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The Annual Conference of the Financial Planning Community

TRACK:	TAX & ESTATE PLANNING
SESSION: 979027	EVALUATING THE BENEFITS OF ROTH CONVERSIONS
	SUNDAY, OCTOBER 11, 2009
	11:00 AM - 12:00 PM
PRESENTER:	Michael E. Kitces, MSFS, CFP®, CLU, ChFC
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Michael E. Kitces, MSFS, MTAX, CFP®, CLU, CHFC, RHU, REBC, CASL, CWPP™, is the Director of Financial Planning for Pinnacle Advisory Group, a private wealth management firm located in Columbia, Maryland that oversees approximately \$600 million of client assets. In addition, he is the publisher of the e-newsletter The Kitces Report and the blog Nerd's Eye View through his website kitces.com, dedicated to advancing knowledge in financial planning. Beyond his website, Michael is an active writer and editor across the industry and has been featured in publications including Financial Planning, the Journal of Financial Planning, Journal of Retirement Planning, Practical Tax Strategies, and Leimberg Information Services, as well as The Wall Street Journal, BusinessWeek, CNBC PowerLunch, NBC Nightly News, and more. In addition, Michael is a co-author with John Olsen of "The Annuity Advisor", the first balanced and objective book on annuities written for attorneys, accountants, and financial planners, and is also a co-author of "Tools & Techniques of Retirement Income Planning" with Steve Leimberg and others. Michael was recognized as one of only 5 financial planning practitioner "Movers and Shakers" for 2006 by Financial Planning magazine, and was recognized as one of 20 "Rising Stars in Wealth Management" by Institutional Investor News for 2007. These awards were presented to honor Michael's active work in the financial planning community, serving as a member of the Editorial Review Board for the Journal of Financial Planning, a Moderator for the discussion boards on Financial-Planning.com, a commentator on annuity, retirement distribution, and retirement planning issues for Leimberg Information Services, Inc., and for his work as an active member of the Financial Planning Association at the local and National level. Michael is also a co-founder of NexGen, a community of the next generation of financial planners that aims to ensure the transference of wisdom, tradition, and integrity, from the pioneers of financial planning to the next generation of the profession.

To Roth Or Not To Roth

By:

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To Roth Or Not To Roth

■ Session Outline

- Basic technical rules
- Comparing tax rates & the tax equivalency principle
- Avoiding RMDs
- Using outside money and the contribution cap
- Estate taxes and Roth conversions
- Roth changes coming in 2010
- Applying the framework
- Q&A

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To Roth Or Not To Roth

■ Basic Rules:

- Traditional IRA
 - Potential tax deduction on contribution, tax-deferred growth, taxable withdrawals
 - Deductibility depends on income and whether taxpayer is an active participant
 - Subject to lifetime RMDs
- Roth IRA
 - Never tax deductible on contribution, tax-deferred growth, potential tax-free withdrawals

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■ Basic Rules - Withdrawals:

- Taxable from IRAs
- Potentially tax-free from Roth IRAs
 - Principal always withdrawn tax-free
 - Growth potentially tax-free
 - 5 year rule, AND either
 - After 59 ½; due to disability; after death; first-time homebuyer
- Both subject to 10% early withdrawal penalty unless exception applies

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■ Basic Rules - Conversions:

- Must have less than \$100,000 of modified AGI
- Taxable at the time of conversion
 - Premature withdrawal penalties do not apply at conversion
 - Early withdrawal penalties on principal are excluded if held for 5 years after conversion
 - May be recharacterized back to traditional IRA by tax filing deadline (plus extensions)
 - And may be reconverted after the later of the tax year following conversion, or 30 days

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■ Determining when it is better to use a Roth vs. traditional IRA:

- Current versus future tax rates
- Ability to extend deferral of tax-deferred growth
- Maximum contributions and paying taxes with outside money
- Estate taxes

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To Roth Or Not To Roth

- Current vs. Future tax rates
 - *Tax equivalency principle*

A certain amount of pre-tax income results in the same amount of after-tax wealth in the end, regardless of which account type it goes to, whenever tax rates remain the same

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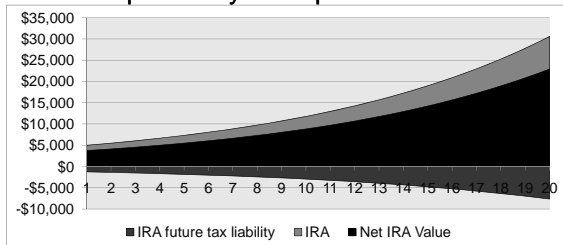
- Client has \$5,000 of pre-tax income to contribute
- Tax rates are currently 25% and are expected to be 25% in the future
- Contribution may be:
 - \$5,000 to Traditional IRA
 - \$3,750 to Roth IRA (less 25% in taxes)
- If account doubles and is then withdrawn:
 - Traditional grows to \$10,000; worth \$7,500 after taxes
 - Roth IRA grows to \$7,500
- When tax rates do not change, final account balances are always equal regardless of growth rate – tax equivalency principle!

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Thanks!

