money to a Roth IRA in 2011. If you have second thoughts later in 2011, you can recharacterize back to the Traditional IRA; however, you cannot again convert the same money to a Roth IRA until 2012. If, on the other hand, you change your mind about the 2012 conversion in 2012, you must wait at least 30 days before you can again convert the same money to a Roth IRA. The main reasons you might want to use your Roth mulligan would be if the account value slipped further after the conversion, or your income tax situation changes substantially and made the conversion less

attractive. Let's say you converted \$100,000 of your retirement account now in mutual funds to a Roth IRA that you also continued to invest in mutual funds. If subsequently the value of your Roth IRA mutual funds decreased in value, you'd want to recharacterize to avoid paying taxes on the higher amount originally converted. You could then later re-convert the same money to a Roth when you felt the value had reached a low point.

By using the mulligan and converting later you will pay fewer taxes since the amount converted to the Roth will be lower. The Roth IRA recharacterization can always work in your favor and is a major advantage of converting to a Roth IRA. Accordingly, if you think you might want to convert to a Roth IRA, you should do so knowing that you can undo it anytime before you file your final tax return for the year in which the conversion occurred. If you do the conversion early in the year, you have up to 21½ months to change your mind and return to your original position. The "free look" could prove to be very valuable.

### **The Main Reason You Want to Roth?**

There are many advantages to using a Roth IRA for some or all of your retirement money, but the overriding reason is that current tax deferred money becomes permanently tax-free after the conversion to a Roth IRA. Tax deferred simply means you, and in many cases your employer, made contributions to your retirement account in un-taxed dollars which will be fully taxed when withdrawn. You'll want to carefully consider your current and future tax circumstances prior to converting to a Roth. For best results, it is recommended that you work with your financial advisor and tax-preparer.

The Roth IRA can be a powerful estate planning tool if you plan to leave money to others. Also, the longer the Roth IRA has to compound tax-free, the larger the potential benefits. Accordingly, if you plan to leave a financial legacy for your heirs, have earmarked funds to be used for emergency only or plan to use the money late in retirement, you'll want to determine with your financial advisor if the Roth IRA is a good option. If you are not yet retired, the money converted to a Roth IRA should be earmarked for retirement and not used before. Of course, if you convert to a Roth and later need the money, it can be withdrawn at your option and used for any purpose.

## **Distributions and *The Five-Year Rule***

The five-year rule has a different meaning for those on either side of age 59½. If you are over age 59½, the only time you will pay income taxes on withdrawals from your Roth is when you have withdrawn the entire amount converted and then withdraw earnings. In this instance only, the earnings are subjected to income taxes. Thus, if you convert your money to a Roth IRA, plan on waiting until the earnings have “seasoned” for five years before withdrawing them. The five years begin running on January 1<sup>st</sup> of the year in which the conversions occurred. Once the five years have passed, all earnings are available tax free.

If you are less than age 59½ and make a withdrawal before five years have passed since conversion, you will pay a penalty tax of 10% on all withdrawals plus ordinary income taxes on any earnings withdrawn. This means that all non-emergency withdrawals from a Roth IRA should be postponed until you are at least age 59½, and the withdrawals of earnings should also be postponed for five years following conversion. You can manage this drawback by doing your Roth conversion in stages or doing partial conversions.

Withdrawals from a Roth conversion are taxed on a first-in, first-out basis under the five-year rule. The five-year rule can be complicated in cases where you have multiple Roth IRA accounts, have made contributions to a Roth 401(k) or 403(b) and in case of death of the owner; thus, before making a withdrawal from a Roth IRA before five years have passed, you should obtain professional advice.

## **Estate Planning**

The tax-free growth of Roth IRAs allows you to do very economical and simple estate planning. Let's say you'd like to leave each of your five grandchildren a tax-free legacy. You could convert \$50,000 of your traditional IRA account to a Roth IRA and pay the taxes at your ordinary income tax rate. The \$50,000 converted into the Roth IRA will list the five grandchildren as equal beneficiaries, and at your death they will share the money equally. Meanwhile, the money is available to you if needed; but if not, it will grow tax-free until your death.

Non-spouse beneficiaries [in this case your grandchildren] must withdraw inherited Roth IRA money in at least substantially equal annual installments over their expected remaining life. Of course they have the option to withdraw it sooner, including lump-sum, unless you have prohibited such as a condition of your gift. This means you can engineer a legacy that stretches tax-free payments over decades. If a non-spouse beneficiary started the payment but died prematurely, *their beneficiary* would be required to take the remaining payments over the normal life expectancy of the original beneficiary. This is simple, easy, tax-free estate planning and is available only with a Roth IRA. If you need help with other aspects of your estate planning, you should seek professional advice from a qualified attorney and financial advisor.

In essence, converting your retirement money to a Roth IRA and paying the taxes with other after-tax money, reduces the size of your estate because you have “prepaid” taxes. If you have life insurance that will bequeath to your heirs a tax-free legacy and now wish to increase it but are no longer insurable, the Roth legacy could make a great deal of sense. The beauty of the Roth IRA is that you never lose control, because you can use it at any time should an emergency arise, but otherwise it grows tax-free and can be passed forward tax-free.

### **The Silver Lining to Market Losses**

Let's say you retired in October 2007 and transferred your company's retirement plan money to a self-directed traditional IRA invested in mutual funds. Since the market [as measured by the DJIA index] was at a peak at this time, you suffered substantial losses (up to 50% were common) over the following 18 months. No doubt the market losses were disturbing, but being an optimist, you think you'll recover from the setback in the next few years.

Let's say you started with \$500,000 in your retirement portfolio but it declined in worth to \$300,000. If you are in the 30% tax bracket, you only own \$210,000 of the \$300,000 account, because your Uncle Sam is a minority partner and owns \$90,000, or 30%, of your retirement money. But, if the market rallies as you hope and you recover your \$200,000 loss, your tax bill would become \$150,000 [leaving you only \$350,000] if income tax rates did not rise in the meantime. By converting to a Roth IRA and paying the taxes, you could have saved \$60,000 in taxes since the gains are tax-free and now you'd have \$410,000 free of all income taxes. Thus, when account values are depressed, you have the appealing opportunity to buy-

out your Uncle Sam partner cheaply and save substantial taxes on future gains. If the market continues downward after the conversion, you can always use your mulligan and go back to the traditional IRA and erase the tax liability. If you want to hedge your position further or make sure you stay in the same marginal tax bracket, you can convert only part of your retirement money to a Roth. There are other substantial advantages of moving your money from a qualified retirement account to a Roth IRA under your control. You'll want to discuss these with your financial advisor.

