ROTH IRAs in 2010:
Roth Conversion Strategies:
Income and Estate Planning Ramifications

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Roth IRAs are an excellent planning tool for retirement. They allow tax-free growth, withdrawal flexibility, and investment flexibility. The decision to convert a Roth occurs on two levels, the simple conversion of a modest amount to stay in the current tax bracket, and the advanced strategies employed by high-income/high net-worth individuals potentially subject to estate taxes and Required Minimum Distributions. In a world of uncertainty and most likely increasing taxes, the Roth is a powerful weapon to reduce uncertainty for many families, but for high-income/high net-worth individuals, the Roth Conversion provides more unique and profitable opportunities, particularly in 2010.

ROTH BASICS

With turmoil in markets and the tax code in transition the Roth IRA has some very attractive features. A Roth IRA is one of three kinds of IRAs (the other two are the deductible IRA and the nondeductible IRA) and has a very special feature: all growth and income from a Roth are free from Federal and usually, state income taxes, if you follow the rules. Roth IRAs were established in 1998 to provide an effective tax-free vehicle for retirement. Any money you contribute or convert to a Roth IRA is after-tax money, which means you've paid taxes on it before contributing to the Roth. This is different from normal pre-tax contributions to 401(k), 403(b) or 457 accounts. Those contributions generally are pre-tax, and you will pay taxes in the future on distributions from those types of plans (which will consist of contributions, capital appreciation and income on those contributions). So with the Roth IRA, the tax-free status can be very appealing for individuals who are in a high tax bracket and will remain in a high or move to a higher tax-bracket. Many employer sponsored retirement plans now allow Designated Roth Account Contributions or 'DRAC'.

Tax- Free: Let's look at some basics: First, there is no Federal and (usually) state income tax on qualifying[1] distributions from a Roth IRA, since contributions (or conversions) to the Roth account are with after-tax dollars. With a Roth, the taxes are paid up front, and all of the growth and income is tax-free. If you expect to be in a lower tax bracket in retirement, for example a person without a significant pension, the option of making tax-deferred contributions to a traditional IRA is usually preferable. If you expect to be in the same or greater tax bracket in retirement, the ability to take tax-free distributions from a Roth is preferable. Add the possibility of a future tax increase, and you see the tax-free growth advantages of a Roth.

[1] IRC §408A(d)(2)(A) defines a qualifying distribution as one made after five years and age 59 ½, or made after the participants' death, disability, or made for a qualified special purpose distribution.

No Required Minimum Distributions: Another advantage of a Roth is that you are not mandated to take "Required Minimum Distributions" (RMDs). With a traditional IRA, 401(k), 403(b) or 457 plan, you must start taking RMDs at age 70½, or pay a 50% penalty, unless you are still working[2]. With a Roth, there are no RMDs. When you die, your Roth passes to your heirs income tax-free as well.

Infinite (almost) choice of investment options: Your investment choices are often limited in employer sponsored qualified retirement plans like 401(k), 403(b) or 457 plans. Investment options within a Roth IRA are nearly limitless, giving the account owner much more investment flexibility.

Additional Benefits: Roth distributions are not added to determine the taxation of Social Security benefits[3] or in determining the amount of your Medicare Part B premium[4] if you are over age 65**.**

Roth Restrictions: Roths do have some restrictions. If you make a contribution to a Roth, you must leave it in for the longer of 5 years or age 59 ½ [5], or any income will be taxed and possibly subject to penalty. You can withdraw your contributions tax-free, first-in, first-out (FIFO)[6]. You need earned income[7] (wages) to contribute to a Roth; but the good news is that only one spouse needs to have earned income and the other can contribute. For example, if one spouse was working and their spouse didn't work, both could contribute to a Roth.

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[2] Reg. §1.401(a)(9)-1. In the case of a greater than 5% owner, Required Minimum Distributions must start April 1 following the year the taxpayer reaches age 70 ½.

[3] The taxability of Social Security benefits is based on another variation of Modified Adjusted Gross Income (MAGI). In general, up to 85% of Social Security benefits may be taxable if the taxpayer's MAGI is above $44,000 ($34,000 for single). Qualifying Roth distributions are not included in income for this calculation. See IRS Pub 915.

[4] Medicare Part B Premiums are calculated based on a needs based formula similar to the taxation of Social Security benefits. Roth distributions are not included in the calculation of MAGI for Medicare Part B premiums. See SSA Publication No. 05-10161

[5] IRC §408A(d)2)

[6] Reg. §1.408A-6 Q&A-8

[7] Earned income is called "Compensation" under IRC §219(f)(1) and includes self-employment income, wages, commissions, fees, tips, taxable alimony and separate maintenance payments. It does not include pension, annuity or deferred compensation payments. Reg. §1.408A-3,A-4.

THERE ARE TWO WAYS TO GET A ROTH[8], CONTRIBUTE OR CONVERT AN EXISTING IRA.

