

CONVERSIONS AND

# tax

## Now or Later?

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**BEGINNING THIS YEAR, NEARLY ALL TAXPAYERS MAY CONVERT REGULAR IRAS TO ROTH IRAS. THE TECHNICAL DETAILS ARE BEYOND THE SCOPE OF THIS READING. HOWEVER, WE CAN DISCUSS THE PRACTICAL STRATEGIES AND TACTICS OF CONVERSIONS. FACT IS, ALMOST ALL CLIENTS ARE, OR WILL SOON BE ASKING: “SHOULD I NOW, OR IN THE FUTURE, CONVERT SOME OF MY IRAS AND QUALIFIED PLANS INTO ROTH IRAS?” CPAS NEED TO HELP THEIR CLIENTS EXPLOIT THE TAX AND FINANCIAL ASPECTS AND OPPORTUNITIES OF CONVERSIONS.**

The new conversion rules provide excellent opportunities, but also present potential pitfalls. CPAs need to become fully informed if they wish to adequately serve their clients' needs. For CPAs who want an in-depth discussion of this topic, the WICPA is offering a course titled, “**Converting your Pension and IRAs to Roth IRAs—A Major New Strategy Your Clients Must Consider**” at its Brookfield office on Thursday, Nov. 18.

Robert Keebler has written insightful articles about the planning and tax issues of conversions (“A CPA’s Guide to Making the Most of the New IRAs” for the American Institute for Certified Public Accountants, 1997) and with Stephen Bigge (“To Convert or Not to Convert, That Is the Question,” Family Tax Planning Forum, *Taxes—The Tax Magazine*, Oct 2008), identified seven circumstances when someone should consider converting to a Roth IRA:

- To take advantage of favorable tax attributes (e.g., charitable deductions carry-forwards, Net Operating Loss (NOL) carry-forwards, investment tax credits, etc.);
- Suspension of the required minimum distribution (RMD) rules during the converting taxpayer’s lifetime;
- Payment of income tax prior to the imposition of estate tax permits greater wealth to be transferred to future generations (due to the fact that no income-tax deduction is allowed for state death taxes levied on IRAs);
- Greater growth potential, to the extent that outside sources (i.e., taxable brokerage account) are used to pay for the taxes due on the Roth IRA conversion;
- To better utilize an IRA owner’s Unified Credit;
- To effectively reduce the taxable state of the IRA owner; and
- To hedge against a projected increase in tax rates when a first spouse dies.

Many factors are critical elements in assessing when Roth conversions may make sense for your client:

- Investment asset mix, including qualified versus nonqualified and liquid versus illiquid assets;
- Traditional or regular IRA balances;
- Time or planning horizon;

- Current and future cash flow needs;
- Current marginal tax rate versus projected future marginal tax rate;
- Capability to pay the conversion income tax with nonqualified funds; and
- Estate planning objectives.

Based on the above factors, the following types of Roth IRA conversions involve distinct planning opportunities:

- Strategic conversions—advantageous of a client’s long-term wealth transfer objectives;
- Tactical conversions—advantageous of short-term client-specific income-tax attributes that are set to expire;
- Opportunistic conversions—advantageous of short-term stock market volatility, sector rotation, and rotation in asset classes; and
- Hedging conversions—advantageous of projected future events that will result in the client being subject to higher tax rates within the near future.

An ideal candidate for strategic conversion is a client who:

- Has outside funds (e.g., nonqualified liquid assets) to pay the income tax on the conversion;
- Will not need the Roth IRA to meet his/her annual living expenses;
- Desires to leave a tax-free asset to children/grandchildren; and
- Expects to be in the same or higher tax bracket in future tax years.

In this situation, the Roth IRA is viewed more as a wealth transfer tool rather than a retirement income vehicle. Because the “required minimum distribution” (RMD) rules do not apply to Roth IRAs until the owners die, the funds within the account are allowed to grow, exponentially, tax free. Also, after the owner’s death, although Roth IRA beneficiaries are required

to take RMDs each year, these withdrawals still will be tax free (under current law). Therefore, Roth IRAs are the perfect retirement asset for which to transfer the greatest amount of after-tax wealth.

Three factors are critical to analyzing strategic conversions: the tax rate differential; the ability to use funds outside qualified plans and IRAs to pay the income tax on conversion; and the planning horizon or time line.

All conversion analyses must apply the same basic principles. However, tactical conversions differ from strategic conversions in that the client uses the conversion as a tool to realize short-term, unused special tax attributes. Such special tax attributes could include:

- Net Operating Loss (NOL) carry-forwards;
- Business and other ordinary losses;
- Deductions and exemptions in excess of income;
- Charitable contribution carry-forwards; and
- Nonrefundable tax credits.

In a typical tactical conversion scenario, the client faces the possibility of losing a favorable tax attribute within the current year or in the near future. In order to realize this favorable tax attribute, the client must generate taxable income. In this case, the client uses the Roth IRA conversion to “free up” the unrealized favorable tax attribute while at the same time virtually paying little to no income tax on the Roth IRA conversion.

An opportunistic conversion is a related type of tactical conversion that takes advantage of short-term economic conditions that are expected to reverse over time. An example of this would be a conversion where the client’s IRA portfolio holds a

stock or fund that is expected to have rapid growth within the near future.

Finally, a hedging conversion is a type of Roth IRA conversion that is done to hedge against some future event that could result in higher taxes. In a nutshell, two main kinds of hedging conversions exist:

- Income-tax hedging conversions that hedge against the likelihood of future higher income-tax rates.
- Estate-tax hedging conversions that

hedge against the possibility that the combined income and estate tax on a traditional IRA will be higher than on the converted Roth IRA.

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