

The year 2010 will bring a unique opportunity for all investors, but particularly for those with adjusted gross income of \$100,000 or more. For 2010 only, the income restriction for converting from a traditional IRA or 401(k) to a Roth will be removed, allowing high net worth investors an opportunity to experience the advantages that the Roth IRA offers. In addition, the tax bill for a 2010 Roth conversion can be spread equally over the 2011 and 2012 tax years, easing the tax burden considerably. While the Roth IRA does provide some advantages over a traditional IRA, the decision about converting is anything but straightforward.

With a traditional IRA, money is usually contributed pre-tax and the earnings and principal are not taxed until withdrawn at retirement. With a Roth IRA, contributions are not tax deductible, but qualified withdrawals are tax-free. The Roth IRA also gives you the opportunity to withdraw principal before the age of 59 ½ without penalty, and does not have the required minimum distributions that traditional IRAs do at age 70 ½.

One of the things an investor needs to understand about a potential Roth conversion, is that if an investor's tax bracket remains constant, then on a very simplistic level the math works out the same whether you convert to a Roth (pay taxes now) or leave the money in a traditional IRA (pay taxes later). Consider the case of a 60-year old investor with \$100,000 in a traditional IRA. Assume that the investor uses IRA funds to pay the taxes, withdraws the money in 10 years with an annualized return of 8%, and has a tax bracket which is constant at 28%. Given these assumptions, the math on both the Roth IRA and traditional IRA is shown below.

| | Leave as Traditional IRA | Convert to Roth IRA |
|------------------------------------|--------------------------|---------------------|
| Initial Portfolio Value | \$100,000 | \$100,000 |
| Taxes Paid Today @ 28% | \$0 | \$28,000 |
| Net Amount Today After Taxes | \$100,000 | \$72,000 |
| Value in 10 Years @ 8% Annually | \$215,893 | \$155,443 |
| Taxes Upon Withdrawal @ 28% | \$60,450 | \$0 |
| Net Amount to Investor in 10 Years | \$155,443 | \$155,443 |

As you can see, in this very simplistic case of a constant tax rate and paying the taxes out of the IRA with no penalties, the net amount to the investor is the same. However, in practice there are several reasons why a Roth conversion could up being better or worse than leaving the money in a traditional IRA. These would include the following:

1. A difference in marginal tax rates (2011-12 versus retirement)
2. Availability of cash outside of the IRA to pay taxes
3. The potential to shrink an investor's estate (and reduce an estate tax liability)
4. The added tax deferral of not having required minimum distributions
5. The potential to have access to the IRA before 59 ½ without penalty

Analysis of Marginal Tax Rates

When considering the 2010 Roth conversion, one of the most important things to evaluate is the marginal tax rate that the investor will be taxed at. Part of that analysis would include an expectation of future tax rates, but an investor also needs to think about all of their income sources, both current and in retirement. An investor currently receiving a substantial salary may be in the top marginal tax rate today, but if their income in retirement is limited to social security and their IRA, then much of the money withdrawn from a traditional IRA in retirement may be taxed at a much lower marginal rate, even if tax rates do go up. Conversely, for a young worker who has not yet hit their peak earnings years, the marginal tax rate today may be lower than what they would expect in retirement.

The example below shows how the marginal tax rate can have a big impact on the value of the Roth conversion. We will use most of the assumptions from the previous scenario, but now we will assume that the 60-year old worker is in their peak earning years and is temporarily in the highest marginal tax bracket of 35%. Their only sources of income in retirement will be their IRA and social security, which will put them in the 28% tax bracket at retirement.

| | Leave as Traditional IRA | Convert to Roth IRA |
|------------------------------------|--------------------------|---------------------|
| Initial Portfolio Value | \$100,000 | \$100,000 |
| Taxes Paid Today @ 35% | \$0 | \$35,000 |
| Amount Today After Taxes | \$100,000 | \$65,000 |
| Value in 10 Years @ 8% Annually | \$215,893 | \$140,330 |
| Taxes Upon Withdrawal @ 28% | \$60,450 | \$0 |
| Net Amount to Investor In 10 Years | \$155,443 | \$140,330 |

As you can see, in this particular case the Roth conversion will actually provide the investor with less money at retirement. We won't run through the math again, but the converse also holds true, and a Roth will generally provide an investor with more money if the investor expects their marginal tax rate to be higher at retirement.