Contributions: You can contribute an amount equal to the lesser of earned income or, if you're under age 50 in 2009, $5,000 (for each spouse) to a Roth IRA. If you're over age 49 in 2009, you can contribute $6,000 (again for each spouse). There is an income limitation: for married couples filing jointly, your Modified Adjusted Gross Income (MAGI)[9] cannot be over $176,000 (there is a phase-out between $166,000 and $176,000). If you are single, the MAGI limit is $120,000 (phased-out between $105,000 and $120,000). You can make a Roth contribution for 2009 up to April 15, 2010; similarly, contributions for 2010 can be made between 01/01/10 and 04/15/11. Some people file their returns early and use their refund to help fund the IRA. The IRS will now direct deposit your refund into an IRA account at your direction. Only one spouse needs to have sufficient earned income for both to be able to make contributions.

How to get a Roth if you're over the limit: Some of us, thankfully, are over the MAGI limit for Roth contributions. There is a modest 'loophole' to allow folks with high MAGI to contribute to a Roth. Make a contribution to a nondeductible IRA (which has no income limit) and then convert that IRA to a Roth. If you only have the nondeductible IRA, you'd only pay taxes on the conversion of the income earned between contribution and conversion. For example, if you made $200,000 in 2009, you could make a contribution to a nondeductible IRA for 2009 (and you could make it until 04/15/10), then convert it in 2010. For a couple, this could work out quite well. If one had earned income, they could both contribute to their respective nondeductible IRAs for 2009 and 2010, and convert. This could allow a prospective Roth creation of $24,000, if both were 50 or older in 2009. Note: that if you have other IRAs, you must aggregate all IRAs when doing a conversion[10]. In other words, if you have traditional and nondeductible IRAs, you have to pro-rate the taxable and nontaxable portions.. See IRS Form 8606 for the specific calculation[11].

Rollovers: Distributions from a qualified plan (including a 401(k), a 403(b) or a 457 plan) can be rolled directly into a Roth IRA. Such rollovers are treated the same as under the conversion rules for a traditional IRA.

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[8] There are, according to Natalie Choate, eight ways to get a Roth IRA funded, contributions to a Roth, conversion to a Roth, rollover from a DRAC, a surviving spouse rollover, US military death gratuities, qualified reservist distributions, Exxon Valdez oil compensation, and airline bankruptcy. For purposes of my paper, I'll stick with the conventional ways.

[9] Modified Adjusted Gross Income is Adjusted Gross income under Code §62, with add-backs for taxable Social Security (§86), passive activity losses (§469), education loan interest expenses (§221), tuition expenses (§222), and IRA contributions (§219). §219(g)(3) has a few other esoteric adjustments as well.

[10] This is what Ed Slott calls the "cream in the coffee" rule, or the aggregation of all IRAs. See IRC §408(d)

[11] I've attached a Form 8606 to the back of this paper.

Conversions: You can turn an existing IRA into a Roth by paying the tax on the amount you want to convert. A lot of advisors (including us) think this is a good idea in a down market, especially when it appears there is a future tax increase. For the optimal results, we look to convert enough to keep you in the tax bracket you're currently in, and not push you up a bracket. In addition, we think it's always a good idea to pay the taxes from outside funds, and not from the conversion. That way, you get tax-free gain on the entire IRA: the portion you would taken as well as the taxes on the converted amount. For 2009, conversions were allowed as long as your Modified Adjusted Gross Income did not exceed $100,000 (regardless if you're married or single[12]). This prevented many high-income individuals or two-earner couples from converting. But here is some good news: in 2010, you can convert an IRA into a Roth regardless of your income level. What's better is that if you convert an IRA to a Roth in 2010, you have the option of reporting ½ of the converted amount as income in 2011 and the other ½ in 2012[13], which means you actually may not need to pay the taxes until April 15, 2012 and April 15, 2013[14]. This election must be made on your 2010 return.

Taxes on Conversions: When you convert a traditional IRA to a Roth, you add the converted amount to your income. Thus, your Federal taxes are at the tax bracket(s) for that level of income. We think the 'stay in the bracket' strategy is sound for most taxpayers. There are no penalties on converting to a Roth from a traditional IRA if you do the conversion correctly. The conversion may be subject to state income taxes. A critical point in Roth conversions is that all analyses show that paying the taxes out of outside (e.g. non-Roth) funds is superior to using the internal IRA funds.

Recharacterization: There's more good news in the form of a 'tax Mulligan'. Like a Mulligan in golf, the recharacterization rule lets you 'unconvert' a Roth if you decide it wasn't a good idea[15]. You can even use it to take advantage of market moves. Suppose you convert a traditional IRA to a Roth when the account is worth $10,000, and later the market declines and your Roth is now worth $8,000. You can recharacterize the Roth back to a traditional IRA and not owe any taxes and then reconvert back to a Roth (and start over). Like a Mulligan in golf can only be used once per round, recharacterization can only be done once a year. An interesting point is that you can recharacterize a Roth anytime until the due date of your return for the year, including any extensions, provided you file the return on time or file an extension. So if you

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[12] An additional restriction is that the taxpayer must not be married filing separately. IRC §408A(c)(3)(B)

[13] IRC §408A(d)(3)(A)(iii) provides that the income is split ratably for 2011 and 2012 unless the taxpayer elects otherwise.

