

Individual Retirement Accounts

2010 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 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)

Currently, for a taxpayer to be eligible to convert a traditional IRA to a Roth IRA, he or she must have a modified adjusted gross income (AGI) that doesn't exceed \$100,000. Also, the taxpayer cannot file a married filing separately return. Now is a good time to meet with your financial advisor and discuss whether a Roth IRA conversion may be right for you.

The current \$100,000 AGI limit includes certain amounts distributed from the traditional IRA. When determining whether your AGI exceeds \$100,000, the amount being converted would not be included, but any taxable amount that is not converted would be included. Also, any required minimum distribution (RMD) amount would not be included. Talk to your financial advisor and discuss your options for converting to a Roth IRA prior to 2010 if your AGI is less than \$100,000.

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

- Qualified plan distribution
- 403(b) plan distribution
- 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 make in-service rollover distributions to a Roth IRA. Consult your retirement plan document and discuss this option with your financial advisor.



To convert or not to convert into a Roth in 2010

Once the AGI limit is lifted in 2010, will converting current retirement savings into a Roth IRA be 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 may pay the tax in two equal installments in 2011 and 2012. To take advantage of this conversion opportunity, you may want to start funding a nondeductible traditional IRA now using the strategy described in the next section.

You should also consider the potential benefits and drawbacks of choosing to pay the taxes due on the conversion in two installments in 2011 and 2012. An increase in tax rates after 2010 could mean a higher tax payment in 2011 and/or 2012.

Strategy for converting a nondeductible IRA to a Roth IRA in 2010

One benefit of a traditional IRA is its tax deductibility, but the opportunity to deduct IRA contributions is phased out based on income. If you are interested in taking advantage of the 2010 Roth IRA conversion, but you are not currently contributing to a traditional IRA because those contributions wouldn't be deductible, you have the option of making nondeductible contributions to a traditional IRA now and converting that to a Roth in 2010. For example, Mike and Sally are eligible to make nondeductible traditional IRA contributions starting in 2008. Because they are both over 50, they can contribute the maximum of \$6,000 each for tax years 2008 through 2010. By the year 2010, they will have made a total of \$18,000 each in nondeductible traditional IRA contributions that they could choose to convert to Roth IRAs. Any earnings made on the contributions at the time of conversion will be taxed as ordinary income.

To make traditional IRA contributions, taxpayers must have earned income and be under 70½. They must also analyze their 2010 conversion tax liability based on the total amount invested in IRAs, not just the amount invested in nondeductible IRAs – this is known as the pro rata rule. If a taxpayer has substantial amounts in rollover, SEP, SIMPLE or other traditional IRAs, this conversion strategy may create too large a tax burden. You'll want to consult your tax advisor before using this strategy.

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.² Second, because there are no 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 looking for an estate planning tool.
- Have an AGI greater than \$100,000 and were previously unable to fund a Roth IRA.

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Estate planning strategy for 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 the same as those for traditional IRAs, and they are treated as if the Roth IRA owner died before turning 70½. Distributions must begin before the end of the calendar year following the year of death. The amount of 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 roll over inherited qualified plan assets into an inherited Roth IRA. Assuming the retirement plan allows for this type of rollover, and the beneficiary meets the modified AGI and filing requirements, this could be an additional advantage for the beneficiary. If allowed, this type of rollover 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 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 when figuring taxation on Social Security benefits during retirement.

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 advisor 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 advisor. 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 back at Sally from our first example. Sally 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.³ 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 advisor. 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 Aim has a variety of materials available to provide you with additional information.

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

2 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.

3 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. This information does not constitute tax advice. Please consult your tax advisor about your particular situation.

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Supplemental Information

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