A Keystone Financial Solutions, P.C. White Paper

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Converting a Traditional IRA to a Roth IRA . . .

One of the Most Important Financial Decisions You May Ever Make

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INTRODUCTION

The tax rules regarding Roth IRAs (Individual Retirement Accounts) is going to dramatically change effective January 1, 2010. Americans are going to be besieged with radio announcements, seminar invitations, webinar invitations, direct mail advertising, newspaper ads, television sound-bites, etc. recommending that they convert their traditional IRA accounts (and other retirement plans) to a Roth IRA beginning in 2010. This tax law change poses **significant tax and financial planning challenges and opportunities**, particularly for high-income (wealthy) taxpayers who have previously been precluded from contributing to a Roth IRA or converting their traditional IRA to a Roth because of qualifying income limitations.

When I began to write this paper, my focus was solely on the tax considerations of determining whether a Roth conversion made sense. However, I quickly realized that this conversion decision transcends taxes. This is a great opportunity for IRA account holders to reevaluate their retirement planning strategies. And for those of you who have not considered the adequacy of your retirement plans, this is an excellent time to begin. When you don't have a plan, you end up making emotional instead of educated decisions. When knowledge is used, it is a powerful tool and the key to a brighter financial future. When knowledge is not used, it succumbs to inertia.

It is vital that anyone with a traditional IRA and who is thinking of converting to a Roth IRA carefully consider if this conversion opportunity is in their best financial interest, and if it is, how to best position their retirement funds.

I have written this paper to summarize pertinent issues that you need to understand before making this conversion decision and why it is of the upmost importance to consult with a competent and knowledgeable financial advisor. You need to control your finances. Otherwise, your finances will control you.

DISCLAIMERS

Pursuant to IRS Circular 230, I am required to advise you that any advice included in this communication, including attachments and enclosures, is not intended or written to be used, and it cannot be used by you or any other person or entity, for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.

This paper is designed to provide accurate and authoritative information regarding the subject matter covered. I am not assuming any responsibility for errors and omissions and specifically disclaim any liability resulting from the use or application of the information contained herein. I am not an attorney nor am I securities licensed. Thus, this information is neither intended nor should be relied upon as legal, tax, financial, investment or any other advice related to your individual situation. Laws and products change rapidly, and you want to make sure when you implement a plan that it is based on the most current information available. If you need individual advice on the topics covered in this paper, please contact me or another qualified professional for an individual consultation. You should always seek counsel from a competent

advisor before taking actions based on this or any publication. This paper is designed to provide relevant information in regard to the subject matter discussed herein with the purpose of educating you about the various factors that need to be considered when analyzing a Roth conversion.

BACKGROUND INFORMATION

With a traditional IRA, you make a contribution today (sometimes tax deductible) and the money ***grows tax deferred*** until it is distributed to you. Beginning with age 70.5, you are **required** to receive a RMD (required minimum distribution) from your IRA. It does not matter if you need the money, by law you are required to receive the RMD. If you fail to take your RMD, the IRS imposes a very onerous 50% excise tax penalty on the RMD shortfall. *The RMD is taxed as ordinary income to you in the year received*. The receipt of the RMD increases the individual's adjusted gross income (AGI) and taxable income, may limit deductions that are based on the taxpayer's AGI, may tax as much as 85% of social security benefits received, and may push the taxpayer into a higher tax bracket.

A Roth IRA uses ***after-tax dollars*** and ***grows tax-free*** (indefinitely) and ***comes out income tax-free*** *when distributed*. **The Roth IRA account holder (excluding heirs) determines if, when and the amount of distributions that will be made** rather than the government controlling these factors with the traditional IRA. The Roth IRA allows the taxpayer to better manage his/her taxes and estate.

Could misinformed or commission-driven investment advisors use the following sales pitch? "Would you rather have your money invested in a traditional IRA where your distributions are taxable, or would you rather convert those monies to a Roth IRA where your monies grow tax-free and come out tax-free to you?" The expected response is quite obvious! "Yes, I want tax-free growth and tax-free distributions. How do I accomplish this?"

