tax and financial ISSUES

December 2010 | Taxpayers try to reconcile their particular tax situation against an uncertain legal and economic situation. Things to consider before year-end 2010...

Roth Conversion Strategy

Acting rationally in the face of an unsteady economy and dysfunctional government

Background

Since the early 1980s, Americans have been using tax deferred pension and IRA accounts as the principal vehicles for retirement savings. This asset accumulation was supported by direct contributions to IRA accounts and tax free rollovers from employer pension plans.

Most IRA accounts were funded with deductible contributions, giving the accounts a zero-tax basis. This means that all distributions are taxable income. These accounts are pretax assets. The primary exception occurs when non-deductible contributions are made to IRAs. Tax basis usually amounts to a small percentage of fair market value.

In 1998 the Roth IRA was created. It is an account where future distributions are exempt from taxation. These accounts had to be funded with nondeductible contributions.

Congress also allowed for taxable transfers from regular IRA accounts to Roth accounts as long as a taxpayer's Adjusted Gross Income is below $100,000. These taxable transfers are essentially after tax contributions. Effective for 2010, the income limit on Roth conversions was eliminated.

If Roth conversions are made in 2010, the income is recognized ratably in 2011 and 2012 unless the taxpayer elects to recognize the income in 2010.

Required IRA distributions

Distributions for taxable IRA accounts must commence starting within six months of when the account owner turns 70½. Single life tables are used for most taxpayers, but married taxpayers can use joint life tables that allow for smaller minimum distributions.

In comparison, distributions are not required from Roth IRA accounts during an owner's lifetime. However, unless the account is rolled over to a surviving spouse, distributions must be commence in the calendar year following the owner's date of death if the beneficiary wants to make distributions over his or her life.

The Great Unwinding

So you are a baby boomer who has saved diligently over the past 30 years. You have contributed the maximum amount to your 401(k) and IRA each year. Now you are approaching the time when you need to access the money for retirement. You have some simple goals.

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- You would like to make IRA withdrawals at low tax rates.

- You would like your retirement assets to retain their purchasing power.

- You would like to avoid paying taxes on retirement assets until you need to make withdrawals to meet living expenses.

- You would like to leave some assets on the table for the next generation in the event you are fortunate enough to not need them yourself.

- In the event you are able to leave IRA assets to your heirs, you don't want the value to be eroded by estate taxes.

- And finally, you don't want to see your thrift punished by means testing of benefits.

Most individual anticipated being able to make IRA distributions at reasonably low tax brackets after retiring.

Roth Conversion Mechanics

A conversion is elected by transferring assets from a traditional IRA account to a Roth IRA. The transfer is taxable. The excess of the fair market value of assets transferred over their tax basis is a taxable transaction.

The transfer must occur by the last day of the tax year.

You can reverse the conversion until the extended due date of your tax return for the year of conversion.

Current developments

Individuals approaching retirement age are now looking at the management of our economy with a fair amount of trepidation. They believe that:

- Runaway government spending will lead to higher taxes.

- Federal Reserve money printing in the guise of economic stimulus will lead to inflation and a loss of purchasing power.

- Social Security and Medicare will be subjected to means testing as a way of reducing government deficits.

All of these factors are upsetting the conventional approach to managing IRA accounts.

Traditional IRA strategy

IRA strategies have involved a mix of the following:

- **Maximizing the deferral period**
  Make only Minimum Required Distributions (MRDs).
  Use assets outside IRA accounts for living expenses.
  Name younger spouses as designated beneficiaries.
  Name grandchildren as designated beneficiaries.

- **Minimize state taxes**
  Establish residency in a state with no state income tax, or in a state that doesn't tax retirement income.

- **Minimize the expected tax rate on distributions**
  Take taxable distributions in years when taxable income is low.
  Name individuals with low tax brackets as designated beneficiaries.

- **Control living expenses so you don't have to accelerate distributions.**

Call this the maximum deferral strategy. You try to delay the tax event (distributions) as long as possible, and minimize the tax rates.