[14] To preclude a penalty for underpayment, taxpayers should pay the required estimates, so taxes may be due and payable considerably earlier than the due date of the return to avoid penalty.

[15] IRC §408A(d)(6)

converted a Roth in 2009, you have until 10/15/2010 to recharacterize[16]. If you convert in 2010, you have until 10/15/2011 to recharacterize. There are some rules about recharacterization, so you want to make sure you keep your converted Roth separate from a contributory Roth, if you might recharacterize (and why not keep your options open?). You must wait at least 30 days to reconvert and you cannot do it in the same calendar year as the original conversion. Recharacterization rules:

1. To recharacterize, you must make a transfer back to the traditional IRA, and not use the rollover method where you may take the funds for up to 60 days.[17];

2. The original contribution plus any net income or gains allocable to the contributions must be retransferred;

3. The election to recharacterize is made by providing notice and directions to the IRA custodians. The election cannot be revoked after the transfer back to the traditional IRA[18].

Recharacterizations are treated as having been contributed to the transferee IRA on the same date (and for a contribution) for the same years as the contribution was made to the transferor IRA[19]. A recharacterization is not treated as a rollover for purposes of the one-rollover-per-year limitation[20].

PLANNING WITH ROTH CONVERSIONS

Who Should Consider a Roth IRA conversion? A Roth IRA conversion is where you take an IRA or qualified retirement plan (with tax-deferred funds or a combination of after-tax and tax-deferred funds) and 'convert' it to a Roth IRA by declaring the income (and paying the taxes) on the taxable portion of the IRA. There are several reasons to consider a Roth conversion:

1. **The taxpayer will be in the same or higher tax bracket at some later date**. Since all growth within a Roth IRA is tax-free future withdrawals will not be taxable. Thus a taxpayer that may be in a higher bracket later, for example if they have a significant pension or large Required Minimum Distributions ('RMD') from a traditional IRA or qualified plan, you should consider a Roth Conversion. Similarly, taxpayers who think

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[16] It is unnecessary to actually file an extension to get the 10/15 date for recharacterization. However, the tax return must be either filed on a timely basis (e.g. before 4/15) or properly extended. If the return is filed late, the last date for recharacterization is April 15.

[17] Reg. §1.408A-5, A-1(a)

[18] Reg. §1.408A-5, A-6(b)

[19] Reg. §1.408A-5, A-3

[20] Reg. §1.408A-5, A-8

they will be in a higher marginal bracket at a later date due to tax law changes (for example, taxpayers currently in the two highest tax brackets) should also consider a conversion.

2. **The taxpayer's heirs will be in a higher bracket at some later date**. A Roth IRA passes to the surviving spouse, if named as beneficiary of the spouse's Roth. So, a couple with significant income in a high bracket could benefit from a Roth since the surviving spouse could be in a higher bracket (since the tax rates for married filing joint and single are different). For example, a couple taking RMDs from a large IRA in one spouse's name would have their distributions taxed at Married Filing Joint rates. If one spouse dies, the other now generally continues to receive the RMD, but at the higher Single Taxpayer rate. Similarly, a parent with successful children could be providing a significant legacy benefit to their children if the children were in a higher bracket. Example: Mom is 76, with a pension, Social Security, investment income, and Required Minimum Distributions from her rollover IRA. She is in the 25% bracket. Her son is a successful businessman and in the top bracket, as is her daughter, a physician. Converting part or all of her IRA to a Roth will have a positive tax effect on her children, who will be able to take distributions tax-free over their lifetimes[21]. This can similarly be used with grandchildren (who obviously will have longer life expectancies than their parents). Be careful with the grandkids on large Roth beneficiary designations, there is a 'Generation Skipping Transfer Tax' (and if you are subject to it, you clearly need an advisor[22]).

3. **The taxpayer is in an estate tax situation (subject to prospective Federal Estate Taxes), and a portion of their taxable estate is a rollover IRA or qualified plan**. Using a Roth conversion provides an interesting situation in that the estate is reduced by the taxes on the Roth conversion. For example, suppose taxpayer Bill has an estate worth $4M (and further suppose they actually do change the estate tax credit amount to $3.5M). Bill's rollover IRA is worth $1M. If Bill dies with a conventional IRA, his estate taxes are about $225,000 and his heirs (let's presume his kids) will pay income taxes on the $1M (with some benefit from the rule on income with respect to a decedent[23]). If Bill converts his IRA to a Roth (let's presume he's in the top bracket and would stay there), then he would pay about $350,000 in taxes (from outside sources) on the conversion. His estate taxes would be $67,500, because the estate taxes are reduced by the income taxes paid on

[21] Non-spouse beneficiaries of an inherited Roth must take Required Minimum Distributions. This means the maximum period they can stretch withdrawals is over their life expectancy. IRS Notice 2007-7, 2007-5 I.R.B. 395. Funds are segregated in an inherited Roth and may not be combined with other Roths.