U.S. Treasury officials have warned taxpayers who convert that they may be worse off, especially if they withdrew their money quickly instead of allowing their Roth accounts to grow in value. One of the Treasury officials, in discussing the expected advertising by investment houses encouraging conversions, warned that much of the tax advice on Roths that he saw promoted on the Internet was flawed. This Treasury official noted that even technical violations of retirement savings rules could result in draconian tax penalties. "This is a very tricky area," he said. The Treasury official also noted that if tax rates fell or the government switched from an income tax to a consumption tax, the estimated tax savings would shrink or even vanish. (*AccountantsWorld* dated May 16, 2006). Hopefully after reading this paper, you will better understand the various factors that need to be considered and will make a prudent decision rather than following the pied piper (financial advisor).

If given a choice of funding a traditional IRA or a Roth IRA today, the universal consensus is likely that one should select the Roth IRA. I have hedged the preceding sentence because some individuals who contribute annually to a traditional IRA receive a current tax deduction. While I do not believe that receiving a current tax deduction by contributing to a traditional IRA outweighs the tax-free distributions benefit of the Roth IRA, there may be some myopic advisors who disagree.

Through 2009, most wealthy taxpayers were not eligible to contribute to a Roth IRA or to convert to a Roth IRA because of the modified AGI limitations in the tax code. "Wealthy" individuals are persons whose annual income has (1) exceeded the annual modified adjusted gross income (MAGI) limitation for making Roth IRA contributions (in 2008 the MAGI limitation for married persons filing jointly was between $159,000 and $169,000) or (2) have been precluded from converting a traditional IRA to a Roth IRA because their AGI exceeded $100,000.

A very large source of traditional IRA monies will be generated by the Baby Boomer generation when they retire. Most of these people will likely rollover their company's 401(k), 403(b) or other retirement plan monies to a traditional IRA upon retirement. In addition to traditional IRAs, a simplified employee pension (SEP) or a savings incentive match plan for employees (SIMPLE) IRA may be converted to a Roth IRA. However, there are additional restrictions on conversions from SEPs or SIMPLEs. For example, SIMPLE IRAs cannot be converted to a Roth IRA within the first two years the taxpayer participated in the SIMPLE plan and once a conversion is made from a SEP or SIMPLE IRA, no future contributions to the SEP or SIMPLE may be converted to a Roth IRA.

Normally when a distribution is made from an IRA to the owner who has not attained the age of 59.5, the distribution is subject to a 10% penalty PLUS income taxes. If you convert to a Roth IRA before age 59.5 beginning in 2010, the normal 10% penalty for early withdrawal will be waived so long as you wait 5 years before taking the money out of your new Roth IRA and are over 59.5 when taking distributions.

As you can imagine, there is going to be a very large pool of traditional IRA monies that are going to be eligible for the Roth IRA conversion. It is this large pool of money that will have many financial advisors salivating and which will generate the aforementioned flood of promotional materials.

2009 CONSIDERATIONS

One possible strategy is to make a nondeductible IRA contribution of up to $5,000 ($6,000, if age 50 or older) in 2009, and convert it next year into a Roth IRA. The conversion generally is taxable only to the extent of earnings on the nondeductible contributions. However, if you previously made deductible IRA contributions, or rolled over qualified plan funds to an IRA, complex rules determine the taxable amount which are beyond the scope of this paper.

Another strategy is to take a 2009 distribution from your traditional IRA. Looking at the 2009 federal tax rate schedule, a person filing a married filing jointly tax return is in the 28% tax bracket if their joint taxable income is between $131,451 and $200,300. Assuming that the account holder's taxable income is projected to be $131,451 without the IRA distribution, this joint taxpayer could distribute approximately $68,000 of IRA monies without increasing his/her tax bracket. This could be effective tax planning for a person who planned to convert significant dollars to a Roth IRA in 2010 and is concerned about jumping one or more tax brackets. By making a 2009 distribution, the individual may be able to make a conversion in 2010 without jumping to a higher tax bracket in that year.

Am I saying that accelerating the payment of income taxes in 2009 may make economic sense? Yes, if certain conditions are satisfied. The person needs to . . .