Caution: This strategy is sub-optimal for individuals who expect to be paying estate taxes. When estate taxes are incurred with respect to a traditional IRA, the estate taxes are itemized deductions. However, the income tax benefit is usually minor because of the standard deduction or itemized deduction phaseouts. It's usually better for the account owner to pay the income taxes by making a Roth conversion. The tax payment reduces the size of the taxable estate.

The current economic and tax environment collides with the maximum deferral strategy.

To bring the change of environment into focus, taxpayers need to focus on certain key issues.

- Bond yields
- Income tax rates
- Estate tax rates
- Possibility of hyperinflation
- Validity of inflation indexing calculations
- Means testing of benefits

The following table shows these sea changes. From 1980 to 2000, the period when tax advantaged saving gathered momentum, the environment was supportive. Looking forward from 2010, the environment looks less favorable, it not hostile.

Effect of Economic Environment on IRA Management

Economic Environment	Regular IRA - With Maxiumum Deferral Strategy	Roth Conversion Strategy	Comments
Low bond yields	Good (Preserves Capital)	Poor (Low tax-free income)	How long do you expect the low interest rate environment to last?
Rigged CPI calculations	Poor	Good	It's preferable to pay taxes at the lower rates before inflation indexing distorts tax brackets.
Estate tax paying?	Poor	Good	Paying the income tax on the Roth conversions reduces the size of your estate.
Hyperinflation	Uncertain	Uncertain	Tax rates in this environment would be difficult to estimate.
Means testing of benefits	Poor	Good	The Roth conversion lowers your income in future years.

- **Bond yields**
  From 1980 to 2000, bond yields were high and decreasing. Not only could investors capture these yields in exempt accounts, capital gains were possible. When yields are low and increasing, there is the risk that capital losses will more than offset interest income.

- **Income tax rates**
  Most individuals that have used credit understand that spending now means that you will spend less in the future. Nonproductive stimulus spending now must be paid for out of future income, leaving less for consumption. This translates into higher taxes for servicing government debt.

  The key to tax arbitrage is to create deductions at high tax rates, and recognize income at low rates. From 1980 to 2010, tax rates decreased. Now it appears they can only go up. This reduces the attractiveness of tax deferrals.

- **Possibility of hyperinflation**
  In 1981 the 30 year treasury bond peaked at 15.25%. The Federal Reserve under Paul Volcker jacked up short-term interest rates to snuff out inflation. After stoking a housing bubble, the Federal Reserve now pines for the return of inflation so debtors can be bailed out. The problem with printing money is that you never get exactly the inflation that you want.

- **Validity of inflation indexing calculations**
  Questions have been raised as to whether the Consumer Price Index (CPI) reflects real changes in the cost of living. The CPI has been morphing toward becoming a standard of living index. The index now reflects changes in the quality of goods purchased and product substitution.

  CPI calculations are important because government payments like Social Security and TIPS (Treasury Inflation Protected Securities) bond payments are determined by CPI changes. Tax rates are inflation indexed. Understating inflation increases taxes because nominal incomes increase faster than indexing increases tax brackets.

  The government has a real incentive to understate inflation. If inflation gets to unmanageable levels, what confidence will you have in the inflation indexing calculations?

- **Means testing of benefits**
  Before the baby boomers starting hitting retirement age, there will plenty of workers paying into the system relative to retirees. When boomers starting retiring the financial pressure increased, as the ratio of workers retirees trended lower. Since 2007 higher income taxpayers have paid more for Medicare benefits.

  There is a well grounded fear that taxpayers who have behaved well (worked, limited consumption, saved consistently and accumulated retirement assets) will be punished by losing benefits.

