



# CORNERCAP INVESTMENT COUNSEL ANALYZES THE ROTH IRA CONVERSION OPPORTUNITY FOR 2010

By Douglas M. Dougherty, CFA

Beginning in 2010, all individuals are eligible to convert a traditional IRA to a Roth IRA, and this issue will receive increasing coverage from the media as well as from accounting, legal, and investment professionals. The key questions to help one decide if a Roth IRA conversion makes economic sense are:

- 1) *Can you fund your retirement lifestyle without the use of your IRA assets?*
- 2) *Do you wish to maximize the potential total wealth generated for your heirs?*
- 3) *Do you have sufficient sources of liquidity outside of your IRA to fund your retirement lifestyle and pay the conversion tax?*

If you can answer “yes” to these three questions, then a conversion may prove to be a fantastic wealth generating opportunity for your family.

## Summary

On May 17, 2006 President Bush signed the Tax Increase Protection Reconciliation Act of 2005 (TIPRA), and for the first time since the Roth IRA was created in 1997,<sup>(1)</sup> high income earners will be able to convert their traditional IRA to a Roth IRA in 2010 regardless of income level.<sup>(2)</sup> In addition to removing the income limitation for a Roth conversion during 2010, this act offers the option of paying the conversion tax in 2010 or to equally spread the income recognition and tax payment over the 2011 and 2012 tax years. Individuals who do not plan to use their IRA during their lifetimes and wish to maximize the total wealth transferred to a future generation will benefit tremendously from this provision.

From a purely economic standpoint, the numbers can be eye-popping – on the order of magnitude of 2x – 3x greater wealth transferred over time.<sup>(3)</sup> After a brief discussion of the assumptions used in this analysis, we describe a model that we developed to perform the quantitative analysis, followed by several examples. We then explore the more important intangible considerations which will ultimately drive the conversion decision for many wealthy IRA owners. Lastly, we discuss various options and strategies for implementation.

## Background

A Roth IRA is similar to a traditional IRA in that the earnings grow tax-deferred, contributions are phased out under certain income limitations, and both types of IRA can be assigned to a beneficiary.<sup>(4)</sup> The key differences are that the Roth IRA has no Required Minimum Distribution (RMD) during the owner’s lifetime – this is crucial because mandated RMDs beginning at age 70 ½ from traditional IRAs are taxed at ordinary income rates – and most importantly, all qualified withdrawals from a Roth IRA are tax-free.

Since Roth IRAs grow tax free and do not have to be withdrawn during the owner’s lifetime, and scheduled withdrawals over the life of the beneficiary are tax-free, the potential to maximize the transfer of wealth to a future generation is huge. Discounted back to present value, the difference over a 50+ year lifespan can be 3x – with a breakeven period in the 15 – 20 year range.<sup>(5)</sup> We will walk through some examples in a moment – but first, let’s examine the purely numerical drivers.

## Investment Performance

The rate of investment return will ultimately determine the total amount of wealth generated in the portfolio. Using conservative estimates for this analysis, we assumed a range of long-term average annual investment returns of 5% - 8% (net of fees, gross of taxes).<sup>(6)</sup> Balanced, conservative accounts



should experience the lower end of the range of returns, while all-equity, more aggressive accounts should see results near the upper bounds of the range over time.

We would be remiss if we did not mention that the real rate of return is what remains after fees, inflation, and taxes. Our assumed range of investment returns is after-fees, so the two remaining determinants are taxes and inflation. The model uses a long-term average rate of inflation – assumed to be 3% – to calculate the Net Present Value (NPV) for comparison purposes. That leaves taxes – which vary for each individual – so we will be forced to make some broad assumptions, albeit with the use of historical data as guideposts.

## **Taxes**

Taxes are the key factor to determining the breakeven period. Remember, traditional IRA's require mandatory distributions beginning at age 70 ½, which are taxed as ordinary income, while Roth IRA's have no distribution requirements. Furthermore, both traditional and Roth IRA's require the beneficiary to take distributions over the course of their lifetime, but again, the key difference is the tax treatment of those distributions – the traditional IRA beneficiary pays ordinary income tax on these distributions, while the Roth beneficiary does not.

The traditional IRA portfolio value is constantly eroding due to the tax treatment of these forced distributions. Over a 15 – 20 year span, this erosion is roughly equal to a present value of the amount of taxes that would be generated by converting to a Roth IRA. And given even longer time-frames – say a 50+ year lifespan of a beneficiary – the differential is phenomenal. By that point, your heirs will have truly experienced the magic of long-term tax-free compounding.

## **The Model**

The quantitative analysis of converting a traditional IRA to a Roth IRA is fairly straightforward. Two scenarios are run side-by-side, in order to determine which scenario has the greatest bottom line on the terminal date. The first scenario is the base case, and assumes that no conversion takes place. The beginning values include the traditional IRA market value plus a second, taxable account equal to the amount of tax that would be due if a conversion were to take place. The thinking is thus: it does not make sense to pay the conversion tax out of the existing IRA principal – so after-tax funds will be required. If no conversion takes place, those assets would otherwise be available for investment.

