BRADYCO Fidelity INVESTMENTS

Some Basics regarding changes in the Roth IRA rules for 2010

What's changing in 2010?

Starting in 2010, most taxpayers — regardless of their income or tax-filing status — will be able to convert a Traditional IRA to a Roth IRA as spelled out in the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), passed in May 2006. Before TIPRA, only people — single or married filing jointly — with modified adjusted gross income below $100,000 could convert.

Benefits of Roth IRAs

Roth IRAs offer certain benefits that are not available with a Traditional IRA:

- Qualified distributions are not included in your gross income if you have met the five-year aging requirement and are age 59½ or older. (Early withdrawals are subject to a 10% penalty, although certain exceptions apply.)

- Once the five-year aging requirement is satisfied, heirs can also withdraw the money without paying federal income tax. Beneficiaries, however, are required to take annual minimum distributions.

- Unlike a Traditional IRA, the Roth IRA does not require you to take annual minimum distributions beginning at age 70½, which gives you added flexibility. You can withdraw money when needed or let it potentially grow free from federal, and in most cases, state income taxes, which can dramatically increase the amount available for your retirement or for your beneficiaries who inherit the account.

- Another possibility is to roll over your workplace savings plan, such as a 401(k) plan, to a Roth IRA. This is a strategy you may want to consider if you are about to change jobs or are approaching retirement. Here, too, the $100,000 income limitation will be eliminated in 2010.

BRADYCO FINANCIAL

16 Sargent Street, Cambridge, MA 02140-2514 617-945-1991 FAX 617-517-9197

Email: Brad@BradycoFinancial.com

Tax Implications of a Roth IRA Conversion

When converting from a Traditional IRA to a Roth IRA, you will owe income tax on any taxable portion of the account balance. (An important point to note if you have made non-deductible contributions to your Traditional IRA account: Conversions must occur on a pro rata basis, meaning you cannot choose to only convert the portion you've already paid taxes on. For example, say you have an existing $100,000 rollover IRA with pretax money. You make $5,000 in after-tax contributions to it every year from 2008 to 2010, for $15,000 in total. You'd owe taxes on 87% of the $15,000 because taxes are calculated as a proportion of the total of your IRA accounts ($115,000). This is a simplified example, so please consult a tax advisor to see what this may mean in your situation.)

If you do the conversion in 2010, TIPRA offers an additional benefit. You can elect to pay any federal tax on the conversion in 2010, or, as long as the converted amounts are not distributed before 2012, half of the taxable amount will be included in income for 2011 and half for 2012. Those who convert in 2010 may have a dramatically higher tax bill in 2011 and 2012. Of course, it is generally better not to pay those taxes with funds withdrawn from the IRA or other retirement accounts, since doing that could generate yet more tax. Again, please consult with a tax advisor to understand the implications for your situation.

Potential Estate-Planning Benefits of a Roth IRA

People who inherit Roth IRAs also get favorable tax treatment, so converting a Traditional IRA or workplace savings account to a Roth IRA may be a savvy estate-planning tool. Non-spouse beneficiaries must take distributions over their life expectancies but, unlike with a Traditional IRA, they generally don't have to pay income tax on the withdrawals. When a spouse — let's assume it's a wife — inherits a Roth IRA, she has the additional option she has with a Traditional IRA, which is to roll over the retirement account into her own Roth IRA.

Who Should Convert?

Here are a few key factors to consider:

<u>Consider the source you use to pay the taxes.</u> It is generally better to pay the tax with funds that are not withdrawn from an IRA or other retirement account. Withdrawing funds from an IRA or other retirement account solely to pay the conversion tax could generate yet more tax.

<u>Do you expect tax rates to go up?</u> Currently, 35%[1] is the highest tax bracket for federal ordinary income tax purposes. But if Congress raises tax rates, it would increase both the tax on distributions from a Traditional IRA and the taxes on a Roth IRA conversion

[1] According to the WSJ (11/20/09), marginal income-tax rates will rise several percentage points in 2011 unless Congress acts to undo the change. The top rate, for example, would rise from 35% to 39.6%.

Do you want to pay taxes now or later? When converting from a Traditional IRA to a Roth IRA, keep in mind that you will owe income tax on any taxable portion of the amount that you convert. If you do the conversion in 2010, current law offers what amounts to an extended payment plan. Under TIPRA, you do not have to pay any federal tax on the conversion in 2010, but instead have the option of paying the tax in two installments — half with the 2011 income tax return and the remainder with the 2012 income tax return.

Do you plan to leave at least some of the funds to family? If you have total assets of more than $2 million in your own name when you pass away, the assets in a Traditional IRA would currently be subject to a 45% estate tax through 2009[2]. Independent of any estate tax they may owe, the beneficiaries of a Traditional IRA must include any taxable distributions they receive in their gross income. The beneficiary may be able to claim a deduction for estate tax resulting from certain distributions from a Traditional IRA. The beneficiary can deduct the estate tax paid on any part of a distribution that is income with respect to a decedent. Because you pay the income tax up front, generally in the year of a Roth conversion, your beneficiaries won't be subject to the income tax later. However, the Roth IRA assets may still be subject to estate tax.

Additional Considerations

Two wild cards may affect planning for Roth IRA conversions. One is the prospect that Congress will raise tax rates[3], which would increase the toll charge for doing a conversion. The other is the prospect of a new law repealing these provisions of TIPRA before they take effect in 2010.

Bottom Line

The Roth IRA conversion rules are complicated. Further, the benefits of any Roth conversions depend in most cases on assumptions regarding both one's future financial plans and future income tax & investment returns – all of which are inherently uncertain. Thus, there are no simple answers to the question of whether or not to convert.

Depending upon one's circumstances, converting at least some Traditional IRA funds into a Roth IRA may make sense. Given both the complexity of the various tax laws regarding this matter and the wide differences in individual tax situations, consulting your tax advisor is a good strategy.

Sources: Fidelity Investments, Bradyco Financial

[2] Under current law, during 2010, estates would be subject to capital gains taxes, but NOT estate taxes. The House of Representatives passed legislation on 12/3/09 that would repeal this provision and extend the current exclusion of $3.5 million after 12/31/09. The Senate is working on similar legislation.

[3] According to the WSJ (11/20/09), marginal income-tax rates will rise several percentage points in 2011 unless Congress acts to undo the change. The top rate, for example, would rise from 35% to 39.6%. Also, the top rate on capital-gains would rise to 20% and dividends would be taxed at ordinary income rates.