

Strategy Corner

Roth IRAs: New Opportunities in 2010

This month we explore the benefits and pitfalls of Roth IRAs and why you might want to take a fresh look at them. All of you have heard of Roth IRAs, but most of you have not paid too much attention to them because they have had income limitations that have made them irrelevant to many wealthier families.

However, in 2005 Congress passed an amendment to the rules that will expand Roth IRA opportunities to everyone regardless of their wealth, beginning in 2010.

Roth IRAs: The basics

The general rules of a Roth IRA are that contributions are nondeductible and earnings accruing within the Roth IRA are not taxed at the time that they are earned. Most important, qualified distributions from a Roth IRA are not includable in income. You can't deduct your contributions from your income going in, but as long as you are making a qualified distribution, the contributions and all of their earnings are not taxed on the way out.

Comparison to traditional IRAs

For the most part, Roth IRAs are treated the same as traditional IRAs. For example, Roth IRAs must be established and maintained by the same types of institutions that maintain traditional IRAs, and the contribution limits are the same. Contributions must be in cash and must be made by the regular April 15 due date for your income tax return. As with traditional IRAs, you can fund Roth IRAs in two ways: making annual contributions and rolling over funds from another account (see below).

Because Roth IRAs are funded with after-tax dollars, any transfer of funds from a traditional IRA to a Roth IRA is subject to income tax at the time of the transfer. To distinguish these taxable transfers from the tax-free transfers among traditional IRAs, a transfer of funds from a traditional IRA to a Roth IRA is sometimes referred to as a "conversion" instead of a rollover.

How to get money into a Roth: Annual contributions

As with traditional IRAs, you can make a contribution to a Roth IRA for each taxable year, limited to the "deductible amount" or 100% of taxable compensation, whichever is less. Even though Roth IRA contributions are not deductible, they are based on the deductible amount for traditional IRAs, which is \$5,000 (beginning in 2010, this will be indexed for inflation in \$500 increments). Anyone who is age 50 or older before the end of the contribution year may contribute an additional \$1,000.

But Roth IRAs have two additional and more restrictive contribution limits. First, if you contribute to both a Roth IRA and a traditional IRA, the maximum contribution limit for the Roth IRA is reduced by your contributions for the year to any traditional IRA. Second, allowable contributions to a Roth IRA are reduced or eliminated if your income is above a certain amount.

In 2009 if you're a single individual, the amount you can contribute to a Roth IRA will be gradually phased out if your modified adjusted gross income (a tax-related number that is less than your gross income) is between \$105,000 and \$120,000. For a married couple filing a joint return, the phase-out occurs between \$166,000 and \$176,000.

It is because of these income limitations that many of you simply have not qualified to use a Roth IRA in the past.

How to get money into a Roth: Conversions under new rules

In the past, not only could your income prevent you from contributing to a Roth IRA, it could also preclude you from converting a traditional IRA to a Roth IRA. Beginning in 2010, though, the income limit for conversions will be lifted. Converting a traditional IRA into a Roth IRA will be treated as a rollover regardless of the conversion method.

Most of the rules for rollovers that apply to traditional IRAs also apply to Roth IRAs, except that there isn't a one-year waiting period and the taxable amount of any traditional IRA must be included in income in the year of the conversion. There are three ways to do a conversion:

1. You may receive a distribution from a traditional IRA and roll it over to a Roth IRA within 60 days after the distribution.
2. You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
3. If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

Pros and cons of conversions

The advantages of a Roth IRA conversion include:

- Probability of tax-free future withdrawals
- No withdrawal requirements, even after age 70½

This means that you could continue to grow the assets in your Roth IRA tax free, even after you reach the age of 70½. Any benefit not realized by you could be realized by your heirs. Beneficiaries of Roth IRAs do not have to pay income taxes on the assets, while beneficiaries of traditional IRAs can face hefty income taxes.

The biggest disadvantage of a Roth IRA conversion is the tax bill you will face, particularly if your current income-tax bracket is higher than your anticipated tax

bracket upon retirement. Generally speaking, if you would pay the taxes due on the Roth conversion out of the IRA itself, conversion would probably not be appropriate. The benefits of a Roth IRA conversion are compelling only if you can pay the taxes with other (non-tax-deferred) funds.

Note that a special provision applies to taxpayers who convert to a Roth IRA in 2010 only: they can choose to spread the income from the conversion over a 2-year period beginning in 2011 rather than recognizing it entirely in the year of conversion. Before deciding to do this, consider the likelihood of future income tax rate increases after 2010. If you have the means, it may prove to your advantage to accelerate all of the tax into 2010.