Let's look at a typical employer-sponsored retirement plan as an example. Your money in the plan, regardless of the investment selection you choose, is managed by an outside party, someone is paid to service the account and render advice [this rarely occurs], and a third-party administrator is hired to audit and administer the plan. All-end to you, the fees are commonly between 2% and 3% of the money you have invested in the plan. By moving the money to your control and investing in the same options, you pare the fees to a fraction of what you are paying inside the employer-sponsored plan. Most employees mistakenly believe the employer pays these fees. Also, the investment choices inside the plan are generally limited to mutual funds and the stock of the employer. By moving the money to your control, you have an almost unlimited menu of choices from which to choose, including bank CDs, real estate, individual stocks and bonds, variable annuities, fixed annuities, mutual funds from exchange traded to no-load to fully loaded, commodities and more. As we'll see later, there is a way for you to move some or all your qualified retirement money to a Roth IRA regardless of age, without paying taxes, while still working and without missing the next matching contribution/profit sharing from your employer.

## **Which Way Are Taxes Headed?**

If you've been watching the explosion of the federal budget deficit, you're probably worried about how it will be eventually reduced. Speaking as an economist, be assured there are only four options:

- (1) raise taxes
- (2) cut spending
- (3) do a combination of 1 and 2
- (4) default

Items 2 and 4 do not appear to have much support in Washington as we say in the mid-2011 debt ceiling crisis. This leaves only 1 and 3 as most likely. If you're a realist, you know that the only option Washington D.C. will consider short term is raising taxes, even though the increases will be touted as not taxes. The deficit could continue to balloon indefinitely, but at some point in the not-too-distant future, the consequences will be intolerable – leaving only higher taxes as the solution.

If the growing deficit is not addressed, the use of American dollars as international currency and reserves will fade. A weakened U.S. dollar will curb the government's ability to attract foreign creditors to finance the debt. Two drastic consequences are likely to result: higher interest rates and inflation. While the former is less destabilizing, and could even be beneficial for retirees, inflation will have a profound negative impact on anyone living on a fixed income. Retirees and pensioners are the most likely victims. The longer the budget deficit is allowed to grow unchecked, the higher the probability of undesirable consequences; thus, as soon as the economy can tolerate the strain of higher taxes, the consensus opinion is that new taxes will be imposed. Granted, the new taxes may be oblique and hidden behind a crafty disguise but everyone is likely to pay higher taxes, not just the wealthy. Raising taxes on corporations is frequently mentioned, but this has a hollow ring because businesses do not pay taxes: they pass them forward to consumers in the form of higher prices and/or lower salaries. The current rate of deficit spending is rapidly approaching a point when serious economic, financial and social consequences are concerns.

When you do your future income tax assessment, you'll have to consider the taxes that will be levied not only on you but also on the income of your heirs and beneficiaries. There is consensus opinion that our current deficit overload will most definitely be a burden on future generations – your children and grandchildren. These are the same heirs that will inherit your Roth IRA money if not used in your lifetime. Since the Roth IRA will pass to them tax-free and all withdrawals from their inherited Roth will be income tax-free, when the deficit is eventually addressed by raising taxes, the tax-free Roth will prove very valuable. What a great way to atone for the fiscal sins of your generation: leave your loved ones a tax-free income to offset higher taxes on their other income spawned by the huge deficits you helped create. Accordingly, whether you think the deficit will be addressed near-term or long-term, the tax-

free feature of the Roth IRA could result in substantial benefits to you, your spouse and beneficiaries.

Of course, if you believe the future tax rates for you or your heirs will be lower, the wisdom of converting retirement money to a Roth IRA is questionable. There is some possibility, albeit small, that the income tax could be replaced with a value-added or alternative form of taxation not connected to income. In the unlikely event this happens, Roth IRA withdrawals could possibly be subject to the new form of taxes, but probably only after a lengthy legal battle settled by the U.S. Supreme Court. Based on the prohibition of *ex-post facto* changes in laws provided for in the U.S. Constitution, the retroactive implementation of income taxes on tax-exempt Roth IRAs would encounter serious legal challenges. Of course, new laws could be passed to halt the tax-free provisions of new Roth IRA conversions in future years. Since income taxes are expected to rise, tax-free income from previously converted Roth IRAs represent a major loophole for tax paying Americans, especially the affluent. Accordingly, converting to a Roth IRA, if appropriate, makes a great deal of sense. This legal tax escape hatch could be closed at any time by a Congress that is desperate for new revenue.

## **Converting Retirement Money at Ex-Employers**

Let's say you have retirement money in an ex-employer's plan. Since you are an ex-employee, there is no longer employer matching contributions that make it attractive to keep your money at your ex-employer. Also, as an ex-employee you are not likely to have any influence on the investment options inside your ex-employer's plan and certainly will not participate in any profit-sharing contributions as an inactive participant. Therefore, there is seldom a reason to leave your retirement money at a past employer. Generally it is best to transfer your money tax-free to a new trustee with the investments under your control and management. Why permit an ex-employer to select your investment advisor when you can choose one that will render personal service and most likely do a better job for you at a lower cost? It is recommended you use a financial advisor to make sure the transfer is done properly.

Not only would you want to transfer your money to a self-directed retirement account when you leave an employer because of your disassociation, but also because you can avoid unnecessary fees and charges. These fees are generally both high and assessed directly to the

plan participants. Why not move your money from the plan sponsored by your past employer into a traditional or Roth IRA where you have an almost endless list of investments with low, or no, fees? The savings from lower fees alone will result in significantly better growth in a surprisingly short period of time. For example, let's say you have \$100,000 in your ex-employer's retirement plan, the annual fees are 2% and the yearly earnings are 6%. If you move the money under your direction and avoid fees while continuing to earn 6%, your money's growth will improve as shown in Table.1.

