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Futures

A no-nonsense newsletter for estate planners and financial advisors from The Dayton Foundation

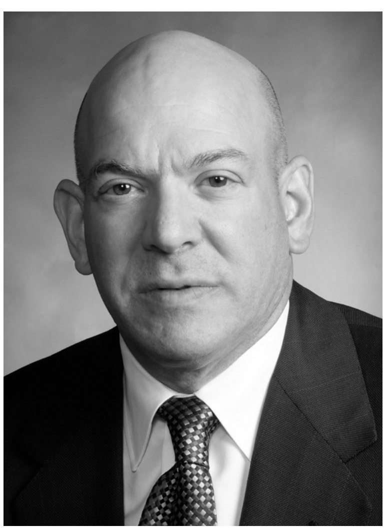
"The type of individual most likely to benefit from making the conversion is someone who has a high income tax bracket and expects to remain there for the next several years."
– Stanley J. Katz

Roth IRA Conversions and the Charitable Option

By Stanley J. Katz, Principal, ClientFirst Financial Strategies, Inc.

New tax rules for 2010 enable people with modified, adjusted gross incomes of more than $100,000 to convert assets held in traditional IRAs to Roth IRAs.

While individuals with a modified AGI of $120,000 or more and couples with $177,000 or more still will be ineligible to *contribute* to Roth accounts, anyone willing to pay the income taxes associated with converting the assets from a regular IRA to a Roth IRA will be able to direct their funds into a Roth where it will grow tax free (not tax deferred). This will give high-earners another way to fund Roth IRAs on a continuous basis.



STANLEY J. KATZ

In this article, I discuss why a client might wish to convert to a Roth IRA, the tax implications, who is likely to benefit, and how charity can add value to the conversion.

Why Convert?

Many clients are aware of the advantages that Roth IRAs can have over their traditional counterparts. The most significant is the tax benefit – Roth IRAs are funded with after-tax dollars, so they grow *tax free*, as long as the account holder follows the rules for minimum holding periods. Withdrawals from Roth IRAs may take place when the account holder is 59-1/2 years old or after a five-year holding period, whichever is later. Furthermore, each IRA asset conversion comes with its own five-year holding period. Otherwise, any withdrawals on converted assets will come with a penalty.

Another great advantage is there are no required distributions from Roth IRAs, so assets may continue to grow tax free. In contrast, traditional IRAs have a minimum required distribution after the recipient is 70-1/2 years old; taxes are due and payable for the year of distribution.

Finally, for clients who may wish to leave their IRAs to their heirs, Roth accounts offer beneficiaries an income-tax-free inheritance, unlike traditional IRAs.

Taxes Associated with the Roth IRA Conversion

When your client converts his or her IRA to a Roth IRA, the amount transferred is considered taxable income – potentially significantly increasing the current tax liability and pushing him/her into a higher tax bracket in the year of the conversion. An individual can choose to pay the taxes in 2010 or spread the additional income equally over the next two years (2011 and 2012 income tax returns).

Paying this converted Roth IRA tax may be problematic for an account holder under 59-1/2. Any withdrawal from the traditional IRA that does not go directly into the Roth IRA will incur a 10% Federal Surcharge along with the ordinary income taxes (federal and state). To keep the transfer "pure" and penalty-free, all IRA assets must remain intact, so the tax dollars due from this transfer must come from another source.

In order to estimate taxes in the year you make the conversion, you first calculate your basis ratio (any after-tax contributions you have made to your IRAs, divided by the total balance in your IRAs).

For example, if your client contributed $40,000 after taxes

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Roth IRA Conversions

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to his/her IRAs and has a total of $250,000 in those accounts, his/her basis would be 16%. So, if $100,000 of his or her traditional IRAs are converted to a Roth, 16% of the $100,000 will be considered income-tax-free.

Keep in mind that one does not have to convert his or her entire traditional IRA or do so immediately. In some cases, it may make more sense to extend the conversion several years to make it more affordable. Clients should seek counsel from their tax advisor.

Affordability and the Charitable Option

The wisdom that suggests one should make a major tax-deductible charitable gift during an unusually high income year holds true for a year in which one converts a traditional IRA to a Roth IRA.

To help offset this higher income year and lessen the tax consequences, the client could make a charitable contribution to establish an endowed charitable fund or a Charitable Checking Account℠ at The Dayton Foundation. This provides a vehicle for family giving to charities of the client's choice.

A gift to a Dayton Foundation fund or account offers several benefits. These include favorable tax treatments, the ability to support multiple charitable interests through a variety of fund options, access to local grantmaking expertise, and the opportunity to grow the gift over time through an endowment fund. The Dayton Foundation makes the process simple. They manage all the administrative details, including issuing grants to the client's selected charities in the name of his or her fund or account (or anonymously if he or she prefers) and providing the client with a single year-end statement detailing the gift and grant history for his or her tax-reporting needs.

The charitable contribution, however, must come from another source of funds, i.e., cash, appreciated stock, real estate or other assets – not from the original IRA – to stay free from penalties.

Classic Candidates for IRA Conversion

The type of individual most likely to benefit from making the conversion is someone who is in a high income tax bracket and expects to remain there for the next several years. Many believe today's tax rates likely will rise in the future, so they may prefer to pay the taxes at today's rates.

Higher income individuals also may be interested in tax-free and more certain income in retirement. They also may expect that their IRA will pass to heirs and wish to do so with the lowest tax implications.

A Roth IRA conversion may provide the opportunity to make a tax-deductible charitable gift. If so, community foundations like The Dayton Foundation can provide vehicles for years of charitable grants to important causes of the client's choice.

Roth IRA conversions also can be advantageous for those at the other end of the spectrum – someone young and currently in a low tax bracket – who may have significantly higher earned income or inherited wealth in the future.

In Conclusion

A Roth IRA conversion is clearly not for everyone. For those in a specific set of circumstances, it provides the right situation for them to marry their charitable goals with tax advantages. But many considerations come into play.

Clients need to work with their financial and estate advisors – and perhaps charitable giving experts like The Dayton Foundation – to determine what truly will work best for each client in his or her particular situation. The staff of The Dayton Foundation can be very helpful to advisors as they look at the best alternatives to present to their clients. ❧

Note: Solutions will differ from case to case. The above does not constitute professional financial or tax advice.

Stanley J. Katz has been helping clients achieve their financial goals for over 27 years. He is Principal of ClientFirst Financial Strategies, Inc., an independent investment advisory firm with a focus on investment management and retirement planning.

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