



ROTH CONVERSION ANALYSIS

Prepared for John & Jane Dough

November 20, 2009

ROTH CONVERSION ANALYSIS

In 2010 many Americans will have their first opportunity to convert their Traditional IRA and 401(k) assets into a Roth IRA. Roth IRA's differ from their Traditional cousins in that all qualified withdrawals from a Roth are free of income taxes. On the surface, the decision to convert your retirement savings into a vehicle that could produce tax free income sounds great.

In making the conversion, though, income taxes on the amount converted are due. Normally the conversion income is taxed in the year of the Roth conversion. This could create a large tax bill as the conversion amount is added on top of any other income you have and could push you into a much higher income tax bracket.

In 2010, though, you'll have the ability to split the conversion amount and add it onto your 2011 and 2012 income. Depending on the amount converted, this could still create a large income tax bill.

If you don't have funds available outside of a retirement account to pay the extra income taxes due on the conversion then it's best not to do a Roth conversion. If you are under age 59 ½ then funds that are pulled from your IRA and not converted into the Roth would be subject to a 10% penalty tax on top of the income taxes. Only in rare circumstances would it make sense to pay such a high tax rate on the conversion and still have it make sense.

Inflation

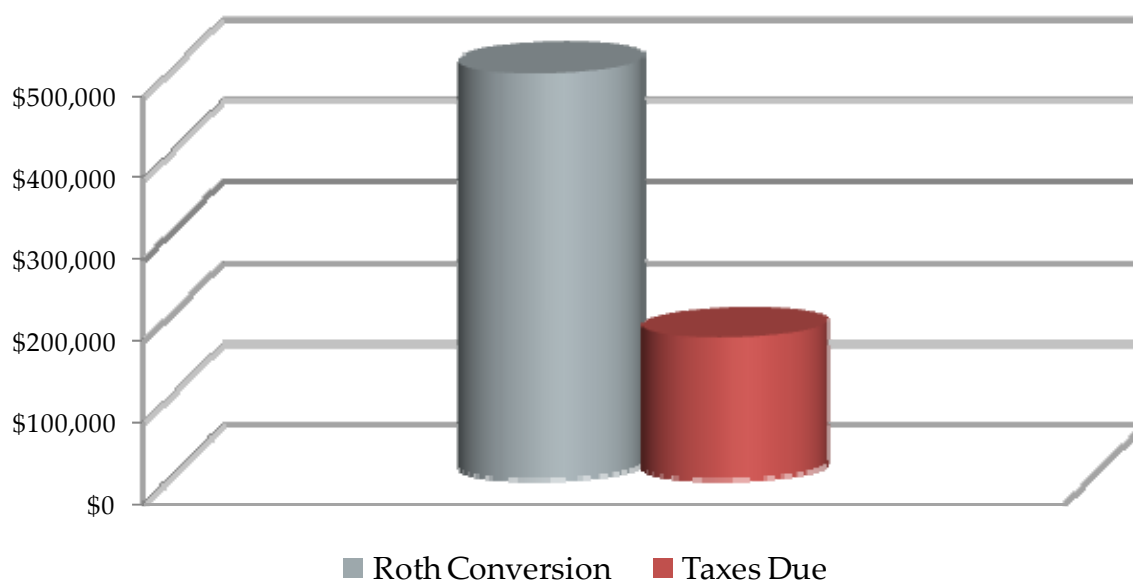
The cost of living seems to rise year in and year out which makes it difficult to compare future dollars to today's values. Income tax rates today are tied to inflation so you won't get bumped into a higher tax bracket simply because of a higher cost of living. For our analysis we've adjusted for inflation so that all dollar figures are in today's dollars which makes comparisons much easier. Our assumptions are also that your income and annual savings figures will rise with inflation.