**TABLE.1**

	<b>401(k)</b>	<b>Self Directed IRA</b>
Fees	2.0%	0.0%
Return	6.0%	6.0%
Year 1	\$100,000	\$100,000
Year 5	\$121,665	\$133,823
Year 10	\$148,024	\$179,085
Year 15	\$180,094	\$239,656
Year 20	\$219,112	\$320,714

Perhaps you'd like to move your money into investment or savings places that are free of market risk, because you think the value will decrease if left in the market, or you simply cannot afford the risk. Bank CDs, fixed annuities and other safe money places are options for IRAs but generally not for 401(k)s. If your money is now in a retirement plan with limited investment options, converting to a traditional or Roth IRA to lower fees and gain access to a broader menu of tax-free options could be very attractive. Of course, you'll want to work with your financial advisor to make sure your selections are appropriate.

If you can lower the fees and raise the rate of return, this double dipping can really add zip to your retirement account. There is a considerable body of empirical evidence which documents that the performance of most money managers fail to match the market averages; thus, it is highly likely that selecting market index-linked investments with very low, or zero, fees will improve investment performance. Let's assume the self-directed IRA earns 8% rather than the previously assumed 6%. The results are in Table.2.

**TABLE.2**

---

	<b>401(k)</b>	<b>Self Directed IRA</b>
Fees	2.0%	0.0%
Return	6.0%	8.0%
Year 1	\$100,000	\$100,000
Year 5	\$121,665	\$146,933
Year 10	\$148,024	\$215,892
Year 15	\$180,094	\$317,217
Year 20	\$219,112	\$466,096

As you can see from Table.2 the change in fees and a marginal boost in earnings makes a great deal of difference in your retirement account balance. Least you think the number of years used in the above Table.2 do not apply to you, remind yourself that you'll be in retirement for many years and the use of some of your retirement money could match these time frames. Of course, if retirement money is bequeathed to heirs, the longer time horizon could lead to dramatic growth differences. The Case Study in the Appendix will show you the comparisons of taxable versus tax-free.

### **The Time May be Ripe Now**

The Great Recession, which started in late 2007 or early 2008, and dragged interest rates to the lowest level in a generation caused the incomes of many to nosedive. This was especially true of the self-employed, small business owners, employees of downsized companies and those working for hard-hit industries like automotive, banking and housing. Before the Roth IRA laws were changed in 2010, many of these individuals did not convert to a Roth IRA because their income was too high [income limits existed before 2010]. Also, many of these individuals had sizeable qualified retirement accounts, especially in 401(k) plans, which can now be moved because they are no longer employed or have changed employers. Also many of these individuals low enough income that moved them to considerable lower taxes temporarily or permanently. This temporary valley, hopefully, in taxable income could be an excellent time to convert qualified retirement money to a Roth IRA, because as the economy recovers and business improves, they will again move to higher tax brackets but have tax-free gains. Give the continued depressed economy and the extremely volatile stock market, opportunities for a Roth conversion are constantly being presented.

As an example, let's look at Marty Benefield. Marty is age 39 and married with two school age children. He is a petroleum engineer that made \$15,000 per month prior to being laid off at the beginning of 2011. He had \$100,000 in his employer's 401(k) when he was laid off. Once he left his ex-employer, he moved his 401(k) money via trustee-to-trustee transfer to his brokerage company as a self-directed IRA. He has not yet found suitable employment, and it appears he will report less than \$20,000 in total income for 2011. When Marty was working, he made enough money to place him in the 28% marginal tax bracket, and he is highly confident that once the economy recovers he'll again be able to find comparable employment. In the meantime, he is fortunate to have enough in regular savings to fund the modified lifestyle of his family for at least two years.

Marty and his financial advisor have determined that if he converts the \$100,000 IRA to a Roth IRA, he can use some of the savings he has to pay the associated taxes. If everything goes according to plan, this could be a good move longer term because he'll be paying taxes at a much lower rate. The \$100,000 he converts to a Roth IRA plus the roughly \$20,000 he made early in 2011 less itemized deductions will leave Marty with about \$65,000 in taxable income for 2011. Of course, this could change if he finds a new job soon and starts making money again. An annual income of \$65,000 [including the \$100,000 converted to the Roth IRA] places Marty and his family in the 15% tax bracket. This means his tax rate is roughly one-half what it has been in the past and what he hopes it will be in the future. Should taxes rise as Marty and his advisor think, the 15% they will pay now represents a super bargain for converting money to the tax-free status of the Roth IRA. Accordingly, Marty decides to convert his self-directed IRA to a Roth now and pay the taxes when he files his 2011 tax return in 2012. Should he find another job soon and his earning place him in a higher tax bracket, he can also review the decision and recharacterize to the traditional IRA to avoid the tax liability associated with the Roth conversion. He is a little worried that extended unemployment could force him to need some of the Roth IRA money for living expenses, but he thinks the 10% penalty he'd have to pay is a reasonable risk for the income taxes he'll potentially save during this low income period. Many previously high income earners who are now without work are in a similar situation and a total, or partial, Roth conversion makes sense.

## **You Can't Roth if You Can't Roll**

Let assume that after consultation with your financial advisor that you've decided converting some or all of your retirement money to a Roth IRA is a good decision for you and your family. Let's further assume you've worked for the same employer for many years and have faithfully contributed to the company's retirement plan and your employer has also made matching contributions. If you're typical, a large part of your retirement money is held in this plan. What's more, let's say you're in the red zone of retirement, i.e., age 55 or more. You experienced a set back in the dot.com bust in 2000-2002 and again suffered sizeable losses in the Great Recession of 2007-2009. While the market sometimes acts like it has recovered from the Great Recession valley, you're still nervous because there is not a lot of time until you retire and the current uncertain market outlook scares you. Accordingly, you and your financial advisor have decided that safe investments are in your best interest, and its time you change your investment choices. But before you convert to a Roth IRA, you decide to re-visit the investment selections in your employer's plan to make sure you're not missing something. Upon investigation you learned that your company plan only offers mutual funds and the stock of your employer as investment choices. Among the mutual funds you have the choice of several growth funds ranging from large cap to small cap, and from aggressive to conservative. You also can choose from several bond, or income, funds and balanced funds which contain both growth and income investments. There's even a lifetime fund option that purports to dial down your exposure to the market as you near retirement, but you've noticed that even at retirement roughly half of your retirement money would be invested in the market under this lifetime option.