The second comparison scenario assumes that the traditional IRA was converted to a Roth IRA, and the beginning Roth IRA value is the beginning value of the traditional IRA. The portfolio grows tax-deferred until withdrawn, after which all qualified withdrawals are tax-free. In both scenarios, we assume that the beneficiary takes out the minimum required distributions from the inherited IRA over the remainder of their lifetime, as prescribed by the IRS.<sup>(7)</sup> Both traditional and Roth IRA's are subject to this requirement once they have passed to the beneficiary.

## **Examples**

Now let us consider several examples, summarized in Table 1. In Example 1, John has a traditional IRA roll-over funded entirely by before-tax contributions. John is in the top marginal tax bracket, is 60 years old, and has two children, ages 29 and 23. He has a moderately aggressive investment policy, so assume a long-term investment return of 7.5% and 3% long-term average inflation. John's life expectancy is 25 years, and his oldest child's life expectancy is 56 years. Currently, the existing IRA is valued at \$1 million.

Plugging the numbers into the model results in a calculated payback period of 21 years – the amount of time necessary under the given assumptions before the Roth IRA future value exceeds the combined future values of the traditional IRA plus the funds used to pay the conversion tax. In this case, John may be indifferent to converting, as he would have to forego \$350,000 of liquidity today in order to achieve a 4.7% IRR. However, when we continue the analysis through to the end of the beneficiary's life expectancy, the difference in total generated wealth is 2.7x greater by converting to the Roth.

**TABLE 1**

Example <sup>(a)</sup>	1	2	3	4
IRA Owner	John	Martha	Robert	Vivienne
Owner's Age	60	67	58	42
Owner's Life Exp (Yrs)	25	17	20	42
Beneficiary's Age	29	12	42	6
Beneficiary's Life Exp (Yrs)	56	75	42	77
IRA Value	\$1,000,000	\$850,000	\$1,900,000	\$280,000
Income Tax Bracket	35%	28%	35%	33%
Conversion Tax	\$350,000	\$269,500	\$665,000	\$98,000
Investment Return Rate	7.5%	6%	8%	7%
Inflation	3%	3%	3%	3%
Breakeven Period (Years)	21	17	23	35
IRR	4.69%	0.64%	-2.42%	4.81%
Wealth Increase Factor	2.7 x	3.4 x	1.8 x	2.8 x

a. All examples are run with the following assumptions: turnover = 33%, the realized portion of gains each year is comprised of 80% long-term gains and 20% short-term gains (derived from CornerCap's long-term portfolio management experience), unrealized gains are harvested each year by a percentage that is determined by the average holding period times two, the blended (federal + state) long-term capital gains tax rate is 20%, the top marginal income tax bracket is 35% through 2010, and 40% thereafter (the top marginal tax bracket reverts to the previous 39.6% after 2010), only required minimum distributions come out of the traditional IRA, only required distributions are taken from the inherited IRA (either traditional or Roth), and all after-tax distributions are invested in the taxable account.

In Example 2, Martha, 67 years old, has an IRA valued at \$850,000 funded with a mixture of before- and after-tax contributions. The after-tax contributions total \$80,000. Martha has a 17 year life expectancy, and she plans to leave her IRA in equal parts to her four grandchildren, ages 11, 9, 4 and 1 – the oldest grandchild has a 75 year life expectancy. Martha is a conservative investor, so use a 6% average return, and she is currently in the 28% federal tax bracket. Inflation is assumed to average 3% for the duration. The model results show a 0.6% IRR with a 17 year breakeven period, equal to Martha's life expectancy – so she will definitely be indifferent to a conversion. But due to the young ages of her beneficiaries, the total wealth generated by the Roth is 3.4x greater than the base case (do nothing) over the course of the beneficiary's lifetime.

In Example 3, consider Robert, who is 58 and in poor health, and plans to leave his \$1.9 million IRA to his adoring wife Christina, who is 42. Robert's life expectancy is 20 years and Christina's is 42 years, and the IRA is currently invested entirely in equities with an assumed 8% average annual rate of return. We also assume a 3% long-term rate of inflation, and Robert is in the top marginal tax bracket. The model results for Robert indicate a 23 year breakeven period – 3 years longer than his expected lifespan – with a -2.4% IRR. Therefore, in looking at the projected asset levels for each scenario that would pass on to Christina, she will end up inheriting a larger sum if Robert does not convert. However, Christina would stand to reap 1.8x more wealth over her projected lifetime if Robert does the conversion.

Example 4 looks at a younger IRA owner. Vivienne, age 42, has a \$280,000 IRA that was funded by a 401(k) rollover from her previous employer. Her children are ages 6 and 4, with a 77 year life expectancy for the oldest child, Oscar, and 42 years for Vivienne. Inflation is assumed to average 3% throughout the duration, and Vivienne's portfolio is expected to return 7% annually on average. Vivienne is currently in the 33% tax bracket. Her model results indicate a 4.8% IRR with a 35 year breakeven period, with post-conversion projected values 2.8x greater over Oscar's lifetime.

