Memorandum

TO: ***Clients and Friends***

FROM: ***Richard Gregory***

RE: ***Consider Converting Your IRA to a Roth***

DATE: ***October / November, 2008***

"Convert a traditional IRA to a Roth IRA and you may come out ahead."[1] *I am beginning to see more and more "teaser" lines like this one, and the story behind the headline is worth telling. Beginning in 2010 affluent individuals will have an opportunity to convert their traditional IRAs to Roths. Roth IRAs are a premier wealth-building tool, and so it is not surprising that financial firms are touting the benefits of a Roth conversion. This newsletter takes a closer look at the opportunity.*

Basic Principles

First, let's review some basic principles. An income tax deduction may be available for contributions to a traditional IRA, but the main benefit is that earnings and gains on investments held in the IRA are sheltered from current income tax. All distributions from the IRA are subject to tax as ordinary income, except for nondeductible contributions.

Roths are like traditional IRAs in that earnings and gains on investments held in the IRA are sheltered from current income tax. But unlike traditional IRAs, distributions from a Roth are income-tax free if the owner is at least 59½ and the Roth is at least 5 years old.

Conversion Tax

Converting a traditional IRA to a Roth comes at a substantial income-tax cost. The cost is the additional tax one must pay on account of including the amount converted in taxable income. If a taxpayer is in the 30% federal/state income tax bracket, converting $1,000 of a traditional IRA to a Roth would cost $300. Some relief is available in that the amount included in income may be spread over the two taxable years following the conversion year.

Is a Roth Conversion for You?

A Roth conversion is not for everyone. Those who may need all of their IRA investments for living expenses will likely decide that the future benefits of a Roth conversion are not worth the immediate income-tax cost. Those who feel they can set aside all or a portion of their IRA investments and who are interested in planning for the financial success of children or grandchildren are more likely to take advantage of the opportunity. They will pay the conversion tax from non-IRA funds, and they will view that cost as a modest price to pay for an arrangement that will benefit the people they love for generations.

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[1] *"Creative Living", a publication of Northwestern Mutual Life, Fall 2008, pp.4-5*

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<u>The IRA Story – 5 Financial Lessons</u>

The IRA story begins with tax-free growth of investments. If a $1,000 investment earns $70 in an IRA in year 1, the IRA will start year 2 with $1,070 (7% return). If the same investment earns $70 in an account subject to federal/state income tax at 30%, the account will start year 2 with $1,049 (4.9% return).

<u>Lesson #1</u>: IRAs increase the effective return on an investment.

Is the difference between a pre-tax return of 7% and an after-tax return of 4.9% a "big deal"? Maybe not if you look at one year in isolation, but time changes everything. Some say that the Eighth Wonder of the World is the "miracle" of compound interest. We say that even a small difference in the rate of return on an investment will result, over time, in a very big difference in the ending balance. If 7% pre-tax and 4.9% after-tax rates of return are repeated every year for 10 years, there will be $1,967 in the IRA but only $1,613 in the taxable account. And after 20 years, there will be $3,870 in the IRA but only $2,603 in the taxable account.

<u>Lesson #2</u>: Put time on your side. Keep investments in a tax-free environment for as long as possible.

There is a big difference between traditional IRAs and Roths as to how long investments may be kept in the IRA. "Minimum Distribution Rules" set forth in Treasury Regulations require the owner of a traditional IRA to begin taking distributions not later than April 1 of the year after he or she turns 70½. Roths are not subject to these rules during the owner's lifetime, so investments may be kept in the Roth and grow income-tax free.

The practical effect of the Minimum Distribution Rules is striking. Harry is 70, and he has $1,000 in his traditional IRA. If his IRA grows at 7% and he takes only the minimum distribution each year, he will have $1,323 in the account at age 80, and $1,319 at 90. If he invests all net-after-tax proceeds of the distributions he is required to take in a taxable side fund with an after-tax return of 4.9%, his investments (IRA plus side fund) will total $1,819 at 80 and $2,941 at 90. Contrast Harry's results with Richard's experience. Richard has $1,000 in a Roth IRA. Since Richard does not need funds for living expenses, and since his Roth is not subject to the Minimum Distribution Rules, he decides to leave all funds in his IRA. Based on the same assumptions, his investments will grow to $2,105 at 80 and $4,141 at 90.