After consultation with your financial advisor, you've concluded that you'll be exposed to market risks regardless of your selection. While the stock of the employer appears to be solid, it has fluctuated considerably in price over the past decade. There are no fixed rate options like bank CDs, Guaranteed Insurance Contracts ["GICs] or fixed annuities on the menu of your plan. Also, you do not have the option of converting to a Roth IRA unless you withdraw your money from the company-sponsored plan. After a careful review with your financial advisor, you have decided that your best interest is served by taking your money out of the company plan and converting it to a Roth IRA because such action would allow you to:

- (a) pay deferred taxes while your account value is low;
- (b) pay at today's lower tax rates as you expect rates to rise;
- (c) move your money to safer options under your control;
- (d) reduce the fees and charges which will boost your growth;
- (e) work with your financial advisor rather than the one your employer has chosen for their plan.

Your meeting with the retirement specialist in the Human Resources Department did not go well, because you learned that your money cannot be withdrawn until you retire unless you quit your job, die or become disabled. It seems your employer's plan stipulates that vested employer contributions and your own voluntary contributions cannot be withdrawn until you reach normal retirement age or you actually retire. Since you were born in 1950, your normal retirement age is 66, a full six years from now. You find it hard to believe that you can't even withdraw your own contributions from the plan, so you ask your financial advisor to consult with a retirement plan expert.

The expert provides eye-opening information. You learned that according to the Employee Retirement Income Security Act [ERISA] of 1974 [the law that governs qualified retirement plans including the one sponsored by your employer] vested employer contributions can be withdrawn at any age but employers have the right to stipulate older ages, including normal retirement age. You also learned that ERISA does not permit employees to withdraw their voluntary contributions made to their company's qualified employer plan until they reach age 59½ but the employer can stipulate an older age such as normal retirement age. Of course, you can move vested employer money and your contributions if you quit, die, become disabled or actually retire, but given your age and the current job market, quitting is not a good option and you do not have enough money to retire.

The retirement plan expert confirmed that your employer could add an in-service, non-hardship withdrawal provision to the plan without cost, hassle or delay. This provision permits employer vested contributions to be withdrawn at any age stipulated by the employer and your voluntary contributions withdrawn as early as age 59½. Your intention is to bring this to the attention of your employer and insist that they make the change so you can withdraw your money and convert to a Roth IRA. [See *"Tapping Into Your 401(k) Before Retirement"* by Shelby Smith, Ph.D. & Whet Smith, J.D. (2009)].

## Paying the Taxes on a Roth Conversion

When you convert your retirement money to a Roth IRA, you need to take special care not to boost your taxable income into a higher marginal income tax bracket. In 2011, the tax bracket breaks for a married couple filing jointly are as follows:

- 10%** on the income between \$0 and \$16,700
- 15%** between \$16,700 and \$67,900; *plus* \$1,670
- 25%** between \$67,900 and \$137,050; *plus* \$9,350
- 28%** between \$137,050 and \$208,850; *plus* \$26,637.50
- 33%** between \$208,850 and \$372,950; *plus* \$46,741.50
- 35%** on the income over \$372,950; *plus* \$100,894.50

Since you can convert all or some of your qualified retirement money into a Roth IRA annually, you can manage the amount you convert in order to remain in the lower marginal income tax bracket. Since income limit on Roth IRA conversion was \$100,000 prior to 2010 and this limit could be re-imposed at any time, partial or no conversion now risks losing the opportunity if the law changes. Thus, it might be wise to convert as much as suitable as soon as possible.

You and your financial advisor have determined that it makes sense for you to convert to a Roth IRA. Let's say you have \$150,000 in a traditional IRA and \$70,000 in taxable income. How much can you convert and stay in the lowest tax bracket? From the above schedule you see that the 25% tax bracket – which you are now in – continues until your taxable income reaches \$137,050. Accordingly, you can convert as much as \$67,050 to a Roth IRA without leaving the 25% bracket. If you convert more, the taxable income above \$137,050 will be taxed at 28%. For example, if you converted all \$150,000 you would pay 25% on the first \$67,050 followed by 28% on the next \$71,800 and 33% on the remaining \$11,150 of the amount you converted. You'll want to consider how the Roth conversion affects your taxable income and proceed accordingly by successively converting money annually until you reach the amount you wish to convert. The danger in successive conversion is that the tax laws can be changed at any time and you could be caught in a rising tax environment, or your future

annual income could exceed new limits imposed. Since the consensus opinion currently is that future taxes will rise, you'll want to watch the rising tax danger very carefully.

## Medicare Part B

Medicare is a medical entitlement plan that is available to virtually every American citizen aged 65 or older. The basic coverage [Part A] provides benefits for inpatient care in skilled nursing facilities, hospice and home health care, critical access hospitals and hospital care. Part A is free for most people. Part B covers outpatient care, doctor's services, physical or occupational therapists and additional home health care as well as paying for medically necessary services and supplies. Most people will have to pay a premium to receive Part B coverage. The premium is based on Modified Adjusted Gross Income [MAGI] that was discussed previously.

Below in Table.3 is the current premium schedule for Medicare Part B [Congress has not approved these levels beyond 2011].

**Table.3**

<b>Monthly Premium</b>	<b>Yearly Modified Adjusted Annual Income is</b>	
	<b>Single</b>	<b>Married Filing Jointly</b>
\$96.40	\$85,000 or less	\$170,000 or less
\$161.50	\$85,001 - \$107,000	\$170,001 - \$214,000
\$230.70	\$107,001 - \$160,000	\$214,001 - \$320,000
\$299.90	\$160,001 - \$214,000	\$320,001 - \$428,000
\$369.10	\$Above \$214,000	Above \$428,000

Since MAGI used to determine the premiums for Medicare Part B is the same as that used by the Social Security Administration to determine taxes on your Social Security, we know that Roth IRA withdrawals are excluded. Accordingly, by converting traditional IRA or other qualified retirement money to a Roth IRA, premiums on your Medicare Part B could be lower. For a married couple at the extreme, it is possible to save over \$6,500 annually in Medicare premiums. Since the MAGI threshold levels are not indexed to inflation, and it is highly likely that Medicare premiums will increase in the future, the Medicare costs savings of a Roth IRA

could grow over time. When these potential savings are added to the lower taxes on Social Security benefits, the cost effectiveness of the Roth IRA conversion becomes meaningful. This cost savings becomes a lifetime benefit unless Congress changes the rules.

