



## December 2009 Hot Topics

# IRA to Roth Re-Characterization

*The benefits of a Roth IRA can be summarized as tax-free income, no required distribution and ability to pass the account tax-free to heirs. The earnings on the contribution are returned to you tax-free and no penalty if you're over 59 1/2 and otherwise meet the requirements for a qualified distribution. You can withdraw your contribution at any time without penalty. Unfortunately, households with a modified adjusted gross income of \$100,000 or more were unable to have a Roth account. This about to change.*

The ability to re-characterize an IRA to a Roth has always been available to people below the \$100,000 gross income level. You will have a tax liability on the conversion amount which is due by April 15<sup>th</sup> of the following year. You will also have to wait five years and be over the age of 59 1/2 before you can access the principal and growth tax/penalty-free.

What has changed is beginning January 1, 2010, any household at any income level can convert a traditional IRA to a Roth IRA. You will have to pay taxes on the conversion at your current rate. For example, if you are at the 25% tax level, on a \$100,000 conversation you will be taxed \$25,000. But if you convert in 2010, you'll have the opportunity to recognize half the income in 2010 and the other half in 2011. In other words, you will have two years to pay the taxes on the conversion. The five year and 59 1/2 rule will apply to the conversion.

### Considerations

For many people, this is a great one-time opportunity to create future tax-free distributions. However, the conversion is not for everyone. Things to consider:

**If you expect your tax rate to decline in the future, then it would make sense to forgo the conversation and just pay the tax on the IRA distribution.** The closer you are to retirement and to taking withdrawals, the stronger this argument becomes. There is no guarantee however that your tax rate or tax liability will decline in the future even with a reduced income. With huge government spending, the deficit is growing rapidly

which means some taxes will, in the future, be going up. Or the government could reduce the allowable deductions we now enjoy. Either way, the end result will effectively increase your tax rate. Most financial analysts expect tax rates to increase at some point in the future.

**You should have the money available to pay the tax without raiding the IRA.** Using the IRA to pay the taxes is self-defeating. This may subject you to a 10% penalty and you would lose the tax-free growth on the money sheltered within the account. The need to pay the tax sooner and in much larger lumps is the major disadvantage of the IRA to Roth conversion. Fortunately, the conversion is not an all or nothing proposition. You can convert some of the IRA assets to a Roth while leaving the balance in the IRA. In other words, you can convert the amount for which you have the money on hand to pay the tax, not the entire IRA amount.

One idea would be to increase your payroll withholdings beginning in January 2010 and running through December 2011. Work with your CPA to estimate the total tax overpayment and then use that amount to pay the conversion tax. Remember you have two years to pay the tax, but the conversion goes to work for you immediately.

**The government may attempt to touch Roth accounts.** The government could realize a huge influx of income (taxes) over the next two years at the expense of future administrations. Future administrations may attempt to recoup some of the 'lost' revenue by taxing Roth withdrawals. This is not likely as it would be double taxation but they could remove the tax-free ability to pass the account onto your heirs. Or they could decide to tax the Roth earning. This would be an unpopular decision but there may be other creative ways the government could tap the Roth accounts. Although possible, I don't think the government will attempt to touch Roth accounts in the foreseeable future.

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## The Best Approach

The best approach may be to transfer as much as you can afford into your Roth in 2010 and leave the balance in your IRA. You can always re-characterize portions of your IRA to your Roth at a future time if your gross income is less than \$100,000. The only 2010 urgency is the removal of the gross income restriction and having the ability to spread the tax liability over a two year period. And then again, the government may extend the program into 2011 and beyond.

All IRA to Roth re-characterizations are taxable events and will have to meet the five-year rule before the distributions will be tax-free. If you have a number of years before retirement, this can be a good retirement planning. If you're already over 59 ½, you can take IRA distributions now, pay the tax and place the distribution in your Roth.

## The Divide and Conquer Strategy

For most people, a partial IRA conversion is the best option because of the tax liability involved. Fortunately, creative planning can help you get the most mileage from a partial conversion. If you place the full conversion amount into a single Roth account, the tax effects of losses and gains are proportional to the account. But if you split the IRA conversion into multiple Roth accounts each with a single asset class, then you can use re-characterizations to take maximum advantage of the tax break. This strategy is available to you every year.

## A Step by Step Example

**Assumptions:** You are in the 25% tax bracket and have \$200,000 in an IRA. You have \$5,000 available to pay the tax on the conversion.

**Step 1.** January 2010: Convert \$100,000 in the IRA into five separate Roth accounts with each with \$20,000 and each invested in a single, and different, asset class. Asset classes could be high yield bonds, emerging markets, REITs, domestic small caps and foreign stocks. This is a temporary allocation and other asset classes could be used. The idea to achieve hyper-returns from one or more asset classes.

**Step 2.** April 15, 2011: Pay the \$5,000 tax but file for an automatic extension on the return. This will give you until October 15, 2011 to file the final return.

**Step 3.** October 1, 2011: Review each Roth account and decide which one to keep. Then re-characterize the other four back to the IRA before October 15, 2011. The

end result is you paid the \$5,000 tax on the conversion, enjoyed 21 months of earnings and started the clock on tax-free withdrawals in January 2010.