[22] At the time of the publishing of this paper, the GST was repealed for the year 2010. It is the opinion of the author the tax will be reinstated (prospectively retroactively) to either a 3.5M or $5M credit equivalent.

[23] See Rev. Rule 92-47, 1992-1 CB 198.

the conversion (I know, it sounds weird). His kids would get the $1M Roth tax-free over their lifetimes.

4. **The taxpayer has significant unneeded Required Minimum Distributions (RMD**). This applies to taxpayers in high brackets over age 70 ½ who don't need the funds from their RMD for living expenses. Take Paul and Candace, who are both over 70 ½, have considerable pensions and collect Social Security. Furthermore, presume they have sufficient assets and income from those assets to preserve their lifestyle (say $150,000). They have $2M in rollover IRAs from their respective employers. Both are age 72. If they live to a collective age of 90 (it doesn't matter which dies first if they have spousal rollover provisions), they will have taken over their lifetimes, cumulative RMDs of about $3.05M. On those RMDs, the cumulative federal taxes would be about $957K[24] (presuming no tax increase). If they made 8% on the IRA, their IRAs would be worth about $3.1M on the last spouse's death (which the kids would then pay income taxes on). If they accumulated the extra RMDs after tax and made 4% on the accumulation, they would have about $4.2M more in their estate pre-estate tax for the heirs. If they converted the entire IRA balance to a Roth, they would have paid about $787K in taxes to convert (which would shrink the taxable estate by that amount). Their Roth, if left undisturbed, would grow to $8M. Bottom line: under the conventional IRA arrangement, the kids get $3.05M taxable and $4.2M after-tax (total $7.25M). Under the conversion, we have $8M. $750,000 positive difference.

SEGREGATED ROTH CONVERSIONS: VERTICAL, HORIZONTAL AND MATRIX SEGREGATED ROTHS

A **Segregated Roth Conversion** is where you use multiple Roth IRA accounts to facilitate flexibility in the conversion[25]. The reason for segregating the Roths is the rule of 'recharacterization'. Like a Mulligan in golf, the recharacterization rule lets you 'unconvert' a Roth if you decide it wasn't a good idea. You can even use it to take advantage of market moves. Suppose you convert a Traditional IRA to a Roth when the account is worth $10,000, and later the market corrects and your Roth is now worth $8,000. You can recharacterize the Roth at $8,000 and then reconvert back to a Roth. Like a Mulligan in golf can only be used once per round, recharacterization can only be done once a year. An interesting point is that you can recharacterize a Roth anytime until the due date of your return for the year, including any extensions, regardless of when you file your return (you do have to file it timely to get the use of the extension to recharacterize, though). So if you converted a Roth in 2009, you would have

[24] For purposes of this illustration, state income taxes are ignored.

[25] See Reg. §1.408-5, A-2(b), (c)(5) and (6), Example 2. See further Robert Keebler's article in *Taxes*, June, 2003.

until 10/15/2010 to recharacterize it. If you convert in 2010, you have until 10/15/2011[26] to recharacterize. There are some rules about re-characterization, so you want to make sure you keep your converted Roth separate from a contributory Roth, if you might recharacterize (and as I said earlier, why not keep your options open?). In addition, you can only recharacterize a traditional IRA contribution, not a SIMPLE or SEP.

With Roth conversions, you can have multiple do-overs. The rules on recharacterization are at the account level. This means you can have multiple Roth conversion accounts, and can selectively recharacterize those conversions. There is nothing in the current tax law that prevents this. By segregating Roth conversion IRAs, each holding different investments you may selectively recharacterize. Suppose you have a $100,000 traditional IRA consisting of $50,000 of AAPL stock and $50,000 of F stock. Suppose further the AAPL goes down to $35,000 and the F goes up to $60,000. If you convert both securities into one Roth, you may only recharacterize the entire account, your tax savings would only be on $5,000 (the original $100,000 conversion, less the $95,000 recharacterization). But suppose you made two Roth conversions into separate accounts, maybe a day apart, one holding AAPL and the other holding F? The AAPL Roth could be recharacterized, and the F Roth could be left alone, you are then saving ordinary income tax on $15,000. If you wait until the next taxable year (or at least 30 days, whichever is longer) you could reconvert the AAPL to another Roth.

Under this Vertically Segregated Roth, if one Roth goes up, you simply leave it alone. If one goes down, you can recharacterize that Roth, and possibly reconvert it at the lower value. This could be taken to the extreme by creating many Roth conversion accounts, encompassing multiple assets classes (a Roth containing Large Cap domestic stocks, another holding Emerging Markets or commodities) but the general idea is to allow flexibility for recharacterizations – numerous Mulligan opportunities. After the recharacterization date has passed, you may want to blend the Roth accounts together to simplify record keeping. Also recognize that recharacterization and reconverting re-starts the five-year holding period for the Roth conversion IRA.