## **Best Source for Tax Money**

It is generally best to pay the taxes from other money so that 100% of the converted money will be in the Roth growing tax-free and available to you, your spouse and your heirs free of income taxes. If you must take the money to pay the taxes from the amount you wish to convert to the Roth IRA, carefully analyze the results to make sure ample benefits will result. This does not mean that a Roth conversion should not be done unless the taxes are paid from outside sources: it simply means the benefits will not be as great. Also, if you must take the money from the qualified account to pay the taxes, be aware that you will be assessed a penalty tax if you are less than age 59½. As pointed out previously, withdrawals from a Roth before five years have elapsed should be done very cautiously to avoid penalty and ordinary income taxes.

The importance of paying the taxes associated with a Roth conversion from outside money is punctuated by the fact that this allows you to shelter tax-free more of your retirement money. If you have \$100,000 in your tax-deferred retirement account and your neighbors have the same amount in a Roth IRA, they have more retirement money than you because they have no IRS partner. If at all possible, you'll want to keep the balances in the Roth IRA as high as possible after conversion. This is done by paying taxes from outside sources.

## **Creating a Tax-Free Defined Benefits Plan**

Why have you been saving money in your tax-deferred retirement account? The typical answer is: to pay for retirement. Retirement is probably the largest purchase you'll ever make, and you cannot borrow money to pay for it. This inability to "finance retirement" like you would a house or car is why the greatest fear of most retirees is outliving their money. The fear has become so common it's been given a name: longevity risk. As you'll see below, you can transfer the management of longevity risk to someone else.

Virtually every working person regrets that they'll not have a defined benefits plan like that of their father or grandfather. A defined benefit plan provides you a guaranteed lifetime income paid by your ex-employer or the government; however, most current retirement plans sponsored by employers are defined contribution that do not guarantee you a lifetime pension. Even though you may have worked for the same company until retirement, your employer is not likely to guarantee you a lifetime income. Instead, you have been presented an opportunity to participate in a "defined contribution" plan whereby you have part of your pay withheld each pay period and placed into your retirement account. The employer may or may not provide some matching funds and/or profit sharing.

It is beyond the scope of this report to assess whether or not defined contribution plans are the best approach, but suffice it to say that typically investment selections are few, the limited menu of options are market linked, fees and other costs are high and not transparent, investment advice is most often absent, and once employment ends you are totally responsible for the management of your retirement money. Bear in mind that during your working years you delegated the responsibility of managing your retirement money to others, and when that responsibility becomes yours at retirement, you simply do not possess the skills and knowledge to adequately handle it. Accordingly, needed changes in defined contribution plans are currently under review by Congress and others, with special focus on fees, market exposure and transferability.

Unfortunately, most retirees think they do understand the intricate complexities of managing money but soon find out that they're paying far too many taxes, taking unsuitable risks and learn too late that it is easy to lose a good chunk of their retirement money to a bad investment or a volatile economy. Sadly, the market meltdown of 2000-02 and again in 2007-09 have painfully punctuated the inexperience of many money-managing retirees and has left them with a scaled down or postponed retirement. The current violent swings in the market are causing substantial angst among those near or in retirement. In some cases, losses in risky or bad investments have forced retirees back into the labor market, oftentimes in menial jobs that pay very little. Wouldn't it be nice if at retirement you could cash out your retirement plan and turn it into a guaranteed lifetime income, i.e., a defined benefit plan? Of course, it is always wise to work with your financial advisor when selecting options for your retirement money.

There is an easy way to get a guaranteed tax-free lifetime income from an insurance company. We turn to insurance when we cannot comfortably shoulder the risks we face. Insurance companies can professionally manage the risk by spreading it over a large number of people. For example, let's look at your homeowners insurance. You know that the probability of a fire destroying your home is small, but it does happen and when it does the financial costs are horrendous. You shift this risk to an insurance company, and for a small annual premium, they assume responsibility for the financial burden if your home is damaged. The risk is managed by relying on the probability of a loss based on years of data from many policyholders. The law of large numbers is the key to managing risks, and this is exactly what insurance companies depend on to manage risk.

Transferring the risk to professional management works because by dealing with a large number of homeowners, the insurance company can accurately assess the probability of a covered event and price their policies accordingly. If you live in earthquake, hurricane or flood prone areas, your premiums will be higher because the probability of damage will be greater; however, coverage is still affordable because those whose homes are damaged receive subsidies, via the insurance company, from those not suffering damage. This "principle of insurance" works to cover the risks associated with medical care [health], life [dying prematurely], auto [having a wreck] and also longevity risk [living longer than expected].

As the aging of the American population has increased and retirement has grown into a "major business", insurance companies have developed policies to provide lifetime income that are guaranteed to continue until death. What's more, many policies for longevity risk will cover the joint lives of married couples and provide a lifetime income until the last spouse dies. As is true of all insurance policies, there is a modest cost.

There is one major difference with longevity policies compared to other insurance coverage: most policies guaranteeing a lifetime income allow the insured to change their mind along the way and receive a lump-sum cash settlement or other payment options. The policies are priced by the insurance company to make them a profit, but anything above a "fair profit" is returned to the insured's estate or passed to their beneficiaries. Thus, premature death generally results in some amount being paid by the insurance company; however, if you live longer than expected, the income continues until death.

The “insurance principle” is the same, spreading the risk over a large number of people. Those that die too soon will subsidize those that live too long, and the insurance company will price their policies to provide adequate coverage and generate a profit for their stockholders. Would you have received a larger lifetime income if you shouldered the longevity risk rather than shifting it to an insurance company? Maybe and maybe not, because you have no idea how long you’ll live. Since your longevity is uncertain and the consequences of living longer than your money can be drastic, it makes a great deal of sense to shift your longevity risk to an insurance company that will guarantee you a lifetime of income that cannot be outlived. Involving an insurance company can change your defined contribution retirement plan into a defined benefits plan with a guaranteed lifetime income for you and, if elected, your spouse. This is how you address your greatest fear about retirement: outliving your money. But, how do you get a tax-free guaranteed lifetime income from the insurance company?