Assumptions

Current Age	50
Retirement Age	62
Age at Death	81
IRA Value	\$600,000
Roth Value	\$40,000
Taxable Account	\$300,000
IRA Annual Savings	\$16,500
Roth Annual Savings	\$3,000
Taxable Annual Savings	\$10,000
Gross Income	\$140,000
Tax Deductions	\$30,000
Other Assets	\$500,000
Beneficiary Ave Age	18
Real Return (over CPI)	3%
Pension Benefit	\$5,000
Social Security Benefits	\$35,000
Taxable Account Yield	3%
Filing Status	Joint
Income Tax Scenario	Obama
Estate Tax Scenario	Current \$1m/55%

For additional calculation assumptions please see the appendix

Roth Conversion Taxes



Roth Conversion Amount	\$500,000
Federal Taxes Due in 2011/12	\$152,247
State Income Taxes Due	\$21,750
Total Conversion Taxes	\$173,997
Effective Tax Rate	34.8%

Income Tax Rates Today and in Retirement

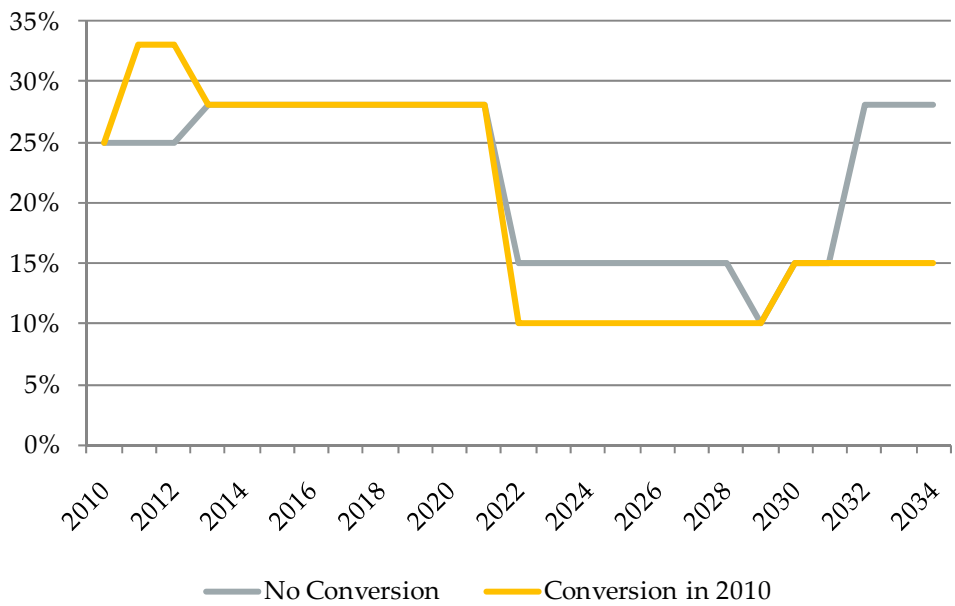
In doing the tax analysis to determine whether a Roth conversion makes sense for you the key is to calculate the tax rate on the conversion amount and then make your best guess as to the your income tax rate during your retirement years. Earnings on both the Roth and Traditional IRA accounts are not subject to income taxes. Also the investment returns on both would likely be the same. This leaves the major part of the analysis to determining the lower tax rate on the withdrawal of the IRA funds, now or in retirement.

Determining your income tax rate for 2010 can be fairly straightforward. You likely have a good idea of your taxable income and deductions and it is unlikely that the tax rates will change very much, if at all. If you opt to spread the conversion amount over 2011 and 2012 there is less certainty but the tax rate structure may become clearer later in 2010. The difficult task is estimating your income tax rate during your retirement years, especially if that's a long time from now.

Most Americans will find themselves in a lower income tax bracket during their retirement years. Their retirement income is generally lower than during their working years and the sources of their income may receive more preferential tax treatment. For instance, only a maximum of 85% of Social Security benefits are taxed, capital gain tax rates are lower and many dividends also qualify for a lower tax rate.

On the other hand the growing federal debt and insolvency of Medicare could mean an increase in tax rates generally. Today's top federal income tax rate of 35% is only half the top rate of the early 1980's so an increase in rates would not be unusual.

Marginal Federal Income Tax Bracket



Future Income Tax Rate Scenarios

In order to do a thorough analysis we'll need to make some assumptions about the future income tax rate structure. Today there are six federal income tax brackets. The first portion of your income is taxed at 10%, then the next at 15% and the brackets rise to a maximum of 35% if your taxable income exceeds \$372,950. This structure was put into place during the Bush administration.

Under the Clinton administration there were five federal tax brackets beginning at 15% and rising to a maximum of 39.6%. During President Obama's campaign he pledged not to raise rates above those of the Clinton era but given today's budget challenges that may be a difficult promise to keep.

