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DEEP ROOTED THOUGHTS

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Why would I want to pay tax on my entire IRA now?

Throughout my career, I have found incredible consistency among the clients I have assisted in their desire to minimize their income taxes to the fullest extent allowed by the law. In 2010, the government has created a window of time during which all taxpayers, regardless of their income level, can convert their Traditional and Spousal Rollover IRAs to Roth IRAs. Roth IRAs are wonderful investment vehicles which grow tax free like Traditional IRAs but have the added benefits of tax-free distributions and no requirement to take minimum distributions upon reaching age 70. The catch to the conversion is that you must pay income tax on the entire taxable distribution from your Traditional IRA at the time of the conversion. (There is an election that can be made to defer the income tax over the 2011 and 2012 tax years, but the fact is that the income tax consequences are unavoidable upon conversion.)

Assuming your income tax rate stays constant from now through the years during which you will withdraw funds from your IRA, there is no difference in the amount of dollars you will receive after taxes whether you convert to a Roth IRA or not. However, current and future tax rates are only one of the factors to consider when evaluating Roth IRA conversions.

So who should be doing Roth IRA conversions this year? Clearly there are some situations that are perfect candidates and others where the conversions may be detrimental. The challenge is in analyzing the situations that are less obvious and determining which families would benefit from the Roth structure despite the near term tax consequences.

If your facts fit the following pattern, you should strongly consider converting some or all of your Traditional IRA in 2010:

- You have taxable accounts which can pay the taxes due on the conversion
- You have a large Net Operating Loss (NOL) carry-forward from your 2009 income tax return that can offset the income generated from the conversion
- You are NOT in the highest marginal income tax bracket
- You do not anticipate rapidly spending down your IRA account or may never need to touch your IRA accounts in retirement due to the availability of other funds
- You think your future tax rates will be the same or higher than they are now

If you have non-IRA accounts with which you can pay the taxes due on a conversion, the math reveals that you will benefit from doing a conversion because you will have a relatively larger portion of your wealth in a tax-free account following the conversion than you did previously. This will allow for greater growth of your investments.

If all or most of your wealth is held in Traditional IRA accounts, the arguments for converting are not as compelling. In fact, you should not rush to convert if your situation includes the following:

- You are living primarily on your IRA accounts
- You are in the highest marginal income tax bracket
- You have minimal investment assets in taxable accounts
- You believe your future income tax rates will be lower than they are currently
- You have a short life expectancy

There are other factors that make converting more or less attractive but the major ones are included above.

The flexibility available for conversions is significant. You can choose to do a partial conversion rather than a complete conversion. You can reverse the conversion the following year if the account has declined in value. You can create multiple Roth IRAs from a single Traditional IRA.

One conversion strategy that takes maximum advantage of the rules and provides the highest likelihood of success is converting a Traditional IRA account into multiple Roth IRA accounts. Each of the Roth IRA accounts would have a specific investment focus. For example, you might choose to have a Roth IRA account invested solely in emerging market stocks, small company stocks, real estate, or other asset classes with high expected returns and correspondingly high volatility. If all the Roth IRA accounts appreciate in value the first year, they can be combined into a single account for simplified management the following year. If one or more of the Roth IRA accounts loses value, you can reverse the conversion for the account(s) that loses value while retaining the benefits of the accounts that appreciated.

There are no taxes or penalties related to reversing a Roth IRA conversion but the reversal must be completed by the income tax filing date of April 15th or as late as October 15th of the following year if extensions of time to file are granted.

2010 presents us with some new financial planning opportunities and challenges. The ability to convert Traditional IRAs to Roth IRAs is just one example. As always, we look forward to discussing the opportunities with you and helping you find the most appropriate solutions.

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