This is the easy part: you convert all or some of your qualified retirement money to a Roth IRA and then place it in an annuity that also has the guaranteed lifetime income feature. You can even put your money into the annuity today as a traditional IRA, convert it totally or partially to a Roth IRA in subsequent years while you delay taking your lifetime income until you actually retire. While your money is in deferral and before you start your lifetime income, it will be guaranteed to grow by a set percentage, usually between 5% and 8%. When you’re ready to convert the traditional IRA to a Roth, just notify your annuity company that you would like to reclassify your money as a Roth IRA. You may find that some trustees that hold your money are unwilling to reclassify your traditional IRA as a Roth IRA unless a new account is opened. If this out-dated position of the trustee is problematic, you may want to move your money to a new trustee.

Once converted to a Roth IRA you do not have to start taking an income – this can be postponed and managed any way you deem appropriate. The really good part is that when you do start taking an income – even the guaranteed lifetime income from your annuity issued by the insurance company – there will be no income taxes due. Also, you can pass the Roth to your surviving spouse and even to non-spouse beneficiaries, and they will not have to pay taxes on the amount you left them or the earning from that money. If you want a guaranteed tax-free lifetime income, the process takes two steps:

- (1) select an insurance company annuity that guarantees you a lifetime income and then
- (2) convert your retirement money to a Roth IRA.

You'll be surprised at the flexibility of annuity policies. You'll want to discuss this strategy with your financial advisor to confirm it is right for you.

## **What About Taxes on Social Security Benefits?**

There is a lot of discussion these days about Social Security and its future. Will it be there when needed? Will the Trust Fund go broke and SS benefits stop? Will benefits be reduced? While there is widespread concern about the viability of Social Security, the chances of it being phased out in the next several decades is zero. With 50+ million current recipients of SS and another 78 million baby boomers born from 1946-64 now reaching the age when benefits can start, doing away with Social Security would be political suicide. Accordingly, it will be there when you retire; however, the benefits may be less than hoped for, the taxation higher than now and the financial burden on both working Americans and taxpayers greater.

At the current time, taxes are levied on Social Security benefits when provisional income [defined earlier] exceeds a pre-determined level. If you are married taxpayers filing jointly and your provisional income reaches \$32,000, 50% of the Social Security benefits received by you and your will be subject to ordinary income taxes. If a married couple's provisional income reaches \$44,000, SS benefits subject to taxation rises to 85%. By the way, these threshold levels are not indexed to inflation, meaning that as prices rise in the future it is virtually certain that more, if not all, of your SS benefits will become taxable. The threshold levels for the 50% and 85% taxation rate for single taxpayers are \$25,000 and \$34,000, respectively. For a comprehensive review of Social Security see *"A Guide to Social Security: Higher Lifetime Benefits & Lower Lifetime Taxes"* by Shelby J. Smith, Ph.D. The taxes you are paying on your Social Security benefits can be exactly determined by your tax preparer, just ask them to show you the schedule they prepared to determine your provisional income.

The "loopholes" in the computation of provisional income is the exclusion of tax-deferred earnings of annuities and the tax-free withdrawals from Roth IRAs. Of course, Congress

could pass a future law to close these loopholes, but at this time there does not appear to be any interest in such legislation. All other interest and earnings even tax-free interest from municipal bonds is included in provisional income and could increase taxation on SS benefits. How can we use this information to lower your income tax liability?

Assume that you have \$250,000 in bank CDs and have no plans to use this money until late in retirement, or not at all unless you have an emergency. Let's dream and say that the bank is paying you 5% interest on your CD that you're not withdrawing and using for your retirement. Under this assumption, each year you will receive \$12,500 in CD interest that will be taxable even though you do not withdraw it from the bank. This \$12,500 in unused CD interest counts as part of provisional income and raises taxes on your SS benefits. In effect, you could say it is subject to double taxation: first as ordinary interest income and second as a boost in the taxes on your SS benefits.

Let's say that you have exceeded the above threshold limits where your SS benefits become taxable and you're in the 25% tax bracket. This means that up to 85% of your SS benefits will become taxable. At the extreme, you'll be paying \$2,656 in extra taxes on your SS benefits [ $\$12,500 \times 85\% \times 25\%$ ]. While this may not sound like much, in fifteen years this amounts to \$47,000 if earning 3% annually and \$55,000 at 5% annual interest. This money can be freed from taxes by converting your retirement money to a Roth IRA, putting it in an annuity or both. How does this work?

Suppose the same \$250,000 is in an annuity. The earnings are tax-free if in a Roth IRA and tax deferred if not. The annuity rate of return will generally be as good as or better than the bank CD; thus, under our assumptions you'll be earning at least \$12,500 annually but there will be a reduction in your taxes for two reasons:

- (1) tax deferred interest not withdrawn from an annuity and tax-free earnings in a Roth IRA, if withdrawn more than five years after converting to a Roth, are not counted as part of your taxable or provisional income, and
- (2) the lower income level could mean lower taxes on your SS benefits.

Of course the bank CD is insured by an agency of the federal government ["FDIC"] whereas the annuity is guaranteed by the financial strength of an insurance company. Historically,

insurance companies have been financially responsible. In the most recent financial meltdowns, insurance companies the issue annuities have fared much better than the other financial service providers such as banks and brokerage firms.

Least you are fearful of the insurance company's ability to honor their obligation to you, consider that you currently have your most valuable assets covered by insurance companies. You trust them with your house, car, health, life, business, and more; thus, do not be fearful about letting insurance companies protect your retirement money and lifestyle. Annuities are used by the legal system to pay lifetime incomes to accident victims winning court judgments, and state lottery agencies use annuities to pay multiple-year lottery obligations. Annuities have been around for centuries, and it is hard to imagine a modern financial system without them. Yet, many retirees are not familiar with annuities. Gradually retirees are learning to use annuities to lower their income taxes. Annuities, used in association with your Roth IRA or independently, are options you need to discuss with your financial advisor.