In looking to the future we've included three different income tax scenarios. The first, which we'll refer to as the Bush scenario, keeps the rate structure the same as today with a top federal rate of 35%. The second scenario, called Clinton, reverts to the late 1990's rate structure with a top rate of 39.6%. For the third, we'll call Obama, the top rate climbs to 43%.

Assumed rates for 2013 and beyond:

Income Tax Scenario	Obama
---------------------	-------

Taxable Income	Rate
\$0	10%
\$16,700	15%
\$67,900	28%
\$137,050	33%
\$208,850	38%
\$372,950	43%

For more income tax rate assumptions and scenarios see appendix.

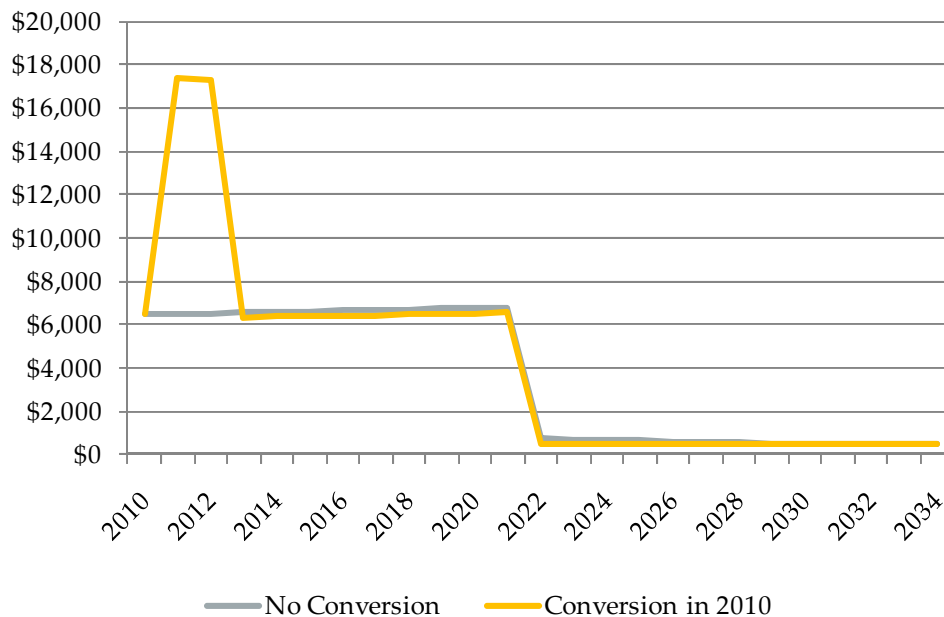
State Income Taxes

Federal income taxes are typically much higher than state income taxes. Yet an analysis isn't complete without considering the state income tax implications of a Roth conversion.

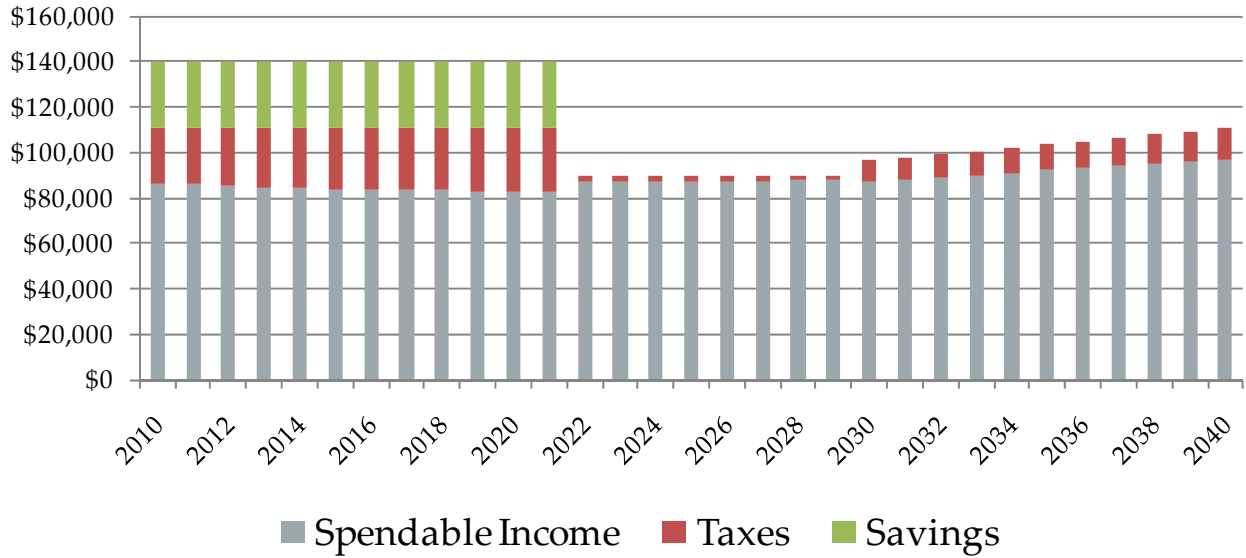
In Michigan today's state income tax rate is a flat 4.35%. Roth conversion amounts would be subject to this tax as well. While Michigan retirees are also in the 4.35% bracket, withdrawals from Traditional IRA accounts up to \$43,440 (\$86,880 joint) are free of Michigan income taxes. **Thus for most Michiganders, a Roth conversion will result in paying state income taxes on IRA funds that would not normally be taxed.**

