



Advanced Planning Strategies

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December 2009

The Senate passed a motion at the beginning of the Thanksgiving week to move forward on the Health Care Reform legislation removing a substantial roadblock for work on this bill. The process now has begun in earnest in the Senate to respond to the House bill with a version that meets majority approval in the Senate. If this is successful, a joint committee will take up the differences and form a compromise bill. The respective bodies will take action on this adjusted legislation for final approval before sending it to the President's desk for his signature. In other words, this process has a long way to go. There are already some statements about a shorter holiday recess if the legislation is not completed. There are certainly no guarantees at this time as to the components of the final bill or its passage. This letter traditionally deals with tax items related to business, financial, retirement, and estate planning. In keeping with our tradition, we'll let you know the implications of this legislation in those arenas if the legislation passes.

There is a possibility that some other tax legislation will be rolled out before the end of the year. There are numerous provisions that are extended from year-to-year that might be dealt with. In addition, the federal estate tax is scheduled for repeal with deaths that occur in 2010. Although it is unlikely that the repeal of the estate and generation-skipping transfer taxes will take effect, the timing and shape of the alternative estate-tax reform has not been established. A new bill was introduced in the Senate that would freeze the exemption amount at \$3.5 million (with inflation indexing) and the maximum rate at 45 percent. The bill would also permit a surviving spouse to "inherit" the exemption that was unused by the deceased spouse.

You may have heard about the opportunity for all taxpayers to make a Roth IRA conversion beginning in 2010. This type of tax-planning opportunity only comes around once or twice a decade and should get serious consideration. There is some strategic benefit to making the conversion early in 2010. For a thorough discussion of the issues to digest before taking action on this opportunity, please read the inside report. We look forward to keeping you abreast of the latest tax developments as we move forward into the new year.

Knowledge is not power. Only knowledge in use is power.

New Opportunities for Roth IRA Conversions

Current law has not given higher income individuals significant access to the Roth IRA. The Roth IRA offers a distinctly different set of advantages than tax-deferred qualified plans and IRAs. With the Roth IRA, contributions are not deductible, but earnings are tax-free as long as distributions satisfy eligibility requirements. Roth IRAs are also attractive because there are no required minimum distributions during the life of the participant (or for the participant's spouse as the designated beneficiary). Other beneficiaries at the participant's death do have to take required minimum distributions, but these generally can be spread over the lifetime of the beneficiary—creating the potential for a tremendous amount of income-tax free benefit to the heirs.

The Roth IRA can be created with new contributions but contributions are not allowed (in 2009) for single taxpayers with adjusted gross income (AGI) in excess of \$120,000 or married taxpayers filing jointly with AGI in excess of \$176,000. Another avenue to create a Roth IRA is to convert all or a portion of a traditional IRA, qualified plan/Sec. 401(k) plan, Sec. 403(b) plan, or a government-sponsored Sec. 457(b) plan into a Roth IRA. (Note: the rules of specific qualified plans must be examined to determine if conversion is permissible.) However, before 2010 only taxpayers (both single and married filing jointly) with AGI of \$100,000 or less were allowed to convert (separate filers could not convert). The amount converted is included as ordinary income (unless a portion represents a return of cost basis) but is not subject to the 10 percent early (prior to age 59 ½) withdrawal penalty tax.

Once the conversion has occurred and taxes are paid, distributions from the Roth IRA are tax-free if they are qualified. This means they are made after the 5-tax-year period after the first contribution was made to the Roth IRA, and the participant has attained age 59 ½ or on account of death, disability or up to \$10,000 of qualifying first-time home-buying expenses. Nonqualified distributions from a converted Roth IRA are also income tax free to the extent that they represent a withdrawal of no more than the converted amount. Note that a special tax rule applies conversions. Even if withdrawals are not subject to income tax, they are subject to the 10 percent premature distribution penalty if withdrawn before age 59 ½ (unless one of the above exceptions apply).

Beginning January 1, 2010, the \$100,000 income cap and the tax filing requirements on Roth IRA conversions are eliminated. This means that all taxpayers, regardless of income level or tax filing status, will be able to convert to a Roth IRA and consequently take advantage of all its opportunities. There is a special rule for conversions that are made in 2010. The Roth IRA owner can elect to pay tax on the conversion in 2010 or include half the income on the 2011 tax return and half the income on the 2012 tax return.

Factors to Consider Before Converting

Income-Tax Rates: Determining whether a Roth IRA conversion is a good idea depends on a number of factors. The first consideration is the expected income-tax rate at the time of conversion versus the tax rate at the time of distributions from the plan. If tax rates go up, conversion results in a larger accumulation than leaving the funds in a tax-deferred plan. For example, let's compare converting or not converting a \$100,000 IRA in 2010 at a 25 percent tax rate. Assume a 7 percent annual return on the account and a tax rate of 35 percent in 2025 (the assumed year of withdrawal). As you can see in the table below the conversion to a Roth IRA results in an after-tax accumulation of \$206,927, as compared to \$179,337 if the amount remained in the traditional IRA.

If tax rates are lower at the time of withdrawal than at the time of conversion the opposite is true. It is better not to convert in that scenario. If tax rates remain the same, the after-tax accumulation is the same in both scenarios.