Horizontally Segregated Roth. Segregating Roth conversions into individual Roth accounts allows for flexibility in recharacterizing the decline of a specific asset or asset class. If recharacterizing a segregated Roth account when it declines in value is good, then **not** recharacterizing a segregated Roth account when it has increased in value can also be good. Hence, our latest plan, the horizontally segregated Roth conversion or the '**Layered Roth Conversion'**. Here's how it works:

You determine in advance two major things: a) how much you want to remain in a traditional IRA and b) what asset allocation you prefer to use in the combined conventional and Roth IRAs. You then determine what the maximum market gain your asset allocation could return during

[26] Assuming the tax return or extension is timely filed.

the allowable recharacterization period. For our purposes, presume you are converting in 2010, so the recharacterization period is from the date of conversion to the due date of your 2010 return, including extensions, or October 15, 2011.

Next step: You set up multiple Roth conversion IRA accounts. One is a 'base' conversion Roth that we expect to be recharacterized back to the converted amount. To determine the amount of the base layer, you take the estimated maximum gain during the recharacterization period and 'gross up' the gain into the base layer. So if you expect the maximum gain for the period 01/01/10 to 10/15/11 to be 25%, then your base layer would be 80% [1.00/(1.00 + .25)]. If you thought the market was going up 40%, you'd set the base at 72% [1.00/(1.+.40)]. The next group of Roths are 'layers', of increments of potential market gain. You can set these layers at any increment, like 1-5%. You have the option of dollar cost averaging the layered portions if you're inclined to do so. For purposes of illustration suppose I think the maximum gain I can expect on a balanced portfolio for the conversion period from 01/02/10 to 10/15/11 is about 25% (I hope I'm wrong on the low side). I'd set up a base Roth conversion with 80% of my assets and 8 separate Roth conversions of 2.5% each (the "Layered Roths"). So if I had a $1,400,000 IRA that I wanted to stay in traditional form, it would look like this:

Base IRA	$1,120,000
Layer 1	35,000
Layer 2	35,000
Layer 3	35,000
Layer 4	35,000
Layer 5	35,000
Layer 6	35,000
Layer 7	35,000
Layer 8	35,000

Now, here's where we have some fun. Here are the rules, and note that even though we wanted to keep $1,400,000 in our traditional IRA, we converted the whole thing.

If the market goes down or stays flat: We recharacterize the whole thing, and we are back where we started. No income taxes are due! If the market was flat and we didn't like the tax situation (say, for example, it was imminent that tax rates would increase), we can selectively recharacterize.

If the market rises: For every 2.5-3%[27] increment the market goes up, we leave one of the Layered Roths in their Roth form. So if the market rises by 2.5%, we recharacterize the base and layers 1-7, leaving layer 8. If the market goes up by 10%, we recharacterize the base and layers 1-4, leaving layers 5-8 in their Roth form.

[27] Theoretically, you would recharacterize for every 2.54% increment. [1-(1/(1+0.025))].

What we're doing should be obvious: we're taking the profits and turning them into Roths. If the market rose 10% during the recharacterization period (I think that's reasonable), our happy little family of segregated Roth IRAs would grow to $1,540,000. If we recharacterized the base and layers 1-4, we'd pay tax on only the $140,000 basis of conversions in levels 5-8. We'd still have $1,386,000 in our conventional IRA (because we recharacterized it), and now have $154,000 in our Roths IRAs. Risk? If the market goes down, we recharacterize the whole thing and call it an exercise in paperwork management. Market goes up, we turn the taxable gains that you would have had in the traditional IRA (had you done nothing), into tax-free money with all the tax advantages of a Roth. Market is flat, we have time to rethink our strategy. Flexibility all around.

Why so darn many Roths? Simple reason: you can't 'cherry pick' your assets. Roth recharacterization is done at the account level, and you can't selectively recharacterize the assets of a Roth Conversion. Layering allows you to keep the gains and return the original amount.

You could carry this to the extreme and layer at 1% levels. You can also combine this strategy with the Vertical Segregated Roth strategy. For example, you could take the part you know you want in a Roth and segregate it into asset class conversion Roths and then take the rest of the IRA and layer it. You'll drive your custodian crazy, but you save taxes on downswings (with the asset class conversions and earn tax free gains on the upside (on the layered conversions).