## **Required Minimum Distributions**

As we discussed above, if your retirement money is in a qualified retirement account like a 401(k), 403(b), TSP or other ERISA covered accounts, you are generally required to start taking minimum withdrawals after reaching age 70½ if you no longer work. If you have a Traditional IRA you must start RMD at 70½ even if you continue working. Another way to view this is to acknowledge that you do not own all your qualified retirement money: the IRS is your partner. Your partner requires you to start paying them no later than April 1<sup>st</sup> of the year following the year in which you reach age 70½. If you do not take the full amount of the RMD as required, the penalty is generally a special tax equal to 50% of the amount you were required to take minus what you actually took. For example, if you were required to take \$10,000 in RMD and you took nothing, you could be liable for a \$5,000 penalty tax [50% of RMD]. If you took only one-half the RMD your penalty tax could be \$2,500, or one half of the amount required but not taken.

As a concession to retirees who had substantial losses in their retirement accounts, the penalty for not taking the RMD was waived for 2009 because withdrawals would further deplete account balances. This government generosity was not continued beyond 2009,

probably because of the mounting gap between taxes collected and expenditures by the federal government. There are three ways to compute the RMD, and you are advised to get professional assistance from your tax preparer to choose the best one for your circumstances.

As pointed out above, once your money has been converted to a Roth IRA there is no RMD during your lifetime or that of your spousal beneficiary. Thus, by converting to a Roth IRA, you can leave unneeded money in your account to grow tax-free and withdraw it if needed rather than being forced to withdraw money you do not need. If the money is transferred to a non-spouse beneficiary at your death, or the death of your surviving spouse, beneficiaries must start taking minimal annual withdrawals in at least an amount that will deplete the account over their lifetime. By selecting the right computation method, the RMD will start relatively small and build gradually until they are near retirement before starting to decline in older age.

For example, let's say you leave \$100,000 to your young grandchild. The money can be invested in almost any type of investment and all withdrawals will be available tax-free when taken. Let's say your grandchild has an expected remaining lifetime of 80 years when the money is bequeathed. The first year, the grandchild can choose the calculation method that requires  $1/80^{\text{th}}$ , or \$1,250 (1.25%), to be withdrawn. At age 55 when life expectancy might only be 35 years,  $1/35^{\text{th}}$  (or 2.86%) would be required as the RMD. Since the earnings rate in the early years is likely to exceed the RMD percentage, the account balance could grow to reach a high point in later-life before gradually declining as the life expectancy age approaches. Bear in mind, that unless you prohibited it as a provision of bequeath, the money could be taken lump sum at any time or in amounts larger than the RMD.

All withdrawals and all earnings are absolutely tax-free since the money is in an inherited Roth IRA that has been "stretched" over the remaining lifetime of the beneficiary. This is a powerful legacy and is only possible by converting to a Roth. Given the current uncertainty about future provisions for converting to a Roth and income tax changes that seem likely, prompt attention to this matter is warranted if converting to a Roth is plausible for you. If you think a Roth conversion could be beneficial do not postpone the opportunity since you can change your mind after the conversion.

If you withdraw or rollover qualified retirement money and take “constructive receipt” because the withdrawal check is made payable to you, you will trigger an income tax liability unless you place it in another qualified account within 60 days. Also, in some instances, trustees are required to withhold 20% of withdrawals from a qualified account. You are permitted to put these funds back into your account, move to another qualified retirement account within the 60-day time limit and then recover the withheld money as a tax credit on your next tax return. If either of these happen to you, converting [by recharacterizing] to a Roth IRA might be a good solution since you are half way there with some of the taxes already paid, but be careful if less than age 59½. Again, you will still have the right to change your mind and undo until you file your final tax return for the year of conversion. As was pointed out above, if possible it is always best to pay the taxes associated with a Roth conversion from outside money rather than taking it from the amount converted.

### **More Reasons for the Roth Conversion**

There are other reasons to convert to a Roth IRA in addition to those already discussed. Getting larger itemized deductions for medical expenses and other tax deductions based on a percentage of adjusted gross income is an often overlooked benefit. This benefit is because Roth withdrawals are not counted as taxable income and most itemized deductions are allowed only after a certain percent of taxable income is reached; thus, the lower the taxable income the sooner the deductions limit will be triggered. Another reason is that at any time Congress could pass a law that totally changes the rules and benefits of converting to a Roth IRA. Also, how Roth withdrawals are treated when computing taxes levied on Social Security benefits could be changed. The current Roth IRA conversion and IRA contribution rules are attractive to the wealthy; thus, future changes in the tax laws could affect Roth conversions.

There are other advantages like hedging your future exposure to income taxes. The best way to prepare for an uncertainty is to “hedge”. If you are uncertain which investment is the best, you can hedge by choosing different investments or savings vehicles. If one performs poorly, possible other ones will do better to offset the poor one. Diversification does not always work as planned, but it is generally less risky than concentrating all your money in one option.

If you are unsure if interest rates will rise or fall, you can hedge by spreading out your choices so they mature at periodic intervals in the future. This technique is called “laddering” and can be done with most fixed rate investment choices. Laddering allows you time to structure your maturities to come due at the exact time the money is needed and the technique generally works very well for retirement planning. Also, laddering is a great way to make certain you get the average rate over a period of years rather than trying to guess the “one” best maturity and run the risk of being wrong. You’ll want to get the help of a professional prior to repositioning your money into laddering maturities.

You can also hedge future tax changes by mixing tax deferred, tax-free and taxable places to put your retirement money. You hold some of your money for near-term use in taxable places, some in longer term tax-deferred places like annuities for intermediate use and the rest in a tax-free Roth IRA for longer term needs or to pass as a legacy. So regardless of what happens to future taxes, you are hedged and will tend to pay the “average”. Again, make sure you discuss this tax strategy with your financial advisor.