<u>Lesson #3</u>: Roths are far superior for accumulating investments during the owner's lifetime.

After the IRA owner's death, the Minimum Distribution Rules apply equally to traditional IRAs and Roths. The rules permit a "designated beneficiary" who inherits the IRA to take distributions over the beneficiary's life expectancy. A 50-year-old individual has a life expectancy of 34.2 years, and a 20 year-old has a life expectancy of 63.0 years. If Harry and Richard die at 90 and leave their IRAs to Helen and Renee (each age 20), their IRAs can continue for an additional 63 years!

Although Harry's traditional IRA and Richard's Roth will be subject to the same distribution rules after their deaths, Richard's Roth will start with a big lead and extend that lead over the years. If Helen receives sage advice and acts accordingly (i.e., she takes only the minimum distribution each year and invests the net after-tax proceeds in a side fund), she will have $7,706 in her IRA and $16,287 in her side fund (total $23,992) when she retires at age 60. And if Renee follows Helen's example, her Roth and side fund will have grown to $24,199 and $26,474, respectively (total $50,673). Patience has its rewards!

<u>Lesson #4</u>: To maximize the power of an IRA, name a grandchild as "designated beneficiary".

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Naming a grandchild as designated beneficiary of an IRA may have unintended consequences. Although IRAs must make minimum distributions, there is no legal maximum. A grandchild who inherits an IRA may take the entire balance of the account at any time for any reason or no reason. Imagine what a young man or woman might do with a lot of money. Such thoughts are the stuff of which nightmares are made – more frightening than any ghost or goblin you may have encountered on Halloween. This is not to say that IRA wealth should be kept under lock and key forever, but it is important to recognize that early and easy access to unearned cash often does a young person more harm than good.

The solution is to separate the grandchild from decision-making authority over IRA funds until he or she develops maturity and common sense. In order to ensure that the extended benefits of an IRA will be realized, name a specialized IRA trust as beneficiary of the IRA, the grandchild as beneficiary of the trust and a steady, sensible relative or other advisor or institution as trustee.

Trusts also protect against other risks, including loss of family resources through bad marriages, etc.

Lesson #5: Use a special trust to guarantee safety and sensible decision-making re the distribution and expenditure of IRA investments.

The following table compiles the projection of financial results related to the above discussion. Entries are based on hypothetical traditional and Roth IRAs, each having a balance of $1,000 when the account owner is 70. Net after-tax proceeds of distributions from IRAs are invested in a taxable side fund. Financial results are based on a constant pre-tax return on invested balances of 7% and a blended income tax rate of 30% applicable to taxable distributions and earnings on taxable accounts.

Age of Owner / Beneficiary	Trad. IRA Balance	Trad. IRA Side Fund Balance	Total	Roth IRA Balance	Roth IRA Side Fund Balance	Total	Ratio of Roth to Trad.
70 (O)	1,034	26	1,059	1,070		1,070	1.010
80 (O)	1,323	496	1,819	2,105		2,105	1.157
90 (O)	1,319	1,622	2,941	4,141		4,141	1.408
20 (B)			same as above				
30 (B)	2,320	2,883	5,203	7,285	1,298	8,583	1.650
40 (B)	3,738	5,181	8,919	11,740	4,469	16,209	1.817
50 (B)	5,705	9,417	15,122	17,915	11,956	29,871	1.975
60 (B)	7,706	16,287	23,992	24,199	26,474	50,673	2.112

In summary, Roth IRAs are a premier wealth-building tool. Investments held in a Roth grow income-tax free, and there are no mandatory withdrawals during the owner's lifetime. When distributions must be made after the owner's death, they are received income-tax free. If you put these financial advantages to work for your family over time, the results can be extraordinary.

We hope these thoughts help you make sense out of an important opportunity. Please call if you have questions or we can be helpful in any way.

Best regards,

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