- Be over age 59.5 to avoid the 10% penalty for early distributions.
- Realize that the distributed funds available for use will be decreased by the income taxes due on the distribution.
- Be able to reasonably estimate his/her taxable income for 2009.
- Be able to "absorb" the taxable distribution without jumping to a higher tax bracket.

The benefit of taking a distribution in 2009 is that you now have the funds (which you previously lacked) to immediately invest in a life insurance policy that you have decided is an integral part of your overall financial and retirement plan!

2010 CONSIDERATIONS

Beginning with the year 2010 (and future years), the $100,000 modified AGI limitation will disappear and wealthy individuals will be allowed to convert their traditional IRA to a Roth IRA. This conversion will be a taxable event, i.e., the amounts in the traditional IRA will be considered to have been distributed to you subject to regular income taxes. This means that if you convert to a Roth IRA in 2010 (or later), your income taxes paid will increase. Using a very simple example and assuming your 2010 tax bracket would have been 25%, a $100,000 conversion would mean you owe the IRS an additional $25,000 in income taxes. However, the simple example is not so simple. Because the distribution is considered taxable income to you, the $100,000 distribution may have pushed you into the 33% tax bracket, meaning that $29,500 needs to be paid to the IRS rather than the expected $25,000.

A unique income inclusion rule will apply for traditional IRA to Roth-IRA conversions occurring in 2010 (not later years). You will ***automatically*** recognize the conversion taxable income over the two-tax year period beginning with the first tax year beginning in 2011 and the remaining 50% conversion income to be recognized in 2012. The taxpayer can elect to have the *entire* distribution taxed in 2010. For example, assume that a taxpayer converts a $100,000 traditional IRA to a Roth IRA in 2010. Unless the taxpayer elects to have the $100,000 taxed in 2010, $50,000 of the distribution will automatically be included as taxable income in 2011 and another $50,000 in 2012.

Why would a taxpayer want to prepay income taxes? Remember that the Bush tax rates are set to expire at the end of 2010. Do you elect to have all of the income taxed in 2010 and pay the tax using the Bush tax rates, or do you defer the payment of the taxes until 2011 and 2012 using the Obama tax rates? By not making the election to have all of the income taxed in 2010, the taxpayer is deferring the inclusion of income to tax years where it is anticipated that the income tax brackets will be higher. But if the taxpayer makes the election to have the entire distribution taxed in 2010, will the person jump more than one tax bracket? If he/she jumps more than one tax bracket, would it have been better to be taxed 50% each in 2011 and 2012?

Absent Congressional action, after 2010 the tax brackets above the 15% bracket will revert to their pre-2001 levels. That means the top four brackets will be 39.6%, 36%, 31%, and 28%, instead of the current top four brackets of 35%, 33%, 28%, and 25%. What's more, there are

proposals on the table to help finance health reform by imposing a surtax on higher-income taxpayers. The surtax proposal adds another factor to the decision process.

If the decision-making process was not confusing enough, let's complicate matters further. Assume that a 60-year old taxpayer (over age 59.5 to avoid the 10% penalty) converts $100,000 to a Roth IRA in 2010. After the funds are sitting in the Roth IRA account, the IRA holder decides to take a $20,000 distribution in 2010 from the converted funds. Since the $20,000 was not kept in the Roth IRA account for five years, under the accelerated inclusion rule, $20,000 is included in taxable income in 2010 and the amounts to be included in 2011 and 2012 will change. The amount included in 2011 is the lesser of half of the income resulting from the conversion ($50,000) or the remaining income from the conversion ($80,000). The amount included in 2012 is the lesser of half of the income resulting from the conversion ($50,000) or the remaining income from the conversion ($30,000). ***This accelerated inclusion rule allows the taxpayer to determine how much of the Roth conversion income will be included in 2010, 2011 and 2012 with the objective of minimizing the income taxes associated with the Roth conversion.***

STATE INCOME TAX CONSIDERATIONS

My experience has been that when analyzing tax consequences of a proposed transaction, most financial advisors look only at the federal side. All factors need to be considered when making this decision, including state income taxes.