The tax free IRA withdrawals, of course, could change in the future. Also Michigan's current budget crisis could result in an increase in the 4.35% rate. In the early 1980's Michigan's income tax rate jumped from 4.6% in 1982 to 6.35% in 1983 and then was gradually reduced back to 4.6% by 1986. While the state tax rate is small compared to the federal rate, Michiganders may want to consider that the rate could increase in the 2010-12 period.

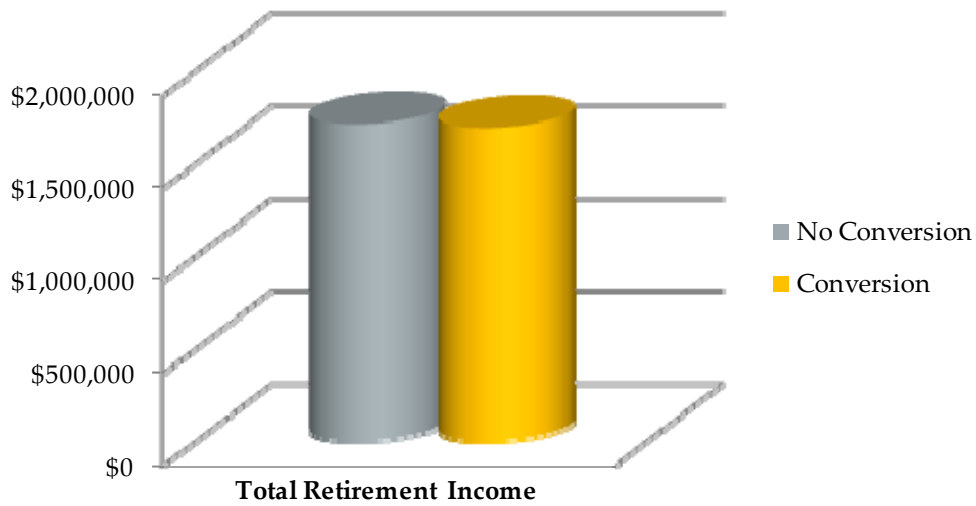
Michigan State Income Taxes



Spendable Income



Total Retirement Income



Spendable Retirement Income (No Conversion)

Year	Age	Total Income	Savings	Taxes	Net to Spend
2010	50	\$140,000	\$29,500	\$24,482	\$86,019
2011	51	\$140,000	\$29,500	\$24,649	\$85,851
2012	52	\$140,000	\$29,500	\$24,821	\$85,679
2013	53	\$140,000	\$29,500	\$26,089	\$84,411
2014	54	\$140,000	\$29,500	\$26,291	\$84,209
2015	55	\$140,000	\$29,500	\$26,498	\$84,002
2016	56	\$140,000	\$29,500	\$26,712	\$83,788
2017	57	\$140,000	\$29,500	\$26,932	\$83,568
2018	58	\$140,000	\$29,500	\$27,159	\$83,341
2019	59	\$140,000	\$29,500	\$27,393	\$83,107
2020	60	\$140,000	\$29,500	\$27,633	\$82,867
2021	61	\$140,000	\$29,500	\$27,881	\$82,619
2022	62	\$90,000	\$0	\$3,184	\$86,816
2023	63	\$90,000	\$0	\$3,051	\$86,949
2024	64	\$90,000	\$0	\$2,914	\$87,086
2025	65	\$90,000	\$0	\$2,773	\$87,227
2026	66	\$90,000	\$0	\$2,628	\$87,372
2027	67	\$90,000	\$0	\$2,478	\$87,522
2028	68	\$90,000	\$0	\$2,324	\$87,676
2029	69	\$90,000	\$0	\$2,172	\$87,828
2030	70	\$96,376	\$0	\$9,558	\$86,818
2031	71	\$97,749	\$0	\$9,793	\$87,956
2032	72	\$99,153	\$0	\$10,200	\$88,953
2033	73	\$100,591	\$0	\$10,654	\$89,937
2034	74	\$102,061	\$0	\$11,119	\$90,943
2035	75	\$103,564	\$0	\$11,594	\$91,971
2036	76	\$105,100	\$0	\$12,080	\$93,021
2037	77	\$106,383	\$0	\$12,497	\$93,886
2038	78	\$107,977	\$0	\$13,002	\$94,975
2039	79	\$109,277	\$0	\$13,428	\$95,849
2040	80	\$110,580	\$0	\$13,855	\$96,724