Taxation of Roth IRA Distributions

Amounts distributed from a Roth IRA are not taxed as income as long as they constitute “qualified distributions.” In general, a qualified distribution is any distribution from a Roth IRA that you make after the five-tax-year period that began with the taxable year for which the first contribution was made. In addition, the distribution must be:

- Made on or after the date you reach age 59½;
- Made as a result of your disability;
- Made to a beneficiary or your estate after your death; or
- Made for purposes of purchasing your first home.

Traditional IRAs are also governed by those requirements and limitations. However, distributions that are a return of regular contributions to a Roth IRA are never included in gross income, even if made in a nonqualified distribution, because those contributions were made with after-tax income in the first place.

Who would make a good candidate for a Roth IRA conversion?

An ideal candidate for a “strategic conversion” would be someone who:

1. Has “outside funds” (not sheltered from taxes) to pay the income tax on the conversion,
2. Will not need the Roth IRA to meet his or her annual living expenses,
3. Wants to leave a tax-free asset to children or grandchildren, and
4. Expects to be in the same or higher tax bracket in future tax years.

For this group, the Roth IRA is viewed more as a wealth transfer tool rather than a retirement income vehicle. Because Roth IRA owners are not subject to required minimum distribution (RMD) rules, the funds within the account are allowed to grow untaxed. Over a period of years, this growth can be exponential. Further, although Roth IRA *beneficiaries* are required to take RMDs each year, these withdrawals will be

tax-free. Thus, the Roth IRA is the perfect retirement asset for transferring the greatest amount of wealth.

Remember the three factors that are essential to analyzing whether strategic conversions are right for you: The differential that you expect between your current and post-retirement tax-rates, your ability to pay the income tax bill with non-IRA funds, and the length of time between the conversion and your retirement.

Ideal candidates for Roth IRAs

Older workers. If you are still earning income but have already reached age 70½, you cannot make contributions to a traditional IRA but you *can* to a Roth IRA. Consider contributing to a Roth IRA if you are below the income limits.

Children with earnings. A teenager with modest earnings from summer or after-school work would be well advised to contribute as much as possible to a Roth IRA when the tax cost of doing it would be minimal. (A parent or grandparent who wants to encourage good saving and investment habits might consider making a corresponding gift to the child so that the child could still enjoy the fruits of her labor.) Note, however, that Contango Capital Advisors and most investment managers and brokerages will not open a Roth IRA account for a minor.

Low-income years. In a year when you don't have much taxable income, consider contributing to a Roth IRA.

Net operating loss years. A business owner will have years when business losses (as distinct from capital losses) offset all other income. Rather than carry the net loss over to subsequent years, consider absorbing it with income that you would realize from converting a traditional IRA to a Roth IRA.

Grandchildren as Roth IRA beneficiaries. If you will be subject to estate tax, you can directly leave only a limited amount to grandchildren without incurring generation-skipping tax (an onerous substitute for the estate tax that would otherwise be due at the death of the grandchild's parent had the property been left to the parent instead). Because of the limits, wealthy investors often want to use an asset with the greatest growth potential for bequests to grandchildren. A Roth IRA, with its tax-free compounding and absence of built-in tax liability, makes an excellent candidate for a generation-skipping bequest. Compared with naming a child as beneficiary, naming a grandchild (or an appropriately drafted trust for a grandchild) as beneficiary enhances the value of the Roth IRA to the family. This is true because the grandchild's significantly longer life expectancy reduces future required annual distributions and therefore enhances the Roth IRA's potential for tax-free growth.

The deathbed conversion. A person who is not expected to live long, has enough wealth to expect an estate tax, owns a substantial traditional IRA, and has other liquid assets with which to pay the tax cost of conversion should consider converting a traditional IRA to a Roth IRA. All of the income tax that would be due on the traditional IRA would thus be paid before death, which then would reduce the estate tax that would ultimately be owed. Income tax rates are lower than estate tax rates.

Beware of bad advice

Every year the IRS issues guidance about transactions that are designed to circumvent the rules. The IRS remains on the watch for what it calls abusive retirement plans, and it continues to find them, including Roth IRAs. The agency is looking for transactions that taxpayers are using to avoid the limitations on contributions to IRAs.

Final thoughts

To convert or to not to convert, that is the question. Paying tax today in order to avoid paying more tax in the future may be attractive. The wild card in weighing long-term strategies where taxes are an issue, however, is that we have no assurance that the tax laws will be the same in the future. Congress is always making changes to our tax laws for political and economic purposes. Will future congresses honor the deals made today? Only time will tell.

If you would like to explore how a Roth conversion might work for you, please contact your Contango advisor.

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