<u>Assumptions</u>	<u>Conversion</u>	<u>No conversion</u>
2010 (25% effective income-tax rate)	\$75,000	\$100,000
Balance 2025 (7% return)	\$206,927	\$275,903
After-tax balance (35% effective income-tax rate)	\$206,927	\$179,337

The consideration of the expected income-tax rate on withdrawals is really just the first step. Of course, it is impossible to know with any certainty where income tax rates will go in the future.

Source of Taxes: One option for paying the taxes at the time of the conversion is to withdraw a portion of the amount converted, thus lowering the Roth IRA balance. It is always better to use another source of funds to pay the tax so that you do not lose the opportunity to earn the tax-free rate of return in the Roth IRA. Remember, a withdrawal from the account could also be subject to the 10 percent penalty tax if the taxpayer is under age 59 ½.

Tax Diversification: Just like diversification of a portfolio, tax diversification can protect against uncertainty and change. For many middle and upper income taxpayers, a significant portion of retirement savings are currently in tax-deferred accounts. Building a source of tax-free income from a Roth IRA can help protect these individuals if future tax rates were to increase. Having different types of income also allows for better income tax planning.

Required Minimum Distributions: With no required distributions during the participant's lifetime, individuals who do not need Roth IRA withdrawals to meet expenses can continue to accumulate funds for either their later retirement years or as an inheritance to leave to heirs.

Estate taxes: For those estates subject to estate and inheritance taxes, paying taxes at the time of the conversion reduces the estate and thus the estate tax. The prepayment of the income taxes might be a method to effectively lowering the tax rate on the conversion. Most individuals subject to estate taxation will also prefer to defer withdrawals, building a larger estate. To make sure that heirs will be able to take advantage of stretching out Roth IRA distributions, it's important to plan for another source of funds to pay the estate taxes on the Roth IRA balances in the estate. Life insurance funding is the most common approach to address this issue.

Miscellaneous Income-Tax Issues: A conversion results in a significant increase in AGI. This can have many unexpected results. For example, it can increase the portion of Social Security benefits that are taxed or result in an increase in the Medicare Part B premium. For this reason, it is critical to discuss the conversion decision with a tax adviser to determine all tax aspects of a proposed conversion. The conversion can have unexpected tax benefits as well. For example, in future years an individual may take tax-free withdrawals from the Roth IRA and such withdrawals will not count toward determining the taxable portion of Social Security or the calculation of the Medicare Part B premium.

Value of the Account: Taxes paid at the time of the conversion are based on the value of the account on the date of the conversion and conversions relate to the year in which the amount is converted. For example, a conversion on January 15, 2010 can only be treated as a 2010 conversion and the tax will be calculated based on the value of the account on January 15. Converting when the value of the account is at the annual low is optimal, but the future value of any account is unpredictable. However, the IRS actually offers a valuable safety valve for account-value fluctuation. If the account value drops after the conversion but before the due date (with extensions) of the tax return for the year of conversion (generally October 15th of the following year) the transaction can be essentially undone through a recharacterization to a traditional IRA and reconversion (if available) in a later year.

Asset Protection for the Account: The Roth conversion from a traditional IRA should have no impact on creditor protection. However, conversion of money in a qualified plan would remove the extensive protection afforded qualified plans and place the account under the rules for IRAs. Although there were changes to the bankruptcy rules that provide substantial protection of IRAs, this only applies to a debtor in bankruptcy. For those concerned with potential liability, counsel should be consulted about the impact under state law of the conversion of a qualified plan account to a Roth IRA.

Who Should Consider a Roth IRA Conversion?

Deciding whether to convert is a complex decision. It is important to discuss this with your financial and tax adviser and to consider the decision in the context of the larger retirement and estate-planning picture. However, here are some general guidelines:

- Many expect that future tax rates for those in the highest income tax bracket will rise. Those in the top 35 percent bracket are candidates for Roth conversions.
- For a number of reasons an individual can have lower income for a year. This can offer the opportunity to convert at a low (or even zero) tax bracket. Remember, partial conversions are permitted. A common strategy is to convert enough to take advantage of a 15 percent or even 25 percent income-tax rate, assuming that tax rates will be higher later.
- Those who do not need withdrawals from the account to meet living expenses will benefit from converting as a way to avoid required minimum distributions after age 70 1/2.
- Taxpayers likely to face a significant estate or inheritance tax should seriously consider converting to maximize after-tax benefits received by heirs.
- Taxpayers who have accumulated most of their retirement savings on a tax deferred basis need to be considering a Roth conversion of some of the funds as a way to diversify.
- Taxpayers should consider at least a partial conversion to begin the 5-year required holding period so that distributions will be qualified tax-free withdrawals. (discussed earlier) Any conversion made in 2010 will start the 5-year period as of January 1, 2010 and will apply to any future conversion or contributions to any Roth IRAs created by the same account owner.
- On the other hand, many lower and middle-income taxpayers will have reduced income in retirement and might remain in a lower tax bracket. This generally weighs against conversion, but the potential for tax-diversification or the ability to convert a portion of an account at the lowest brackets may still indicate at least a partial conversion.
- For those struggling to meet retirement needs, converting reduces available resources by the amount of the income taxes and may not be the best approach—unless conversion can be accomplished at a zero or extremely low tax rate.
- For taxpayers who convert in 2010, the income taxes on the conversion may be deferred into 2011 and 2012. If the taxpayer expects income-tax rates to go up in 2011, it might make sense to pay the taxes on the conversion in 2010.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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for the future***



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