Matrix Roth. Segregating Roth conversions into individual Roth accounts allows for flexibility in recharacterizing the decline of a specific individual Roth. If recharacterizing a segregated Roth account when it declines in value is good, then **not** recharacterizing a segregated Roth account when it has increased in value can also be good. Vertically Segregated Roth accounts are where you take specific asset classes (or even individual securities) and sequester them in individual Roth IRA accounts. This allows you to recharacterize those individual accounts. A Horizontally Segregated Roth conversion or the Layered Roth Conversion is where you segregate 'layers' of prospective account appreciation into segregated accounts, then reconverting the base and selectively reconverting the layers. A Horizontally and Vertically segregated Roth, or 'Matrix' conversion is where you do both. Here's how it works:

You set up multiple Roth conversion IRA accounts. One is a 'base' conversion Roth with about 75-80% of the converted amount (this is the 'base' amount that will be recharacterized under most circumstances). This portfolio would be allocated very similar to your traditional IRA without a conversion. The next group are 'layers', of increments of potential market gain except this time with variations of asset class. For purposes of illustration suppose I think the maximum gain I can expect on a balanced portfolio for the conversion period from 01/02/10 to 10/15/11 is about 25% as I used in the prior example. I'd set up a base Roth conversion with 80% of my assets and 8 separate Roth conversions of 2.5% each (the "Layered Roths"). Notice each layer has a slightly different amount based on the asset allocation strategy you desire. So if I had a $1,400,000 IRA, and I wanted the asset allocation to be 60% equities and 40% fixed; it would look like this:

Base Roth	Balanced 60/40	$1,120,000
Roth 2	Equity (Lg Cap)	42,000
Roth 3	Fixed (Inv Grade)	28,000
Roth 4	Equity (Sm Cap)	42,000
Roth 5	Fixed (Inv Grade)	28,000
Roth 6	Equity (Intl)	42,000
Roth 7	Fixed (High Yld)	28,000
Roth 8	Equity (Emerging Mkt)	42,000
Roth 9	Fixed (Emerging Inc)	28,000

Now, here's where we have more fun.

If the whole market goes down or stays flat: Let's suppose (gasp!) that everything goes down: then we recharacterize the whole thing, and we are back where we started. No income taxes are due!

If the whole market or certain asset classes rise: What happens in a market increase is that certain segments will do better than others. In this case, we can selectively recharacterize the lower performers and leave the gainers. Suppose the outcome on 12/31/10 (note you have longer, until 10/15/11) looks like this:

Base Roth	Balanced 60/40	$1,120,000	1,232,000
Roth 2	Equity (Lg Cap)	42,000	51,000
Roth 3	Fixed (Inv Grade)	28,000	29,400
Roth 4	Equity (Sm Cap)	42,000	54,000
Roth 5	Fixed (Inv Grade)	28,000	29,400
Roth 6	Equity (Intl)	42,000	52,000
Roth 7	Fixed (High Yld)	28,000	33,000
Roth 8	Equity (Emerging Mkt)	42,000	34,000
Roth 9	Fixed (Emerging Inc)	28,000	25,200

What we're doing should be obvious: we're taking the profits and turning them into Roths. If the market rose 10% during the recharacterization period (I think that's reasonable), our happy little family of segregated Roth IRAs would grow to $1,540,000. What we now do is selectively recharacterize: we recharacterize the Base, plus Roths 3, 5, 7, 8, and 9. We now have $1,383,000 in our traditional IRA, which is almost the original balance we started with at the beginning of the year. We also now have $157,000 in Roths (Roths 2, 4, and 6), that we only have to pay taxes on $126,000 Risk? If the entire market goes down, as before, we recharacterize the whole thing and call it an exercise in paperwork management. Market, or parts of the market go up, we turn the gains into tax-free money with all the tax advantages of a Roth.

How much to layer? Given you have the opportunity to seize gains tax free and recharacterize the rest, I'd go long; Mulligans are free and unlimited, with the right planning.

ESTATE PLANNING RAMIFICATIONS OF ROTH CONVERSIONS

Reduction of Estate Taxes. There is a curious element of Roth conversion as it relates to Federal Estate Taxes. A Roth conversion effectively allows you to prepay the income taxes for the heir on the Roth conversion, plus reduce the estate taxes by the income taxes paid[28]. For individuals with a taxable estate, converting some or all of a regular IRA to a Roth effectively creates a tax-free annuity for the heirs. A Roth conversion left to a spouse becomes the spouse's Roth. On the spouse's death, they can leave it to their heirs (presumably the children or grandchildren) and the children have an inherited Roth IRA. For the children, the inherited Roth IRA, not being their IRA, is subject to Required Minimum Distributions. But the children can take those RMDs over their live expectancies, tax-free. So a married couple who converts a $1M IRA to a Roth might pay $350,000 in income taxes, which is in effect a $350,000 deduction from their taxable estate. On their death, their spouse would inherit the Roth IRA and treat it as their own. On the spouses, death the children would inherit the Roth IRA and take RMDs.

If we put some number to the situation, it may look like this: suppose the taxpayer is age 70, and the spouse is as well. The survivor of the taxpayer and spouse die at age 90, leaving the Roth to two children, who are both age 60 at that time. Assume a 7% growth rate on the Roth. They start with $1M, pay $350,000 out of outside funds. By the date of death of the survivor, they have $3,870,000 in the Roth. The children would then take an RMD using their life expectancy from the IRS Table One[29] (25.2 year). This would allow them a tax-free annuity of about $165,000 a year each.