Since many states' tax bases are based on the federal AGI, there would be a state income tax cost to consider unless the state provides a Roth-conversion exclusion. Since most of our individual clients are located in PA which has a gross income tax that is not linked to the federal AGI, you will be glad to learn that PA has stated that "the conversion of a regular IRA to a Roth IRA is not treated as a distribution and is not otherwise taxable if the individual for whom the regular IRA and Roth IRA are maintained receives no payment or distribution." Distributions from Roth IRAs are taxable in PA if the contributions were not previously included in income if made before the individual for whom the account is maintained obtains age 59½ or retires from service. The cost recovery rule is used to determine the portion of a distribution to be included in income.

RETIREMENT FUNDS "TRAPPED" INSIDE AN EMPLOYER PLAN

If you are currently participating in your company's retirement plan and may be a couple of years away from retirement, you may think that this Roth conversion opportunity does not apply to you since you do not have access to your retirement funds and have not set up an IRA. Whereas you realize that your employer will be glad to rollover your retirement funds to a traditional IRA upon separation of service, you may not be aware that some employer plans allow rollovers to a traditional IRA (without adverse tax consequences) while still employed if the participant is age 59.5. You will need to check with your employer's benefits department to see if your employer's plan allows this.

ESTATE TAX CONSIDERATIONS

Many individuals will undoubtedly be overwhelmed by the income tax considerations discussed above. If they were not enough, there are also estate tax considerations that may come into play. Let's assume that you properly planned for retirement and have a substantial amount of monies in your IRAs (traditional or Roth). For illustration purposes, let's assume that you (a single person or surviving spouse) have $1 million in your IRA when you die which is part of your taxable estate (i.e., the amount taxable after the estate tax exclusion). How much will your heirs/beneficiaries receive? $1,000,000? $750,000? $250,000? Does your heir need to pay income taxes on the inherited IRA monies?

The Income in Respect to Decedent (IRD) tax rules include any income that the deceased was entitled to but did not receive over his/her lifetime. This includes IRA monies. The IRS does not want IRA monies passing to your heirs without someone paying income taxes on that money. Therefore income taxes are due on the entire traditional IRA account balance in the year of death, taxed at the appropriate tax rate. Think about how the inclusion of the traditional IRA may impact your income tax bracket! In these situations where an estate tax has been imposed upon the same funds that are subject to income tax, an income tax deduction for the federal estate tax paid on IRD monies is allowed to help mitigate the effect of double-taxation. Note that a deduction is not allowed for state inheritance/estate taxes. For those of you who will have the $1 million of IRA monies included in your taxable estate, estate taxes of 55% could be due (the highest rate beginning in 2011). (If your state has an inheritance or estate tax, further dilution will occur). **The combination of the income and federal estate taxes means that the IRS (and state) may get 70% to 80% of your hard-earned IRA monies**, leaving your heirs with less than $300,000 in this simple example.

Example of non-spousal inheritance of traditional IRA:

Total Value of IRA included in taxable estate	$1,000,000
Gross federal estate tax at 55% using expected 2011 maximum rate	$ (550,000)
PA Inheritance tax rate (used 4.5%, versus 12% & 15% rates)	$ (45,000)
Total federal & state estate taxes	$ (595,000)
Total IRA value	$1,000,000
Less: Income in respect of decedent deduction	$ (550,000)
Taxable IRA value	$ 450,000
Total Income Taxes @ 36% (traditional IRAs only)	$ (162,000)
Total IRA value	$1,000,000
Less: Total federal estate & state inheritance/estate taxes	$ (595,000)
Less: Income taxes	$ (162,000)
Net IRA value	$ 243,000
Percentage of traditional IRA lost to taxes	**75.70%**

If this picture is not bleak enough, penalties for traditional distributions before age 59.5 or Roth distributions that do not meet the "qualified distributions" five-year test may apply which would further reduce your beneficiary's inheritance.