## **Summary**

Converting to a Roth IRA is not for everyone, but it is an option that warrants serious consideration. The Roth IRA offers many advantages that can lead to a better retirement for you and your family, and a legacy that will survive you for the lifetime of your heirs. Once the taxes associated with conversion are paid, the principal and all earnings are tax-free to you, your surviving spouse and your non-spouse beneficiaries. During your life, and that of your surviving spouse, there is no RMD. Your beneficiaries will be required to take at least annual withdrawals that will deplete the money over their expected lifetime. At this time, earnings and withdrawals from a Roth are not counted in the calculation that determines the amount of your Social Security benefits subject to income taxes and are not counted as income in determining the cost of your Medicare Part B coverage.

If your money is currently in an employer’s sponsored retirement plan and can be rolled to a Roth IRA, you can save fees and charges, have a much wider selection of investment options, and self-manage or work with a financial advisor of your choice. We have referenced a publication that tells you how to move to your control some or all of your money in an

employer's plan, regardless of age, without taxation, while still working and without missing the next employer match. You should take the time to read this important report and pass it along to your employer.

The income limit to convert to a Roth IRA was suspended beginning in 2010 and everyone, regardless of age and without dollar limit, is now permitted to convert retirement money to a Roth. This may be a short-term only window because we have no assurance it will be left open by Congress when many of the current tax laws will probably be changed. If you convert your money to a Roth and later change your mind, you can undo the conversion and avoid the tax liability. Thus, if you think you could benefit by converting to a Roth IRA but are not absolutely certain, you may want to do the conversion and then undo it later if you change your mind. The latest you can change your mind is October 15<sup>th</sup> following the year in which you converted.

When undertaking the management of your retirement money, including converting to a Roth IRA, you should get assistance from a financial advisor. Retirement planning and investing are complicated matters, because they can involve large sums of money, cover numerous years and, if done properly, use several investment and tax strategies. Wise decisions and planning are critically important, because they mean the difference between happiness and misery during the last one-third of your life.

Shelby J. Smith, Ph.D.  
The Retirement Pros  
January 2010 (revised August 2011)

**NOTE:** See *Go Roth! Your Guide to the Roth IRA, Roth 401k and Roth 403b* by Kaye A. Thomas for in-depth information on Roth IRA and converting to a Roth IRA (Fairmark Press, 2009 Edition). Also, IRA Publication #590 is an excellent reference for IRA and Roth IRA accounts.

# Appendix

## Case Study:

Mr. and Mrs. Miller, both aged 65, have saved \$250,000 in a retirement account on which they have paid no income taxes. They have decided to retire and will not need the \$250,000 unless there is an emergency. They have substantial income from other sources and expect to remain in their current 35% tax bracket once retired. They are of the belief that their taxes, and tax bracket, will rise in the years ahead. After consulting the actuarial tables, they have concluded that at least one of them can expect to live to age 91.

After consultation with their financial advisor, they have decided to place their money in an annuity at this time and compare an income stream from both a Roth IRA and Traditional IRA once annuitization starts. They chose an annuity because the interest rate was superior to bank CDs and other safe money rates. They assume they can earn 5% during the accumulation period of the annuity and 3% once annuitization begins. They would like to compare annuitization at five-year intervals until age 85. They will pay the income taxes associated with the Roth IRA conversion from other sources to maximize the size of their Roth IRA account. We assume the annual RMD amounts from the traditional IRA will be met, even though such will not be the case if income is delayed beyond age 70-1/2.

### Roth IRA

Year-end/age	Roth Account	Opportunity Loss*	Net Balance After Opp. loss	After Tax Income to age 91
Conversion	\$250,000	\$87,500		
1/66	\$262,500	\$90,147	\$172,353	<b>\$9,898</b>
5/71	\$319,070	\$101,560	\$217,510	<b>\$14,620</b>
10/76	\$407,224	\$117,878	\$289,346	<b>\$24,238</b>
15/81	\$519,732	\$136,819	\$382,913	<b>\$44,889</b>
20/86	\$663,324	\$158,804	\$504,520	<b>\$110,164</b>
25/91	\$846,589			

\*Will lose the earning power of the money they used to pay taxes on the Roth IRA conversion.

## Traditional IRA

Year-end/age	Account Balance	Before Tax Income	After Tax Income to age 91
Starting	\$250,000		
1/66	\$262,500	\$15,075	<b>\$9,120</b>
5/71	\$319,070	\$21,447	<b>\$12,975</b>
10/76	\$407,224	\$34,112	<b>\$20,638</b>
15/81	\$519,732	\$60,928	<b>\$36,862</b>
20/86	\$663,324	\$144,840	<b>\$87,628</b>

The foregoing simplifies away some of the complications, e.g., taking RMD money from the traditional IRA account, the stability of the earnings rate and tax brackets over the holding period and impact each account would encounter if a large lump-sum withdrawal was required to address an emergency. As the last column [After Tax Income to Age 91] shows, the tax-free income from the Roth IRA gets progressively greater than that from the traditional IRA as time passes.

If the above simple analyses included higher tax rates after the conversion to a Roth IRA, the resulting income superiority from the Roth would be even better. Should the time frame be expanded to include a forty or fifty year life span of a non-spouse beneficiary, the tax-free benefits of the Roth IRA would become vastly superior. Rising tax rates is exactly the scenario expected by most political and financial professionals; thus, converting traditional retirement money to a Roth IRA makes a great deal of sense for many retirees. Accordingly, if you plan to use some of your retirement money late in your retirement, or pass it forward to your beneficiaries, you'll want to schedule a meeting with your financial advisor to see if you are a good candidate for a Roth IRA conversion.

Shelby J. Smith, Ph.D.  
January 2010 (revised August 2011)

## ***REVIEWS BY FINANCIAL ADVISORS***

“Dr. Smith shows you how to take advantage of the greatest ‘tax sale’ ever -- don't miss the opportunity.”

– ***AGENT NAME City, State***

“Paying too many taxes now or expect higher rates later? Dr. Smith has your answer in this timely report – read it today!”

– ***PATRICK SMITH Bedford, TX***

“The Roth IRA Conversion strategy is something I frequently encourage our clients to consider. Dr. Smith’s report is one of the best I’ve seen on the who, what, when, where and how of this powerful concept. I highly recommend it.”

– ***TONY WALKER Bowling Green, KY***

Author & Creator – *The Worry Free Retirement™*