This situation is changed further when you take into consideration that the IRA owners are over age 70 ½ and taking RMDs. Consider an expansion of the previous example of Paul and Candace:

> Paul and Candace are both over 70 ½, so they must take RMDs, have considerable pensions and collect Social Security. Furthermore, presume they have sufficient assets and income from those assets to preserve their lifestyle (say $150,000), and will be subject to Federal Estate Taxes if the current exemption is $3.5M or less. They have $2M in rollover IRAs from their respective employers. Both are age 72. If they live to a collective age of 90 (it doesn't matter which dies first if they have spousal rollover provisions), they will have taken over their lifetimes, cumulative RMDs of about $3.05M. On those RMDs, the cumulative Federal Income taxes would be about $957K (presuming no tax increase). If they made 8% on the IRA, their IRAs would be worth about $3.1M on the last spouse's death (which the kids would then pay income taxes on). If they accumulated the extra RMDs after

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[28] Note that unlike gift taxes on gifts made within 3 years of death, income taxes paid on a Roth conversion within three years of death is not brought back into the estate for purposes of computing estate taxes.

[29] IRS Pub 590

tax and made 4% on the accumulation, they would have about $4.2M more in their estate pre-estate tax for the heirs. If they converted the entire IRA balance to a Roth, they would have paid about $787K in taxes to convert (which would shrink the taxable estate by that amount). Their Roth, if left undisturbed, would grow to $8M. Bottom line: under the conventional, the kids get $3.05M taxable and $4.2M after-tax (total $7.25M). Under the conversion, we have $8M. $750,000 positive difference for the parents to pass on to their children.

Taking it to the kid's level, under the no-Roth scenario, the kids would have inherited from mom and dad a taxable IRA of $3.1M and the after-income-tax accumulation of RMDs of $4.2M. Assuming they were in the 30% bracket and made 7% on investments (for purposes of this illustration, presume the kids make the same on tax-deferred and taxable assets, except pay tax on the distributions). If the kids were age 60 at the date of the second parent to die, they would have IRA taxable RMDs of $261,000 a year[30], and taxable investment income of $294,000 a year (total $555,000/yr. taxable). If we amortize the taxable assets to make the illustration robust, the total imputed income stream under the taxable scenario is about $620,000. Under the Roth scenario, the kids would have an annual tax-free distribution of about $684,000[31]. If the kids are in the 35% bracket, the difference is monumental: Over the 25.2 year period, the kids receive almost $4 million more after tax under the Roth scenario!

Other Estate Issues. Obviously, a Roth IRA should not be left to a charity as a designated beneficiary. It is counterproductive to leave tax-free money to a tax-exempt entity. As Natalie Choate points out, Roth IRA distributions can ease the problem of leaving retirement benefits to a "Qualified Domestic Trust" (QDOT) for the benefit of a noncitizen spouse. The Roth is not subject to income with respect to a decedent like conventional retirement plan benefits may be.

Leaving Roth death benefits to grandchildren can be a remarkable legacy wealth creation tool. Note that a distribution to grandchildren would be a 'direct skip' under the Generation Skipping Transfer[32] tax (GST). However, using a Roth eliminates the GST tax on the income taxes inherent in a conventional IRA. In other words, you don't pay tax on the tax.

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[30] Assumes amortization of IRA balance over 25.2 years, at 7%, annual withdrawal

[31] Same assumptions as in footnote above

[32] IRC§2601. Note that at the time of this paper, the GST does not apply to transfers made after 12/31/2009

WHAT CAN GO WRONG?

"No Man's life liberty or property is safe while the legislature is in session." Judge Gideon Tucker

Change in Tax Laws: The above discussion of Roth IRAs and Roth conversions is predicated on the current laws staying the same.

Congress could tax Roth distributions. Some aspects of future taxation of Roths include a change in the tax-free nature of distributions from Roths, or a consumption based tax. The prospect of future income taxation of Roths is possible, but would probably be prospective in nature. In other words, Congress could change tax laws to make distributions from Roths taxable, but would hopefully apply that only to distributions after the law change. Another prospect is not to tax Roth distributions, but to tax what Roth distributions are spent on. Clearly a consumption based tax (like a Value Added Tax) would tax not only Roths, but municipal bond income and a plethora of other forms of income, if spent. My version is that future tax increases are inevitable, especially for higher income taxpayers.

Congress could prohibit conversions. Clearly, another means by which Congress can change the Roth rules is to prohibit conversions, which precludes the strategies we've suggested for the high net-worth high-income individual. From the Committee reports on the original Roth legislation, Roths were intended as a retirement savings tool for the lower and middle income individuals and not an advanced estate and income tax planning tool for higher asset higher income families. However, note that by allowing conversion at all levels, the government is collecting the taxes *now* on the conversion, rather than over time as taxpayers take their RMDs. Do you think they want your money now or later? We can only plan for the law as it is now while allowing enough flexibility to make changes as tax laws and markets change. Nimbleness is an important attribute in all planning, and Roth planning is no exception.

