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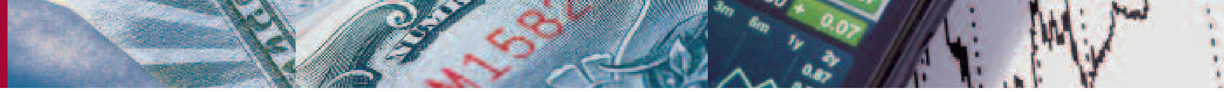
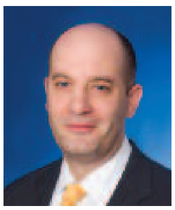


PERSPECTIVE
ON STRATEGIC WEALTH PLANNING

Fiduciary Trust International



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Does It Make Sense to Convert to a Roth IRA?

The question about whether or not to convert a Traditional IRA to a Roth IRA has received much attention this year. A significant change in the IRA rules and the anticipated income tax increases for 2011 have compelled many investors to seek guidance in making this important decision.

In the past, you could convert your Traditional IRA to a Roth IRA only if your income was under $100,000. But in 2010, this restriction was removed. This has made Roth IRAs accessible to even the highest income earners.

Unlike a Traditional IRA that is funded with pre-tax dollars, a Roth IRA is funded with after-tax dollars. While distributions from a Traditional IRA are subject to income tax, distributions from a Roth IRA are income tax-free. Ordinarily, taxpayers have expected to be in lower income tax brackets when they retire, so deferring income taxes until then has made sense. However, with the top Federal income tax rate currently at 35% but scheduled to surpass 43% by 2013, many taxpayers are rethinking this assumption.

> "With expected tax increases only months away, there are a number of strategies that can be implemented now."

THE BENEFITS OF A ROTH IRA

While contributions to a Roth IRA are not tax deductible, any earnings and appreciation are tax-free, as long as you are over age 59½ and at least five years have passed since you established your Roth IRA. And, unlike a Traditional IRA, there are no required minimum distributions. This provides you with the opportunity to be in control of your distributions during your lifetime.

A Roth IRA can be especially beneficial if you do not need to use the assets in your IRA and plan to pass them to heirs. Since there is no distribution requirement with a Roth IRA, the entire account can remain in place to grow tax-free during your lifetime.

DECIDING WHETHER TO MAKE THE SWITCH

Weighing the benefits against the disadvantages of converting—most notably the immediate income tax consequence and the loss of future growth of the assets used to pay taxes—can be very complicated.

The decision has a lot to do with your future income tax bracket, your age, your long-term goals for your IRA assets, and whether you can afford to pay the income and estate taxes from your other assets.

WHEN IS IT BETTER TO CONVERT?

The following illustration demonstrates the difference between keeping a Traditional IRA vs. converting to a Roth IRA. In the scenario, Mrs. Wilson is 55 years old with a $2 million Traditional IRA. She has income from other sources and will not need the income from her IRA during her lifetime. Her two adult children will inherit the account when she passes away at age 85 in the year 2040.

In our example, if Mrs. Wilson makes the Roth IRA conversion, she will pay $700,000 in income taxes out of a non-IRA account. To make the comparison equal, her beginning value includes her Traditional IRA plus $700,000 of her other non-IRA assets. If she converts, she will use these assets to pay the income taxes; if she does not convert, she will keep these assets invested. As she does not need the income, she will invest the mandatory distributions from her Traditional IRA.

TRADITIONAL IRA

With a Traditional IRA, Mrs. Wilson's minimum required distributions are triggered at age 70½ and taxed at 43.4% (her assumed income tax rate during retirement). She will not need these taxable distributions during retirement and places the distributions in a non-IRA account. During her lifetime, she will pay $3.0 million in Federal income taxes on her IRA distributions.

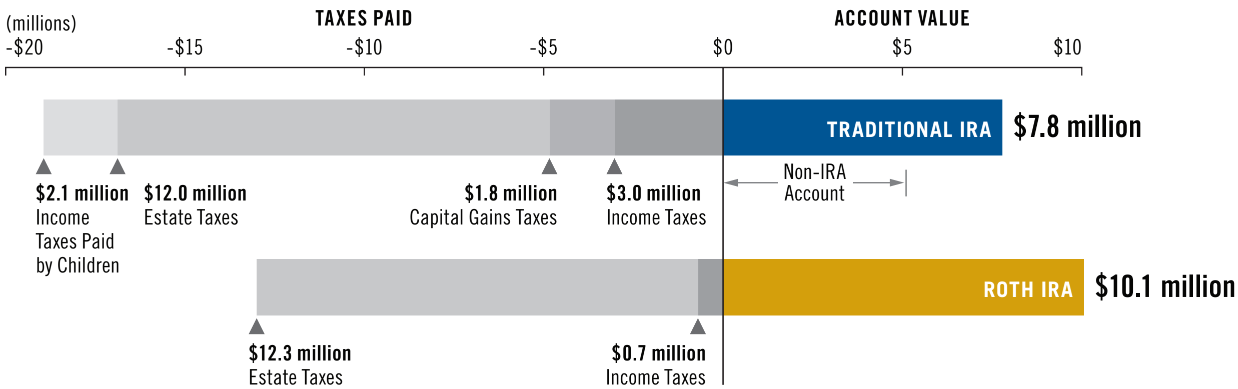
When the assets from both the IRA and the non-IRA account (containing the distributions from her IRA) pass to her children, the children will pay $12.0 million in Federal estate taxes and $2.1 million in Federal income taxes. Their remaining after-tax assets will total $7.8 million.