One major concern investors have right now is that federal tax rates will be raised significantly in the future. However, the Bush tax cuts are set to expire in 2010, and barring any action by Congress there will be a "stealth" tax increase in 2011 from letting these tax cuts expire. The 2010 Roth conversion amount will be split equally between an investor's 2011 and 2012 tax returns, at which point taxes rates may have already risen from where they are now. Thus, converting to a Roth in 2010 may not avoid a potential increase in tax rates that many investors are anticipating.

Source of Funds to Pay Roth Conversion Taxes

A second major consideration in a potential Roth conversion is the ability to use funds outside of the IRA to pay the taxes due upon conversion. If an investor is younger than 59 ½ and has to take money out of the IRA to pay the taxes, they could get hit with a 10% penalty which would likely negate the benefits of a conversion. However, if an investor has funds available outside of the IRA, then a Roth IRA can be beneficial even if an investor's tax bracket is constant.

This can be shown in the chart below. We will go back to our original assumptions of a constant 28% tax bracket and an annualized return of 8%. However, this time we will assume that the investor also has \$28,000 in a taxable account to pay the Roth conversion taxes, rather than taking money out of the IRA.

| | Pay Taxes with Other Funds | | Don't Convert | |
|---------------------------------|----------------------------|-------------|---------------|-------------|
| | IRA | Other Funds | IRA | Other Funds |
| Initial Portfolio Value | \$100,000 | \$28,000 | \$100,000 | \$28,000 |
| Taxes Paid Today @ 28% | \$0 | \$28,000 | \$0 | \$0 |
| Amount Today After Taxes | \$100,000 | \$0 | \$100,000 | \$28,000 |
| Value in 10 Years @ 8% Annually | \$215,893 | \$0 | \$215,893 | \$60,450 |
| Taxes Upon Withdrawal @ 28% | \$0 | -- | \$60,450 | -- |
| Capital Gains Taxes @ 15% | -- | \$0 | -- | \$4,868 |
| Account Values After taxes | \$215,893 | \$0 | \$155,443 | \$55,582 |
| Net Amount to Investor | \$215,893 | | \$211,025 | |

With everything else constant, it becomes advantageous to convert to a Roth if the investor has funds available outside of the IRA to pay taxes. The net benefit is exactly equal to the taxes that would have been paid over the years on the non-IRA funds, had the Roth IRA conversion not occurred. So it essentially allows you to tax-shelter more dollars.

Additional Considerations

In addition to the issues cited previously, a Roth conversion could have potential estate-planning benefits for high net worth investors. As the law currently stands, the federal estate tax exemption is scheduled to revert to \$1 million per individual in 2011 (\$2 million for a couple if planned properly). Anything over this amount could be taxed heavily by the government (up to 48% for federal estate taxes). By converting to a Roth, a high net worth investor will essentially be reducing their estate by an amount equal to the taxes paid upon conversion. In addition, if the high net worth investor didn't actually need the IRA funds to live on, converting to a Roth IRA eliminates the need for required minimum distributions, allowing a longer period of tax-deferred growth.

A further advantage of the Roth IRA for all investors is the ability to access principal prior to age 59 ½ with no penalty. For a Roth conversion, investors will have a 5-year waiting period from the time of conversion, after which they will be able to access their principal tax-free without any penalties (earnings generated after the date of conversion could still be penalized if withdrawn). It's difficult to quantify this benefit, but it does add to the overall flexibility of the Roth compared to a traditional IRA.

Finally, an investor should take into consideration the fact that the risk of loss with a traditional IRA is shared with the government (since you haven't paid taxes yet). With a Roth IRA, the investor is taking on more of the risk of loss. There are ways to get a tax write off if the Roth loses value after the conversion, but it's subject to significant limits and most investors would not be able to write off the full amount of the losses. This is probably a pretty small risk for someone years from retirement, but a bigger risk for investors who will need the money soon.

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The Bottom Line

As you can see, the decision about converting to a Roth requires a fairly detailed analysis of each investor's financial situation. For most investors, the decision is not cut-and-dry and will involve balancing several different pros and cons.

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