The primary reason that the last example has a much longer payback period than the prior examples is due to the relatively young age of the IRA owner, which results in a greater number of years



before RMDs are scheduled to commence. During that time, the traditional IRA grows as fast as the Roth, until the forced taxable distributions begin. However, younger IRA owners who plan on using the IRA later in life might also derive benefits from a conversion.

## **Intangibles**

The purely quantitative NPV analysis of the benefits of a Roth IRA conversion does not capture any of the critical intangible considerations. The first and foremost of these considerations is liquidity. In order to convert, one must have the liquidity available outside of the IRA to pay the tax. In some cases, this may not be feasible, as one's net worth may be skewed towards more illiquid investments – non-income producing real estate, for example. In other cases, existing liquidity may be required to fund future living expenses. And some individuals may have already taken measures through complex estate planning techniques to provide for future generations via gifting, grantor trusts, or other measures, and may feel as though they have already done enough.

Those who have designated traditional IRA assets for charity upon their passing would not be good candidates for a Roth IRA conversion – the charity does not stand to gain much (if any) over the existing traditional IRA. However, persons with complex estates who are also charitably inclined may wish to examine alternative methods of funding the bequest in order to pass on more wealth to their heirs. Moreover, paying the conversion tax will reduce one's taxable estate.

## **Implementation**

The TIPRA language provides an option for tax recognition of the income generated by the Roth IRA conversion. Owners have the choice between recognizing the entire taxable conversion income in 2010, subject to the current income tax rates, or having the income recognition occur in equal amounts in the years 2011 and 2012 at the prevailing income tax rates at those times. If not specified, the default is the latter. We assign a greater probability to higher income tax rates in the future – at a minimum, the top marginal federal tax bracket reverts to 39.6% beginning in 2011 unless Congress acts otherwise.

Business owners with Net Operating Losses (NOL's) can use these losses to offset the taxable income generated by the Roth IRA conversion dollar-for-dollar. IRA owners wishing to convert may also want to consider creating a Charitable Lead Trust (CLT), which offers a dollar-for-dollar offset to income when structured as a grantor trust. Any charitable gifting that can be accelerated forward into 2010 will produce a greatly beneficial tax effect. Again, those who have sizeable estates and have ear-marked their traditional IRA to fund their charitable bequest may want to reconsider this strategy.

Another concern is the protection of Roth IRA assets from creditors. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provides that up to \$1 million of assets held in a traditional IRA or Roth IRA, or a larger amount determined by the bankruptcy court "in the interests of justice," will be exempt from the IRA owner's bankruptcy estate. Other protections are afforded through state law, which varies by state. An umbrella liability policy adds another cost-effective layer of protection.

Another potential issue is control of the wealth that a conversion will generate over time. This can easily be accomplished through the use of an IRA Trust. The IRS provides fairly straightforward guidance on the requirements for this strategy.<sup>(8)</sup> Lastly, a conversion does not require a liquidation of the portfolio.

## **Conclusions**

Converting a traditional IRA to a Roth IRA in 2010 generates substantial economic benefit for one's heirs – a windfall of the current tax law. However, each individual's circumstances will determine whether or not this strategy should be implemented. We do not propose that our model provides the definitive answer, but rather, our intent is that this illustration be used to initiate a more thorough, detailed, one-on-one examination for each individual's particular situation. At a minimum, we want to keep our CornerCap clients and partners informed through this subtly complex evaluation on the possibilities, potential, and pitfalls of this opportunity as it applies to their financial well-being.



## Footnotes:

1. Taxpayer Relief Act of 1997, signed into law August 5, 1997.
2. Prior to 2010, only taxpayers with Adjusted Gross Income of less than \$100,000 are eligible to rollover or convert a regular IRA to a Roth IRA.
3. Model results for traditional IRA owner age 60 with 20 year life expectancy, top marginal tax bracket of 35% current & 40% future, beneficiary current age of 30 with 55 year life expectancy, 7% average annual pre-tax investment return, 3% average annual inflation.
4. IRS Publication 590 page 20 – “A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he or she dies.”
5. Model results for traditional IRA owner age 60 with 20 year life expectancy, top marginal tax bracket of 35% current & 40% future, beneficiary current age of 30 with 55 year life expectancy, 7% average annual pre-tax investment return, 3% average annual inflation.
6. Based upon the CornerCap Group of Funds long-term (since inception) average annual investment results (net of fees and expenses) through 11/30/2009 for the CornerCap Balanced Fund (60% large-cap stocks, 40% corporate and government bonds) of 4.8% (inception date of 5/24/1997) and the CornerCap Small-Cap Value Fund (100% small-cap stocks) of 8.0% (inception date of 9/30/1992)
7. IRS Publication 590, pp.35 - 38.
8. IRS Publication 590 page 38.