STRETCH IRAS

There has been considerable publicity of using "Stretch IRAs" or "Inherited IRAs" to reduce the income taxes due upon the demise of the single IRA account holder (or surviving spouse if married). This strategy applies to both traditional and Roth IRAs. The sales pitch is quite compelling. How would you like to turn your $1,000,000 IRA into $12,500,000 when your 30 year old child turns 65? And if your child does not need the IRA monies, just imagine how much money can be transferred to your grandchildren and future generations. Since inherited IRAs require in most cases that distributions begin the year after the death of the account owner, Stretch IRAs use the ages of the beneficiaries (e.g., children and grandchildren) to lengthen the time over which distributions must be taken. If the beneficiary is considerably younger than the deceased IRA owner, the required RMD and taxes due (traditional IRA) are minimized. That leaves more money in the account to benefit from continued tax-deferred compounding. Beneficiaries are always free to withdraw more than the RMD amount at any time and can do so without the 10% penalty even if they are not 59.5 years old.

While **Stretch IRAs are a great income tax planning technique**, many of those financial advisors who promote them fail to mention that when a stretch IRA passes to the heirs, **estate taxes are due**. And where will the money come from to pay the estate tax? That is correct, from the IRA inheritance. While withdrawals from a traditional IRA account to pay the estate tax would be taxable distributions, these distributions come out tax-free from a Roth IRA. **While the Roth Stretch IRA has a significant advantage, these advisors fail to mention that a very large portion (55%) of the inheritance could be lost to estate taxes plus any state inheritance/estate taxes**.

For those persons who have substantial retirement monies that will be includable in your estate, there are strategies that can be implemented to mitigate the estate tax which are beyond the scope of this paper. For those persons with sizable estates that include retirement funds, Stretch IRAs are not the only answer, and they may not be the best answer.

IS YOUR FINANCIAL ADVISOR SUITABLY QUALIFIED?

As discussed above, this is going to be one of the most important financial decisions that you may ever make. You need to ask yourself the following questions: "Is my financial advisor suitably qualified to analyze the multitude of factors?" "While I have the upmost confidence in my financial advisor, does he/she have the tools to analyze my personal tax consequences to make sure that I pay the minimal taxes if I convert?" "Has my financial advisor recommended that my CPA be consulted when discussing converting my IRA?" "Is my financial advisor acting in my best interests by being held to the higher fiduciary duty standard, or the more lenient "suitability" standard?"

There will be those financial advisors who primarily want to invest your IRA monies, rather than spending the time to analyze what is in your best interest. Under the fiduciary standard, the advisor acts solely in the client's interests. I personally believe that it is incongruent for an advisor who is paid a sales commission to be considered a fiduciary unless disclosure is made to the client as to how the advisor is paid. I am not implying that it is bad to sell products. There

are many excellent products. Rather, the advisor needs to provide full disclosure when receiving a commission from a third-party and not hide behind the "advisor" title.

The Securities and Exchange Commission (SEC) shares this concern. The SEC has stated that many financial advisors do not fully understand their fiduciary duty to their clients such as placing their clients' interest first and to act with the utmost good faith http://www.sec.gov/news/speech/spch022706lar.htm.

I am also suggesting that you ask yourself if your CPA is qualified to advise you. Does your CPA specialize in strategic tax planning, or is your CPA an accountant who prepares tax returns because he/she relies upon tax preparation computer software?

ALTERNATIVE RETIREMENT STRATEGIES

There will be those financial advisors who will automatically recommend that you invest your converted IRA monies into CDs, US Treasuries, stocks, bonds and/or mutual funds. While I personally believe that every portfolio should be diversified, and thus some portion of your portfolio monies should likely include these types of investments, I believe that you need to consider if *some of your retirement funds* could be better positioned if they included cash value life insurance and fixed annuities.

Again, I want to make it clear that I am not security licensed and I am not offering investment advice. Rather, my role as a CPA is to advise my clients to make sound financial decisions that best suit their needs and resources. That means considering all available strategies!

Remember that these are your retirement funds and that they must be there for you in retirement. You need to be aware of those financial advisors who do not make their clients aware of life insurance and fixed annuities or dismiss them because their firms do not sell these products, the financial advisor is not licensed to sell these products, or higher commissions can be earned selling variable annuities or other products.