To Roth Or Not To Roth

- Tax Equivalency Principle



- If no value is created when tax rates do not change – tax equivalency principle – then what happens when tax rates do change?

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Thank!

To Roth Or Not To Roth

■ Current vs. Future tax rates

- The goal is to pay taxes whenever the tax rate will be lowest
- If tax rates are lower now than in the future, pay taxes today (Roth IRA)
- If tax rates are higher now and will be lower in the future, defer taxes to the future (traditional IRA)

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To Roth Or Not To Roth

■ Contribution under current 25% tax rates:

- \$5,000 to Traditional IRA
- \$3,750 to Roth IRA (less 25% in taxes)

Final after-tax balance after growth
doubles account value

Future tax rate	15%	25%	35%
Traditional 401(k)	\$8,500	\$7,500	\$6,500
Roth 401(k)	\$7,500	\$7,500	\$7,500

- Pay your taxes whenever the tax rate will be lower!

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To Roth Or Not To Roth

■ What future tax rate will it be?

■ Factors in evaluating future tax rates:

- Withdrawals from pre-tax accounts to support spending or for future RMDs
- Future pension income
- Inclusion of Social Security benefits in income
- Taxable portfolio income
 - Although ordinary income stacks below long-term capital gains and qualified dividends!
- Acts of Congress

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- Additional factor – avoiding RMDs:
 - Relevant only to individuals who live beyond age 70 ½
 - Not relevant past death!
 - Allows dollars to stay in tax-deferred account instead of being forced out into an annually taxable account
 - Greatest value for those who live significantly beyond age 70 ½
 - Allows for slight drop in future tax rates to still benefit Roth 401(k)

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- Additional factor – avoiding RMDs:

Age	IRA	RMD	Taxable Account (EOY)	IRA (EOY)	After-Tax Net Worth (EOY)	Roth IRA equivalent	Breakeven Roth Rate	Wealth Gained
70	\$100,000	\$3,650	\$2,928	\$104,058	\$80,962	\$81,000	24.96%	\$38
71	\$104,058	\$3,927	\$6,279	\$108,142	\$87,357	\$87,480	24.89%	\$123
72	\$108,142	\$4,224	\$10,095	\$112,231	\$94,216	\$94,478	24.79%	\$263
73	\$112,231	\$4,544	\$14,424	\$116,303	\$101,568	\$102,037	24.66%	\$468
74	\$116,303	\$4,887	\$19,318	\$120,329	\$109,447	\$110,200	24.49%	\$753
75	\$120,329	\$5,255	\$24,835	\$124,281	\$117,887	\$119,016	24.29%	\$1,129
80	\$138,710	\$7,418	\$63,953	\$141,796	\$169,844	\$174,873	22.85%	\$5,029
85	\$150,578	\$10,174	\$129,495	\$151,637	\$242,260	\$256,946	21.76%	\$14,686
90	\$149,783	\$13,139	\$233,401	\$147,575	\$342,305	\$377,538	18.08%	\$35,233
95	\$131,030	\$15,236	\$388,799	\$125,057	\$479,577	\$554,726	15.33%	\$75,149

*Assuming 8% growth and 25% current tax rate

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To Roth Or Not To Roth

- Additional factor – maximum contributions:
 - What if an individual wishes to contribute \$5,000 to a Roth IRA – which requires \$6,667 of pre-tax income (at 25% tax rate)
 - Comparable Traditional IRA contribution of \$6,667 is not possible; client would have to contribute \$5,000 to IRA and have \$1,250 in an after-tax account
 - \$5,000 in a Roth IRA grows more favorable than \$5,000 in a Traditional IRA and \$1,250 in a side account

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To Roth Or Not To Roth

- Applying the framework:
 - Estimate current marginal tax rate on contribution or conversion
 - Estimate anticipated future tax rate
 - After accounting for other existing income factors
 - Be certain to take into account the whole picture
 - Be cautious about calculating an accurate future tax liability with different types of income
 - Remember that future withdrawals may be by a surviving spouse or a beneficiary!

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To Roth Or Not To Roth

- Applying the framework:
 - Evaluate to what extent the other factors may apply:
 - Is the client anticipated to live significantly beyond age 70 ½?
 - Are there available after-tax dollars to pay for a Roth conversion, and/or is the client maximizing the Roth contribution limit?
 - Will state estate taxes be a factor?
 - Will Federal estate taxes be a factor (if the IRA is most of the estate)?

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To Roth Or Not To Roth

- Applying the framework:
 - A word about future tax rates
 - Higher future taxation – in general – does not necessarily mean a higher tax rate on IRA withdrawals
 - Payroll taxes
 - VAT taxes
 - National sales taxes
 - Exemptions for seniors/retirees
 - More progressive tax bracket structure

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- Roth vs. traditional IRA summary:
 - Tax equivalency principle means starting point is to focus on current versus future tax rates
 - Pay the tax when the tax rate is anticipated to be lowest
 - Avoiding RMDs allows for a slightly lower future tax rate to still favor the Roth
 - Making maximum contributions and paying taxes with outside money has a similar effect
 - Estate tax impact possible, but client specific

Questions?

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