Effect of Environmental Changes on Roth Conversion			
Factor	1980 - 2000	2010	Comments
Bond Yields	High & Decreasing	Low and Increasing	An unfavorable change discouraging Roth conversions
Income Tax Rates	Trending Lower	Trending Higher	A change supporting Roth conversions
Estate Tax Thresholds	Increasing	Set to be inflation indexed	You just need to know if you will be paying estate taxes on the IRA.
Prospect of Hyperinflation	Decreasing (After '81)	Increasing	A change that support Roth Conversions. You are able to leave assets in the account to compound tax free.

Current tax developments

- **Two-year extension of the Bush tax cuts**
  Call this the calm before the tax increases. As this letter is being written, a two-year extension of the current tax rates is being negotiated in Congress. If approved, the Democrats will get two years of deficit financed stimulus. The Republicans will get to look tough against those tax-and-spend Democrats. Neither has a clue as to how to unwind the overhang of debt. The fact that tax laws are being voted on during the last month of the year speaks for itself.

  All this does is clear the air for individuals doing Roth conversions in 2010. The rates will be set for two years. Taxpayers can elect the two-year deferral of conversion income with confidence that rates will not increase.

- **The estate tax is back.**
  But likely starting at a higher asset level...

  Currently under negotiation are increases in the value of an estate from $3.5 to $5.0 million. If your estate will exceed $5.0 million, assume that your IRA will be subject to estate taxes. If you expect to pay estate taxes, this makes Roth conversions more attractive. The government had ten years to put the estate tax on a permanent footing. They couldn't get their act together and even let the tax lapse in 2010. Now that's dysfunctional.

- Obamacare
  This has means testing written all over it. Households of moderate means get health insurance subsidies. Higher income households (Adjusted Gross Income > $200,000) pay Medicare taxes on both wage and investment income.

  How does this relate to Roth IRAs? If the maximum deferral strategy will put you into higher brackets in future years, not only will you pay income taxes on the distributions, you will incur Medicare taxes.

The Biggest Risks

So you look at all the environmental uncertainties and decide that it is prudent to do a Roth conversion for protection against future tax increases. What can go wrong?

- **Risk of a market decline**
  Well, once an income tax is paid, you've established your tax basis in the Roth IRA. If your IRA is invested in stocked, it's as if you marked your portfolio to market. If there is a decline in value after the

date of conversion, you get no tax benefit for the loss. Ugh. If you had kept your assets in a traditional IRA, if the market craters, at least you didn't pay any income tax.

- **The Federal Reserve continues its low interest rate policy**
  The idea behind stashing money in a Roth IRA is all those outsized returns that you plan to earn in the future will be tax free. You don't want to pay a 35% income tax for the privilege of earning a 2.5% rate of return. It will take until your next lifetime to restore your principal.

Mitigating the risks

- **Maximize the benefits of tax arbitrage**
  Only convert when you are in a low tax bracket. Only convert when you have a good estimate of your tax bracket. If your income is uncertain, only convert late in the year. This requires taxpayers to calculate their income taxes with and without the Roth conversion.

  Taxpayers also need to do basic estate planning. You need to know if you will be paying estate taxes with the maximum deferral strategy.

- **Use recharacterizations**
  To protect against poor decisions and bad luck, taxpayers are allowed to reverse Roth conversions UP TO THE EXTENDED DUE DATE OF THEIR INCOME TAX RETURN FOR THE YEAR OF CONVERSION. This is called a recharacterization.

  ALL TAXPAYERS WHO DO ROTH CONVERSIONS SHOULD AUTOMATICALLY PUT THAT YEAR'S TAX RETURN ON EXTENSION.

- **Exercise patience and try to time the market**
  The Federal Reserve has lately been trying to boost asset prices with its low interest rate policy. If you believe that this policy can't continue indefinitely, then wait for the policy to be reversed and the related market correction. What you're trying to do is minimize the mark to market adjustment.

- **Stay liquid**
  Convert and invest in short duration fixed income securities. Again, if you expect the low interest rate policy to reverse, you will wait for higher interest rates.

Summary

Before doing Roth conversions:

- Consider the economic and legal environment.

- Consider your specific tax situation in the current year.

- Consider the investment risk.