This paper was not written to educate you about how life insurance and fixed annuities work, but instead to make you aware of the availability of these products as they may better suit your retirement needs and goals. It is important that you understand that you do not have to invest your converted Roth funds in the same types of investments that your traditional IRAs were invested. In other words, **once funds are distributed from your traditional IRA and the income taxes are paid on the distribution, you have to decide what to do with those monies.** Do you convert 100% of the distributed monies to a Roth IRA? If you do, which investment alternatives are best suited for you within the Roth IRA? While IRAs cannot hold life insurance, they can hold annuities. Or do you convert less than 100% of the distributed funds to a Roth IRA and invest the non-converted monies in cash value life insurance or fixed annuities? Whereas most people think of the death benefits associated with life insurance, **life insurance has significant living benefits! For example, similar to a Roth IRA, the earnings grow tax-free, the monies do not have to be distributed to you, and if properly structured, the monies can be distributed to you tax-free from your life insurance policy**.

Equity indexed life insurance policies are available that provide a "guaranteed" minimum rate of return, that allow you to potentially participate in stock market gains, and that protect your principal 100% from stock market declines. In addition, your beneficiaries will receive the life insurance proceeds income-tax free should you have a pre-mature death. If you are concerned about estate taxes, an irrevocable life insurance trust (ILIT) could be used to avoid both income and estate taxes.

There are also fixed annuity products available that will grow per annum at a 7% compounded interest rate (using an accumulation value which is different than the cash value account or cash surrender account value) and which will provide you with a guaranteed monthly income for life that you can never outlive.

Are the following items of interest to you?

- The living benefits of life insurance (which include funding sources for college educations, weddings, long-term care and retirement),
- How to invest monies that provide you with a guaranteed minimum rate of return, protect your principal from bear market losses, and allow you to potentially participate in bull market gains, and
- How you can receive a guaranteed monthly income for life that you cannot outlive

If your financial advisor has not explained how you can avail yourself of the above, perhaps your financial advisor is not placing your interests first.

IDEAL CANDIDATES FOR ROTH CONVERSION

The "ideal" candidates to make the traditional IRA to Roth IRA conversion are individuals who:

- have several years to go before retirement (and are therefore able to use tax-free compounding to recoup the dollars that are lost to taxes on account of the conversion and so they that don't rule afoul of the five-year rule);
- anticipate being taxed in a higher bracket in the future than they are now; and
- can pay the tax on the conversion from non-retirement-account assets (preferably cash accounts to avoid recognizing gain on the sale of any appreciable assets) to avoid depleting the retirement account to pay the taxes due on conversion.

Others who can benefit from the Roth conversion include individuals who (1) view the Roth IRA more as a wealth transfer tool; (2) can benefit by generating taxable income because they have net operating loss (NOL) carryovers, deductions or exemptions in excess of income, charitable contribution carryforwards, or non-refundable income tax credits; and (3) have an IRA portfolio that has significantly dropped in value but holds an asset that is expected to have rapid growth within the next few years.

SHOULD YOU CONVERT?

I hate to say this, but it all depends upon your personal situation. Due to the various factors discussed above, this is a very complex decision.

To quote Oliver Wendell Holmes, Jr., “I find the great thing in this world is not so much where we stand, as in what direction we are moving. We must sail sometimes with the wind and sometimes against it – but we must sail, and not drift, nor lie at anchor.”

Accordingly, there are two approaches that I would not recommend. The first approach is to do nothing. For those of you who religiously follow this approach, it is the path of least resistance. Since we are talking about your retirement dollars, doing nothing may have a significant and negative impact on your retirement savings because you failed to minimize your income and/or estate taxes. If you don’t mind potentially paying 70%-80% of your retirement dollars to Uncle Sam, then do nothing.

The second approach that could be equally as financially disastrous is to ignore tax planning, fail to consider alternative retirement strategies that may benefit you, and simply follow the herd. Go to your financial advisor (who may have no fiduciary responsibility to you) and simply ignore the various complexities of this decision and assume that pre-paying your taxes today rather than paying them in the future is the best course of action.