Estate Taxes

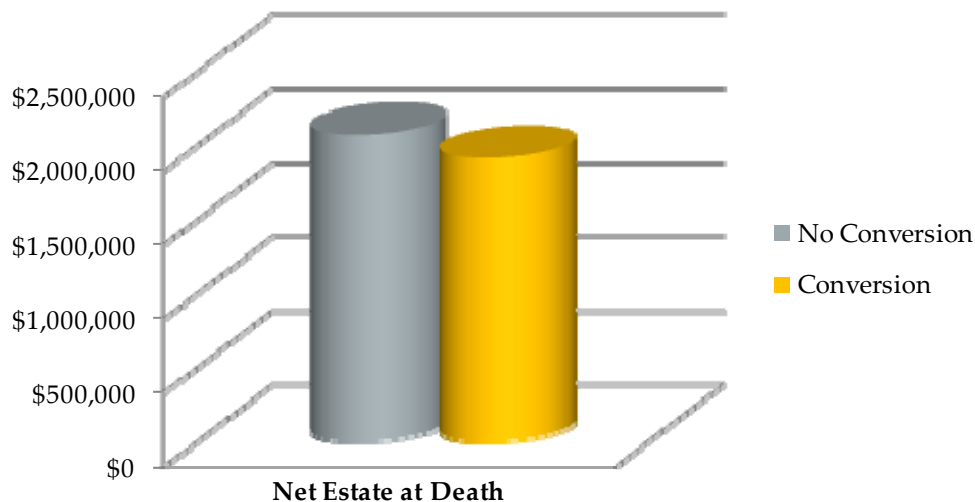
Any tax analysis of a Roth conversion should include the potential impact of estate taxes. By converting a Traditional IRA to a Roth a large income tax bill is generated that results in reducing a person's estate. If you may be subject to estate taxes a conversion would reduce your estate tax.

In 2009 the federal estate tax exemption amount is \$3.5 million per person. This means that anyone dying with an estate under that figure isn't subject to federal estate taxes. Couples with well designed estate plans can exclude up to \$7 million. Unfortunately the estate tax law will likely be changed by the beginning of 2010.

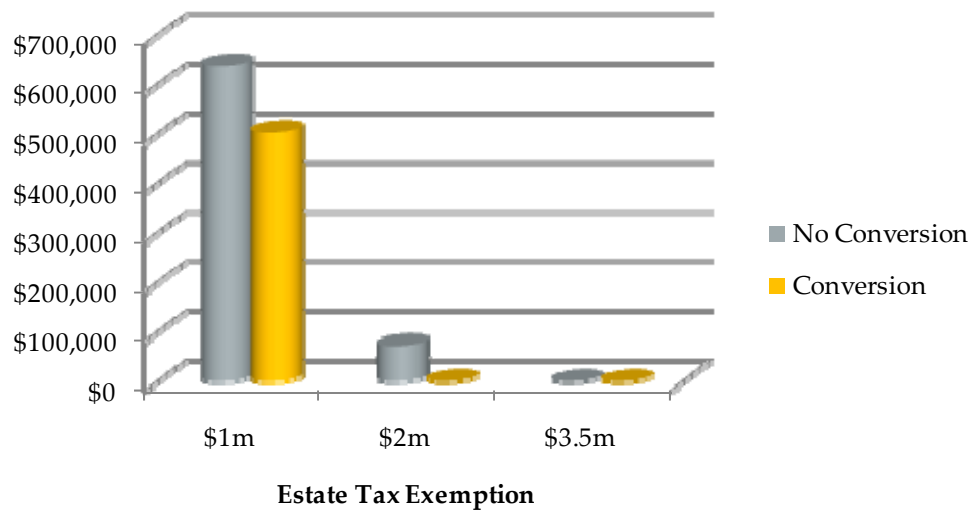
Under current law there will be no federal estate tax in 2010. The general thinking today is that the \$3.5 million exemption amount will be extended for one more year but in 2011 the exemption amount reverts to just \$1 million. Also the estate tax rate jumps from the current 45% to a top rate of 55%.