CONVERTING TO ROTH IRA

If Mrs. Wilson converts to a Roth IRA, she will pay $700,000 in income taxes, assuming the 35% top Federal income tax rate in 2010. To maximize the assets remaining in her IRA, she pays these taxes out of a non-IRA account. There is no mandatory distribution requirement, so she will not take any distributions from the Roth IRA during her lifetime.

When the Roth IRA passes to her children, they will pay $12.3 million in Federal estate taxes. However, since no Federal or state income taxes will be due, the children will be left with $10.1 million in after-tax assets from the account.

Converting to a Roth IRA Significantly Benefits Mrs. Wilson's Heirs



ASSUMPTIONS

2010 IRA balance: $2.0 million. Non-IRA assets used to pay taxes: $700,000. Traditional IRA scenario includes a $700,000 non-IRA account with investment turnover of 30%, taxed at a 20% capital gain and dividend tax rate. Total life of accounts: 30 years. IRA and non-IRA annual growth rate: 8.1%. Inflation rate: 3.00%. Income tax rate: 43.4% for withdrawals. Income tax rate: 35% for the conversion to a Roth IRA. Estate tax rate: 55%.

THE RESULT

Mrs. Wilson's children stand to benefit significantly from the Roth IRA conversion. Since mandatory distributions are not required, Mrs. Wilson will be able to let the entire account grow tax-free during her lifetime. When her children inherit the account, the assets will be free of Federal and state income taxes. The total value of the inheritance will be nearly 30% higher than if Mrs. Wilson kept her Traditional IRA.

A REVERSAL IS POSSIBLE

If you are concerned that your account value will decline after you convert to a Roth IRA, you may reverse the conversion and recoup your tax payment, if you do so before October 15 of the following year. For example, anyone who converts between January and December 2010 will have until October 15, 2011 to reverse (or recharacterize) the conversion. If you choose, you may convert back into a Roth IRA at the beginning of the next calendar year, and pay income taxes on the presumably lower account balance.

SITUATIONS WHERE CONVERTING TO A ROTH IRA MAY MAKE SENSE

- **You expect higher tax rates.** Higher income tax rates in the future make tax-free Roth IRA distributions more valuable in cases where the tax impact on conversion does not outweigh the benefits of tax-free withdrawals.
- **You have the ability to pay income tax and estate taxes from non-IRA funds.** This allows more assets to grow tax free inside the Roth account.
- **You do not need distributions from the IRA and would like to maximize benefits to heirs.** Since there is no minimum distribution requirement for Roth IRAs, the account assets can continue to grow in the account until they are distributed income tax-free to beneficiaries.
- **You would like to accelerate income into 2010.** Converting to a Roth IRA is a way to accelerate the income you would be receiving from taxable IRA withdrawals in future higher-tax years, and paying those income taxes in a lump sum at this year's lower rates.
- **Your tax attributes are favorable.** Taxpayers with special tax attributes, including a high basis ratio, charitable deduction carry forwards, investment tax credits or net operating losses may benefit because these attributes can reduce the effective tax rate of the conversion.

CONSIDER PENALTIES AND OTHER PROVISIONS BEFORE CONVERTING

Watch for events that trigger a penalty. The following situations can trigger a 10% penalty:

- Funds are used from a Traditional IRA to pay the tax. Since these assets are not actually converted to the Roth IRA, they are considered a withdrawal, subject to penalty for account owners under the age of 59½.
- Earnings are withdrawn within five years after the Roth IRA is established.
- Earnings are withdrawn before the Roth IRA owner reaches age 59½.

Understand restrictions for future Roth IRA contributions. While income restrictions are no longer imposed for Roth IRA conversions, contributions are still restricted. If your income is over the limit for a Roth IRA contribution ($177,000 annual adjusted gross income for married taxpayers) you will not be able to contribute new money to your Roth IRA directly. However, you may consider making non-deductible contributions to a Traditional IRA and subsequently converting the funds to a Roth IRA.

SPEAK WITH YOUR ESTATE PLANNER, TAX ADVISOR OR FIDUCIARY TRUST CONTACT TODAY

The decision to convert should be based on your own unique situation and on careful analysis done by a financial professional. As of this writing Congress has not acted to revise the 2011 tax laws—however much can still change. If the scheduled tax increases are implemented, for those who could benefit, converting to a Roth IRA before December 31, 2010 may help to achieve maximum results.

We encourage clients to speak with their estate planner, tax advisor or Fiduciary Trust contact. Our expertise and sophisticated tools allow us to develop conversion scenarios based on your unique circumstances to help guide you in this important decision.

About the Author

Craig S. Richards, CPA/PFS, CFP, is Managing Director and Director of Tax Services. He is a licensed CPA and CFP and a member of the Officer's Executive Committee. Mr. Richards is a member of the New Jersey State Society of Certified Public Accountants and the American Institute of Certified Public Accountants.

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