For those individuals who REALLY understand the importance of this decision and its financial implications to their retirement income and to their heirs’ inheritances, here are some thoughts for you to consider:

1. If any advisor tells you to convert to a Roth IRA and he/she doesn’t discuss your personal tax situation with your CPA, the advisor in my opinion is acting negligently and you should not work with that person.

2. There are other tax advantages to a Roth conversion. Because distributions from Roth IRAs are tax-free (if they are qualified distributions), they may keep you from being taxed in a higher tax bracket that would otherwise apply if you were withdrawing RMD taxable distributions from a traditional IRA, they don't enter into the calculation of tax owed on Social Security payments, and have no effect on AGI-based deductions.

3. Due to income tax considerations, if it is in your best interests to only convert a portion of your traditional IRA monies to a Roth IRA, then you need to identify those assets which have the greatest likelihood of appreciation as the selected assets to convert to a Roth.

4. Many of the IRA conversion software programs fail to consider all of the pertinent factors to arrive at the best decision for you. One flaw in many programs is that the opportunity cost of computing the lost earnings from the monies used to pay the increased taxes is ignored. Some calculators ignore the tax liability associated with selling assets (if cash is not used) to pay the income taxes due on conversion.

5. The decision whether to convert must not be made in a vacuum. Your entire retirement plan needs to be reviewed to ensure that you have sufficient retirement funds available so that you don't outlive your assets and can live in the life style that you desire.

6. As part of your overall retirement plan, you need to consider at what age you should begin receiving your social security benefits. Each year that you delay receiving your social security benefits, your monthly benefit could grow approximately 7-8%.

7. Realize that this is not merely a decision to convert or not to convert, but also how to invest your retirement monies to maximize your retirement benefits, minimize income and estate taxes, and provide you with financial flexibility. Be cautious of those advisors who merely want to manage your money.

8. Where will the funds come from to pay the income taxes due on conversion? If you planned to use the monies in your IRA account, it is very likely that the tax cost to convert will be greater than the tax savings. In other words, it generally does not make sense to convert if you plan to pay the tax using your IRA monies.

9. If you plan to use non-IRA assets to pay the income taxes due on conversion, you must analyze the income taxes due from using those assets if the fair market value of those assets exceeds the tax basis of those assets. For example, if you plan on selling appreciated stock that is worth $100,000 that you purchased for $40,000, you will have a $60,000 gain that is subject to income taxes. Plus, the $60,000 gain could possibly push you into a higher income tax bracket and lose your AGI-based deductions!

10. One of the most important factors to consider when deciding if a Roth conversion is best for you is whether you expect your tax bracket in retirement to decrease, remain the same, or increase. Many people automatically assume that their tax bracket will decrease in retirement because they will no longer be receiving a salary. These same people typically forget that they will be receiving social security benefits (currently taxed up to 85% of the benefit received), will be receiving IRA RMDs (upon reaching age 70.5), and will be "losing" itemized deductions such as mortgage interest and real estate taxes. I believe that you must also consider the health of both spouses. If one spouse's health is not good and he/she is expected to die within the near future, the surviving spouse will be filing as a single person rather than as married filing jointly beginning in the year after death. Assuming that the surviving spouse's income remains unchanged after death, the income tax bracket could increase because of the change in filing status.

11. If you truly believe that your tax rate will decrease, you need to ask yourself if it makes sense to pay taxes today at a higher rate rather than paying taxes in the future when your tax bracket will decrease. Most Roth IRA conversion calculators will likely show that it does not make financial sense to convert. While I am not a seer and do not have a crystal ball to know what future tax rates will be, my educated guess is that tax rates are going to increase due to the budget deficit and the broken Social Security and Medicare programs (and then there is the issue of a national health insurance plan and how that would be funded by tax revenues).

12. If you believe that your tax bracket will be the same when you retire, there may not be an income tax advantage to convert. However, remember that federal tax law does not allow an income tax deduction for any state inheritance or estate taxes paid on IRD.

Thus, the taxpayer is losing a part of the inherited traditional IRA to state inheritance taxes. If you will have a taxable estate, it may be more tax efficient to incur an income tax before incurring an estate tax when considering all taxes paid, income and federal and state inheritance/estate taxes.