The outlook for the exemption amount and estate tax rate in 2011 and beyond is currently up in the air. Congress can ignore the issue and let the exemption drop to \$1 million under current law. If they increase the exemption then the federal budget projections will need to be revised resulting in higher deficits. There is currently a bill before the Senate (722) that would extend the \$3.5 million exemption and 45% rate and index the exemption with inflation. Another bill before the House (2032) would set the exemption at \$2 million, index it with inflation and maintain the 45% rate on estates up to \$5 million.

Net Estate Value at Death



Federal Estate Taxes



Beneficiary IRAs

The comparison of Roth IRA accounts that are free of more income taxes and Traditional IRAs that are only tax deferred needs to consider the time frame until the Traditional IRA taxes are paid. Current tax laws include Required Minimum Distributions that must be withdrawn from Traditional IRAs and taxed beginning at age 70 ½. An easy assumption to make is that any Traditional IRA balance remaining at death will be subject to income taxes at that time. This ignores the possibility of the IRA heirs establishing a Beneficiary IRA.

A Beneficiary IRA is available to the heir of an IRA account and it allows them to keep most of the Traditional IRA tax deferred. The beneficiary must begin taking Required Minimum Distributions in the year following the death of the IRA owner, but the amounts are based on the life expectancy of the beneficiary. Thus a 45 year old heir would only need to withdraw about 2.6% of the value of the IRA in the first year. This can allow for a Traditional IRA to defer income taxes for decades after the death of the account owner.

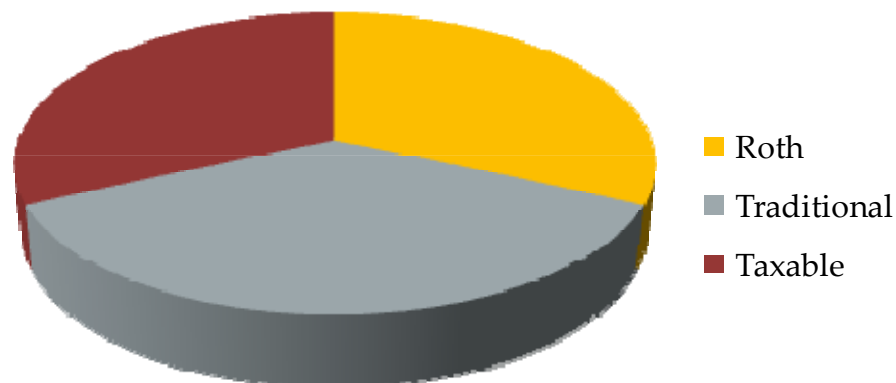
Tax Diversification

For most people, converting their Traditional IRA to a Roth won't make sense because the tax rate will be higher on the conversion than during their retirement years. While a conversion may not make sense, contributing to a Roth IRA or Roth 401(k) may make good sense.

The impediments to a conversion include the likelihood of the amount increasing your income tax rate, the Michigan state income taxes and/or the lack of outside funds to pay the tax bill. Contributions to a Roth aren't subject to these issues so the numbers may work out better.

In order to qualify to contribute to a Roth IRA for 2009 your joint income must be under \$176,000 (single \$120,000). For Roth 401(k) or Roth 403(b) plans there is no income limit and many employers now offer these new plans.

