

Individual Retirement Accounts

Roth IRA conversion strategies and opportunities

The Tax Increase Prevention and Reconciliation Act of 2005 has an important change for many taxpayers: the ability to convert a tax-deferred traditional IRA into a tax-free Roth IRA starting in the year 2010 **regardless of income.**

Dates to Remember

Jan. 1, 2010

First day to convert to a Roth IRA without the \$100,000 AGI limit

Dec. 31, 2010

Last day to convert to take advantage of delaying taxes until tax time for years 2011 and 2012

April 15, 2011

Due date for 2010 income tax return

Oct. 15, 2011

Last day to recharacterize a 2010 conversion (if your taxes are filed by April 15, 2011)

April 15, 2012

Due date for 2011 income tax return

April 15, 2013

Due date for 2012 income tax return

Prior to 2010, for a taxpayer to be eligible to convert a traditional IRA to a Roth IRA, he or she must have had a modified adjusted gross income (AGI) that didn't exceed \$100,000. Also, the taxpayer couldn't file a married filing separately return. With those restrictions lifted, now may be a good time to meet with your financial adviser and discuss whether a Roth IRA conversion may be right for you.

In addition to a traditional IRA, you may also be able to convert the following into a Roth IRA:

- Qualified plan [e.g. 401(k)] distributions that are eligible to rollover
- 403(b) plan distributions that are eligible to rollover
- SIMPLE IRA¹
- SEP IRA

Also, if over the age of 59½ and if the plan allows for it, participants in a qualified retirement plan may be able to convert in-service distributions to a Roth IRA. Consult your retirement plan document and discuss this option with your financial adviser.

To convert or not to convert into a Roth in 2010

Is converting current retirement savings into a Roth IRA the right decision for you?

The first aspect of a Roth IRA conversion to consider is the taxes you will have to pay on the funds that are converted. Taxpayers who convert to a Roth IRA must pay ordinary income tax on the taxable portion of the amount of qualified savings being converted. But, those who convert in 2010 have the option to include the taxable income in two equal installments on their 2011 and 2012 tax returns.

You should consider the potential benefits and drawbacks of choosing to include the taxable income due on the conversion in two installments for tax years 2011 and 2012. An increase in tax rates after 2010 could mean a higher tax payment for tax year 2011 and/or 2012.

¹ SIMPLE IRAs may convert after two years from initial SIMPLE deposit.



Why choose a Roth IRA?

Contributions to Roth IRAs are not tax deductible, but they have two attractive features. First, qualified withdrawals are completely tax free.¹ Second, because there are no required minimum distributions (RMDs) starting at 70½, Roth IRAs may be left in place to accumulate for future generations.

You might consider a Roth IRA if you:

- Are a young high-income earner with a long time until retirement.
- Like the flexibility of the Roth IRA, which does not feature RMDs unless inherited.
- Think you will be in a higher tax bracket during retirement.
- Are a high-net-worth taxpayer and you intend to leave your IRA to a beneficiary who is in a higher tax bracket.
- Have an AGI greater than \$100,000 and were previously unable to fund a Roth IRA.

Estate planning strategy with a Roth IRA

A Roth IRA may be a beneficial estate planning tool. The advantage to you is that, unlike a traditional IRA, you are not required to take a minimum distribution from a Roth IRA when you reach 70½. The advantage to your heirs is that they may receive an income-tax-free inheritance. If the beneficiary of your Roth IRA is someone other than your spouse, he or she will be required to take a minimum distribution. The distribution requirements for inherited Roth IRAs are similar to those for traditional IRAs, and they are treated as if the Roth IRA owner died before turning 70½. The five-year aging period for qualified Roth IRA distributions begins when the decedent established the Roth IRA, not when the beneficiary inherits it. The amount of the RMD for non-spouse beneficiaries will be based on the beneficiary's age.

If you are considering converting to a Roth IRA as a wealth-transfer strategy, the optimum reasons would be:

- You have a long time horizon (20 years or more).
- You expect your heirs to be in a higher tax bracket.
- Your estate tax would be higher than the ordinary income tax you or your beneficiary would pay.