13. If you believe that your future tax rate will increase, your tax- planning thinking needs to be expanded. If you plan to convert and be taxed in 2011 and 2012, you should avoid the standard year-end-planning wisdom of accelerating deductions and deferring income. Rather, you should do the reverse in an effort to avoid being pushed into the highest brackets by a large traditional IRA to Roth IRA conversion. You should be considering ways to defer deductions to 2010 and accelerate income from 2010 into 2009.

14. Again if you believe that your future tax rate will increase, you need to review your current 401(k), 403(b) and other retirement plan contributions. Advocates of qualified retirement plans focus on being able to contribute pre-tax dollars to minimize paying income taxes today. If you are making retirement contributions today to reduce your current taxes, you need to ask yourself if it makes financial sense to defer the taxation of these monies to a future tax year when your tax rates will be higher. To quote author Douglas Andrew, "Would you rather pay taxes on the seed or the harvest if you were a farmer?" Think about it. You are investing your retirement seed monies with the goal of multiplying/growing that seed. Let's assume that your retirement fund grows 100% or 200%. Do you want to pay taxes on the harvest? If your employer is providing you with a company match, it makes sense to take advantage of this "free money." If you are making contributions in excess of the company match, or if your employer provides no company match, your retirement thinking may be in need of a paradigm shift.

THE SOLUTION

In summary, I hope that this paper has advanced your understanding of the various tax factors that need to be considered before making the decision to convert your traditional IRA or other qualified retirement funds to a Roth IRA. Also, if a Roth conversion is in your best financial interest, you are aware of alternative retirement strategies that may better suit your needs.

Keystone Financial Solutions, P.C. is a CPA and financial consulting firm that specializes in providing business owners and individuals with advanced tax and financial planning strategies to minimize income and estate taxes, preserve our clients' wealth, and to enable our clients to fulfill their retirement goals.

Due to the complexities and various factors that will affect the outcome of the optimal decision for you, including the different years that the tax on the conversion can be recognized, Keystone Financial Solutions, P.C. is well-positioned to provide you with the following:

- A written analysis as to whether it makes economic/financial sense for you to convert your traditional IRA to a Roth IRA using state-of-the-art Roth IRA conversation software.
- A written summary of your projected income tax liabilities by tax year considering the aforementioned variables to analyze the different planning scenarios to determine the

"optimum" plan for you, i.e., which conversion/distribution scenario results in the minimal taxes due based on your assumptions of future tax rates.
- Projections that compare investment alternatives . . . what your projected retirement funds will look like if you invest in mutual funds, fixed annuities, whole life, and high cash value equity indexed life insurance. **The results are quite revealing**.

What information is needed from you to perform these analyses? We generally have found that the following key factors need to be identified and addressed to best analyze a Roth IRA conversion:

- Most recent bank, brokerage, mutual fund, etc. statements showing qualified and non-qualified funds and liquidity;
- Most recent traditional IRA statements;
- Your expected date of retirement;
- Current and future cash flow needs (worksheet provided by us);
- Copies of most recent federal and state income tax returns; and
- Estate planning objectives

The author of this paper, Frank Haarlander, is a co-founder of Keystone Financial Solutions, P.C. His educational background includes being a certified public accountant (CPA), having a masters in tax degree from Villanova University's Schools of Law and Commerce, and an MBA from the Rutgers Professional School of Accounting. His credentials also include being a certified wealth preservation planner (CWPP™), a certified asset protection planner (CAPP™), and has earned his "Green Belt" Six Sigma certification. He currently is serving as a Pennsylvania state representative for the Asset Protection Society. His work experience includes serving as the principal tax officer for several Fortune 500 companies, was a tax consultant with PriceWaterhouse Coopers (one of the world's four largest public accounting firms), and has been providing advanced tax and financial planning strategies to individuals and business owners for nearly 40 years. He has served as an adjunct college instructor for undergraduate business and graduate tax courses, has had several articles published and has spoken before the Chamber of Commerce and business associations on various tax and business topics.