Leon C. LaBrecque JD, CPA, CFP® CFA is the CEO and Chief Strategist at the independent advisory firm of LJPR, LLC. LJPR reduces uncertainly for their clients and their families by applying creative wealth management solutions in tax, financial planning, retirement planning and estate planning. To contact us for a consultation or to discuss your financial situation, email info@ljpr.com or call at 248-641-7400. Also visit our blog and website http: LJPR.com

LJPR: Reducing Uncertainty™

Form **8606**

Department of the Treasury
Internal Revenue Service (99)

Nondeductible IRAs

▶ See separate instructions.

▶ Attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-0074

2009

Attachment Sequence No. 48

Name. If married, file a separate form for each spouse required to file Form 8606. See page 5 of the instructions. | **Your social security number**

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street, or P.O. box if mail is not delivered to your home) | Apt. no.

City, town or post office, state, and ZIP code

Part I Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs

Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2009.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2009 **and** you made nondeductible contributions to a traditional IRA in 2009 or an earlier year. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster recovery assistance distribution), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2009 (excluding any portion you recharacterized) **and** you made nondeductible contributions to a traditional IRA in 2009 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2009, including those made for 2009 from January 1, 2010, through April 15, 2010 (see page 5 of the instructions)	1	
2	Enter your total basis in traditional IRAs (see page 5 of the instructions)	2	
3	Add lines 1 and 2	3	

In 2009, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion?

No ▶ Enter the amount from line 3 on line 14. Do not complete the rest of Part I.

Yes ▶ Go to line 4.

4	Enter those contributions included on line 1 that were made from January 1, 2010, through April 15, 2010	4	
5	Subtract line 4 from line 3	5	
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2009, plus any outstanding rollovers. Subtract any repayments of qualified disaster recovery assistance distributions. If the result is zero or less, enter -0- (see page 6 of the instructions)	6	
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2009. **Do not** include rollovers (other than repayments of qualified disaster recovery assistance distributions), qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see page 6 of the instructions)	7	
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2009. **Do not** include amounts converted that you later recharacterized (see page 6 of the instructions). Also enter this amount on line 16	8	
9	Add lines 6, 7, and 8	9	
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× .
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11	
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12	
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions	13	
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2009 and earlier years**	14	
15a	Subtract line 12 from line 7	15a	
b	Amount on line 15a attributable to qualified disaster recovery assistance distributions (see page 6 of the instructions). Also enter this amount on Form 8930, line 22	15b	
c	**Taxable amount.** Subtract line 15b from line 15a. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	15c	

Note: *You may be subject to an additional 10% tax on the amount on line 15c if you were under age $59^1/_2$ at the time of the distribution (see page 7 of the instructions).*

Part II 2009 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs

Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2009 (excluding any portion you recharacterized).

Caution: *If your modified adjusted gross income is over $100,000* ***or*** *you are married filing separately and you lived with your spouse at any time in 2009, you* ***cannot*** *convert any amount from traditional, SEP, or SIMPLE IRAs to Roth IRAs for 2009. If you erroneously made a conversion, you must recharacterize (correct) it (see page 7 of the instructions).*

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2009. **Do not** include amounts you later recharacterized back to traditional, SEP, or SIMPLE IRAs in 2009 or 2010 (see page 7 of the instructions)	16	
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see page 7 of the instructions)	17	
18	**Taxable amount.** Subtract line 17 from line 16. Also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	18	

Part III Distributions From Roth IRAs

Complete this part only if you took a distribution from a Roth IRA in 2009. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster recovery assistance distribution), qualified charitable distribution, one-time distribution to fund an HSA, recharacterization, or return of certain contributions (see page 7 of the instructions).

19	Enter your total nonqualified distributions from Roth IRAs in 2009 including any qualified first-time homebuyer distributions (see page 7 of the instructions)	19	
20	Qualified first-time homebuyer expenses (see page 7 of the instructions). **Do not** enter more than $10,000	20	
21	Subtract line 20 from line 19. If zero or less, enter -0- and skip lines 22 through 25	21	
22	Enter your basis in Roth IRA contributions (see page 7 of the instructions)	22	
23	Subtract line 22 from line 21. If zero or less, enter -0- and skip lines 24 and 25. If more than zero, you may be subject to an additional tax (see page 7 of the instructions)	23	
24	Enter your basis in conversions from traditional, SEP, and SIMPLE IRAs and rollovers from qualified retirement plans to a Roth IRA (see page 7 of the instructions)	24	
25a	Subtract line 24 from line 23. If zero or less, enter -0- and skip lines 25b and 25c	25a	
b	Amount on line 25a attributable to qualified disaster recovery assistance distributions (see page 7 of the instructions). Also enter this amount on Form 8930, line 23	25b	
c	**Taxable amount.** Subtract line 25b from line 25a. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	25c	

Sign Here Only If You Are Filing This Form by Itself and Not With Your Tax Return

Under penalties of perjury, I declare that I have examined this form, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date

Paid Preparer's Use Only				
Preparer's signature		Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code			EIN	
			Phone no.	