Another estate planning opportunity for Roth IRAs was provided by the Pension Protection Act, which allows a non-spouse beneficiary to convert inherited qualified plan assets into an inherited Roth IRA. Assuming the retirement plan allows for this type of conversion, this could be an additional advantage for the beneficiary. If allowed, this type of transaction is required to be a direct trustee-to-trustee transfer.

Reducing your RMD with a Roth IRA

If your required distributions upon reaching 70½ will create an additional tax burden for you, a Roth IRA may be a good vehicle for reducing that burden. For example, Randy, age 62, put most of his dollars into his company's 401(k) plan. At retirement, he has a lump-sum distribution of \$800,000. Randy feels he can live on his taxable income and social security and leave his lump sum for emergency use only.

If Randy leaves his lump sum to grow, it will be worth \$1.5 million in eight years (8% assumed interest rate³). His RMD at 70½ will be \$54,745, which would put him in a higher tax bracket. To reduce his RMD and avoid the higher tax bracket, Randy can start converting amounts to his Roth IRA each year. This strategy would reduce the traditional IRA value subject to RMD. If and when Randy decides to withdraw from his Roth IRA, those withdrawals are not included as provisional income when figuring taxation on Social Security benefits during retirement.

¹ A qualified withdrawal from a Roth IRA is made five years after the owner makes the first contribution and meets one of the following criteria: the account owner is 59½, disabled, buying a first home (\$10,000 lifetime limit) or the distribution is being made to a beneficiary after the account owner's death.

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

Allocating assets across multiple tax strategies

Having a combination of taxable, tax-deferred and tax-free accounts gives you the flexibility to divide your assets and structure your distributions upon retirement. Discuss your specific situation and investments with your financial adviser to determine the best distribution strategy, but a good rule of thumb for distribution order is:

1. Taxable accounts (stocks and mutual funds)
2. Tax-deferred accounts (traditional IRAs and qualified plans)
3. Tax-free accounts (Roth accounts)

Since you already pay taxes on the earnings from taxable accounts, there is no increased tax burden for spending the dividends and capital gains distributions. In addition, keeping assets in tax-advantaged accounts allows them to continue to grow tax deferred for as long as possible – and potentially faster than a comparable investment in a taxable account. Once you have to start taking your RMDs from your tax-deferred accounts, you may want to alter the distribution accordingly and take less from your taxable accounts.

Conversion considerations and tax implications

You will want to discuss the tax implications of a Roth IRA conversion with your financial adviser. One item to pay close attention to is the pro rata rule. If you convert your nondeductible funds from your traditional IRA to your Roth IRA, and you also have other IRAs, it is assumed that your conversion amount is coming pro rata from the total amount in all IRAs.

Let's look at Sally, who opened her nondeductible IRA account in 2008 and began making the maximum \$6,000-per-year contribution. In 2010, assume the amount in her IRA was \$20,000 – \$18,000 in nondeductible contributions and \$2,000 in earnings.¹ When she converted that amount into her Roth IRA, she would owe income taxes on the \$2,000. If, however, Sally also had \$100,000 in a traditional IRA and converted the \$20,000 from her nondeductible IRA, she would owe income tax on \$17,000 of her conversion. The pro rata rule divides the amount of nondeductible contributions by the sum of all IRA accounts to determine the percentage of the conversion amount that is tax free.

One final note: If you move forward with the Roth IRA conversion strategy, make sure you will be able to pay any taxes due from a source other than from the IRA you are converting. This will allow you to get the most potential long-term benefit from opening a Roth IRA.

Next Steps

- Talk to your financial adviser. Discuss how a Roth IRA would fit into your overall financial plan and determine your eligibility for the various strategies mentioned in this brochure.
- Learn more about the potential benefits of retirement accounts. Invesco has a variety of materials available at invescoaim.com.

¹ Assumed interest rate for illustrative purposes only. Not intended to represent the performance of any AIM fund or IRA. Actual return is not likely to be constant from year to year, and there is no guarantee that a specific rate of return will be achieved.

Consider the investment objectives, risks and charges and expenses carefully. For this and other information about AIM funds, obtain a prospectus from your financial adviser and read it carefully before investing.

Note: Not all products, materials or services available at all firms. Advisers, please contact your home office.
This information does not constitute tax advice. Please consult your tax adviser about your particular situation.