One of the chief benefits of adding a Roth account is the ability to diversify the tax treatment of your retirement assets. Your Traditional IRA or 401(k) withdrawals will be subject to income tax rates, your taxable accounts may be subject to varying rates on interest, dividends and capital gains, while the Roth withdrawals are tax free. By having three different sources of retirement income you can decide how much you'll pay in income taxes. If you are in a low tax bracket you can decide to withdraw more from the Traditional IRA or, if your rate is high, draw income from the Roth. Our rough rule of thumb at Vintage is to recommend that people that will accumulate at least \$1 million (in today's \$) in their Traditional IRAs and 401(k)'s consider contributing to a Roth.

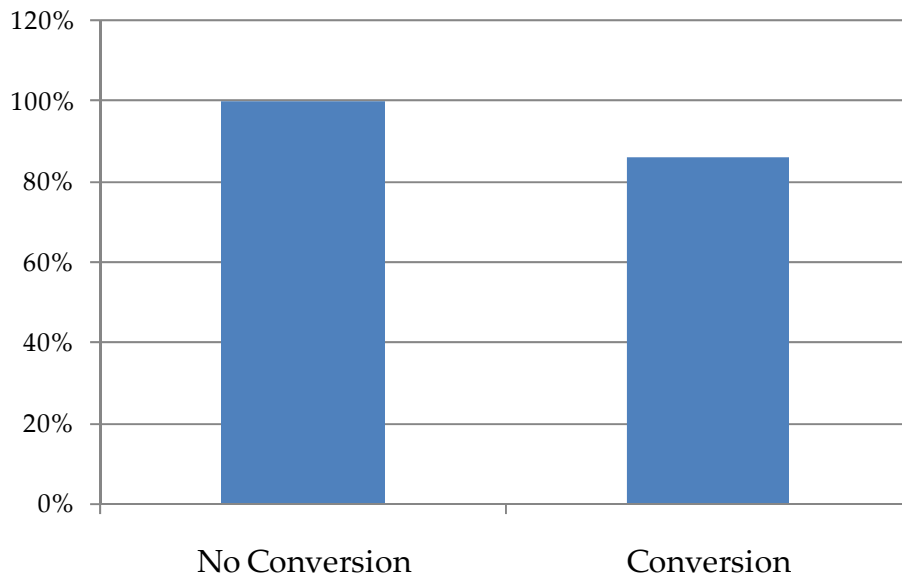


Conclusion

There are many different assumptions we've made in trying to determine whether a Roth conversion makes sense for you. While these calculations can provide precise numbers, the future of our tax code and your financial position are unknown.

It's difficult to come up with a simple total of your income, taxes, and the amount you'll leave to your heirs because, even upon your death, the taxation of the different accounts will vary. For instance, your beneficiaries could elect to withdraw all of your IRA assets upon your death which would result in higher taxes than if they use the Beneficiary IRA.

Our summary figure below includes all of the after tax retirement income available to you and your heirs through 2094. Rather than include a dollar amount, which is somewhat meaningless, we've simply shown the relative difference of converting funds to a Roth.



Appendix

Assumptions

- Figures are all in current (inflation-adjusted) dollars
- Tax rates indexed with inflation including estate tax exemption amount
- Investment return is real return (amount above inflation rate)
- Beneficiaries do not cash out Traditional IRA, take Required Minimum Distributions
- Your Income and Tax deductions rise at rate of inflation
- Annual Savings amount increases at rate of inflation
- Other assets appreciate at the rate of inflation and provide no income
- Social Security Benefits include both spouses if filing jointly, rise with inflation
- Roth conversion is done in 2010 with taxable amount split over 2011 & 2012 income
- Income tax rates remain the same through 2012, indexed with inflation
- State income taxes are included based on current Michigan tax laws and rate of 4.35%
- Taxable investment accounts pay income taxed each year at income tax rate
- Taxable investments appreciate with inflation and are not sold (no capital gains)
- Comparative totals are summed through 2094
- Estate tax computations assume couples each use the maximum exemption amount
- Spouses are assumed to die in same year
- Assumes 85% of SS income is taxed
- Estate tax calculations ignore IRD deduction and possible state estate taxes

Income Tax Scenarios After 2012

Joint Taxable Income	Bush	Clinton	Obama
\$0	10%	15%	10%
\$16,700	15%	15%	15%
\$67,900	25%	28%	28%
\$137,050	28%	31%	33%
\$208,850	33%	36%	38%
\$372,950	35%	39.6%	43%

This analysis is not intended to be a complete assessment of your tax situation. Please consult your tax advisor for additional information specific to your situation before making any tax moves.