What if all five Roth accounts decline in value? Simple, just re-characterize all five back to the IRA, file the tax return and get a refund of the \$5,000. After 31 days, or at the beginning of the year after the original conversion, whichever comes later, you can once again re-characterize the traditional IRA to Roth IRAs, but with a lower tax liability. This strategy will provide you with a lot of tax planning flexibility.

## Piles of Paperwork

The above strategy will require accurate record keeping. You will need to track the IRA and Roth accounts very carefully and document the money movement. Avoid using a single Roth account as the proportional allocations will be difficult to track.

If you want to push back portions of a combined Roth, the custodian will have to determine the amount of the portion conversion and any net income (or loss) allocable to the conversion. If the Roths are combined, you may be required to make up any losses. This is self-defeating so the easiest solution is to create separate Roth accounts.

The Roth you decide to keep should be re-allocated to a more effective diversification. After the five year waiting period, this Roth can be merged into the 'master' Roth without penalty.

The Divide and Conquer strategy can be used every year. The ideal situation would be to have five Roth accounts in the pipeline with one "graduating" each January and merged into the master Roth. Use remaining IRA amounts to create five more Roths. In December of the same year, pick the one you like best and send the rest back to the IRA. Repeat in January.

You can see the importance of accurate paperwork because you will be tracking up to 10 Roth accounts and the IRA account. With separate Roth accounts for each year, the paperwork trail will be easier to manage.

## Summary

The upcoming Roth IRA conversion can be a golden opportunity for the right person. But it's not for everyone. Feel free to contact me and I can help you with the pros and cons for your specific situation.

This material was researched and written by David Snellen.  
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## Asset Allocation Age

*Many financial planners determine portfolio allocation based solely on the client's chronological age. This may not be the best approach.*

Most financial planners use some version of age based investment strategy. Client needs are different. The investment strategy for a 30 year old will be different than those of a 70 year old. The reasons are simple. An older person has less time to make up losses than a younger person. The older the investor, the less risk that investor should take.

### A Simple, but Effective Approach

Many financial planners use an asset allocation model known as "Your Age in Bonds." Very simply, whatever a person's age is, that is the allocation in they should have in bonds. For example, for a 50-year old investor, the target for bonds and cash would be 50% of the portfolio value. The remainder of the portfolio should be in foreign and domestic stocks. The allocation is reviewed annually and adjustments made as the investor ages.

As simple as this concept is, it may not be practical for every person's portfolio. Different people have different needs and their chronological age may not be the best way to determine portfolio allocation.

### Age Contrasts

Everyone's needs are different. A 30-year old is typically working, may be investing in the company 401(k) and has minimum saving. Market gyrations will have little impact on their net worth. They have many years of working and many opportunities to build a savings. So a 70/30 allocation in stocks and bonds would be a good start.

There is no such thing as a typical 55-year old investor. Some have accumulated significant wealth while other have few asset and significant debts. Some have 401(k)s, other's have pension plans and some are relying on their own saving for retirement.

Family status is diversified also. Some have small families, no family or a large extended family. Some may have aging parent. While the "Your Age in Bonds" is a good asset allocation model, it cannot be applied to every investor.

Rather than use an investor's chronological age as the primary yardstick, it makes more sense to use the investor's allocation age to guide asset allocation. A

person's allocation age may be higher or lower than their chronological age. The allocation age takes individual life situations into account.

An example: Say a 65-year old couple has accumulated \$2 million in liquid assets. They have two grown children who do not need financial support. The couple spends about \$100,000 a year of which about \$60,000 comes from pensions and social security. The balance of \$40,000 comes from their savings account. A standard 35/65 stock/bond allocation would not be appropriate for this couple.

One approach would be to divide their assets into two portfolios. One portfolio of \$1 million would be 35/65 stocks/bonds mix allocated to meet the income needs of the couple. The remaining \$1 million is not likely to be needed by the couple and will pass to their children. So the second portfolio should be asset allocated to match their children's age. Their average age is 35 so an appropriate allocation for this portfolio would be 65/35 which is the recipient's allocation age. Instead of splitting the portfolio, the \$2 million portfolio could be asset allocated as a 50/50 mix of stocks/bonds which is the couple's asset allocation age.

### Tale of Two Women

Assume a 55-year old woman is barely getting by. She has a small amount in her 401(k), has some housing debt and is caring for her aging parents. This person would have an asset allocation age of about 70 because she has a high cash flow risk. She is financially vulnerable and cannot afford to lose any sizable amount of her savings.

A second 55-year old woman has a pension plan, no housing debt and a large Roth account. Plus she expects to inherit a sizable estate from her parents. Her allocation age would be about 40 as she has no cash flow risk and no foreseen liabilities.

Two women, same age, but at vastly different asset allocation ages. The first woman should have at least 70% in bonds due to her financial situation. The second woman may have 60% in stocks and 40% in bonds because she is in much better financial shape and can tolerate more risk.

Chronological age is a good place to start with asset allocation. But the ultimate asset allocation is based on your asset allocation age which may higher, or lower than your chronological age.

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