

# Roth to Riches?

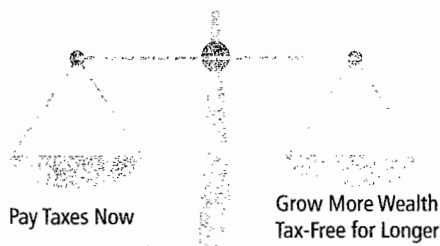
## Determining Whether a Roth Conversion Makes Sense

### To Roth or Not to Roth?

Roth IRAs, despite their attractive features, have yet to match the popularity of traditional Individual Retirement Accounts. Of course, one reason Roths constitute such a small percentage of total retirement assets (just 5%) is that many wealthier individuals—who potentially stand to benefit the most from them—have been ineligible either to contribute to one or to convert their existing traditional IRAs to a Roth.<sup>1</sup>

But as of January 2010, the IRS income ceiling for Roth conversions disappears, presenting investors of means with an interesting quandary: If they convert they will accelerate taxable income into an earlier year, which flies in the face of the cardinal rule that you pay no tax before it is due. On the other hand, a Roth, unlike a traditional IRA, would enable both tax-free withdrawals<sup>2</sup> and the avoidance of required minimum distributions (RMDs)—allowing more wealth to grow tax-free for a longer period of time. It's not an easy decision (*display below*).

### The Roth conversion trade-off



<sup>1</sup> Over \$3.5 trillion was invested in traditional IRAs as of year-end 2008, compared with a mere \$165 billion in Roth IRAs (2009 Investment Company Fact Book). Generally, contributions to a Roth IRA are subject to both contribution limits and income limits. For 2009, the income limits phase out the available maximum yearly contribution to a Roth IRA for single individuals with modified adjusted gross income (MAGI) between \$105,000 and \$120,000; for joint filers and qualified widow(ers) with MAGI between \$166,000 and \$176,000; and for married individuals filing separately with MAGI between \$0 and \$10,000. MAGI represents an individual's adjusted gross income as shown on his or her return with certain items added back in or subtracted out. Unlike contributions, conversion of a traditional IRA to a Roth IRA is subject only to an income limit, which is scheduled for elimination in 2010. For 2009, the income limit on conversions requires that adjusted gross income not exceed \$100,000 (and the taxpayer not be married filing separately).

<sup>2</sup> In general, to qualify for tax-free withdrawals from a Roth: 1) You must have made a contribution to a Roth account long enough ago to satisfy a five-tax-year rule (which can be shorter than five years in some cases); and 2) You must be age 59½ or older. However, tax-free withdrawals may be possible under other circumstances. See Section 408A(d)(2) of the Internal Revenue Code.

Determining whether to convert a traditional IRA to a Roth IRA is a complicated decision based on your individual circumstances. Because Bernstein does not provide tax, legal, actuarial, or accounting advice, you should consult professionals in those areas before you decide whether or not to do so.

### SUMMARY

The Roth IRA is arguably the most powerful retirement and estate planning tool *not* available to wealthier investors—until now. Those who have enough wealth in their personal accounts to pay the taxes on the conversion and still have sufficient assets to delay drawing from their IRA until late in retirement will clearly benefit from converting. In particular, future generations will be far better off inheriting a tax-free Roth than either taxable assets or a traditional IRA.

To cut through the uncertainty and provide a framework for weighing the pros and cons of conversion, we used the quantitative analytics in our Wealth Forecasting System<sup>SM</sup> to model future market scenarios, focusing on the three key variables involved in the decision: investor tax rates, spending needs, and time horizon. Our research suggests that the best conversion candidates are those who can afford to pay the cost of conversion from their taxable assets and fit *any one* of the following criteria:

- ☒ They don't expect a significant decline in their effective tax rate in retirement;
- ☒ They are making the conversion at a younger age;
- ☒ They don't expect to spend meaningfully (or at all) from their IRA or will begin drawing from it only much later in retirement; or
- ☒ They intend to transfer their IRA at death to beneficiaries who will then "stretch" it.

## 1. The Basic Math of Roth Conversions

At first glance, it may appear that the decision to convert or not would depend solely on a guess about future tax rates: Favor the Roth if you anticipate higher tax rates down the road (since those higher rates can be avoided when funds are withdrawn), and stick with a traditional IRA if tax rates are expected to fall in retirement (since the higher rates today can be avoided). However, the Roth offers two advantages over a traditional IRA that can make it far more appealing to high-net-worth investors—even if their tax rates are likely to fall in their retirement years:

- ☒ *Grow more wealth tax-free: To the extent that an investor can pay any tax due from converting to a Roth from a taxable account, he can shift more of his wealth into a tax-free savings vehicle.*
- ☒ *For longer: Because they are exempt from RMDs, Roth dollars can grow tax-advantaged for a longer time period.*

<sup>3</sup>We model a \$450,000 personal account so that the individual has enough to pay the tax on the conversion out of his taxable portfolio. We used a 45% combined federal/state tax rate to account for the possibility of higher state and local taxes as well as the scheduled increase in tax rates in 2011, when the highest bracket is to move from 35% to 39.6%.

<sup>4</sup>In all of the analyses in this paper we use our Wealth Forecasting System (WFS), a proprietary planning tool designed to model wealth over time, given specific variables and starting conditions. It can predict the potential returns of portfolios built with stocks, bonds, and other asset classes, and show the effect of inflation, taxes, currencies, and spending, across generations and, if desired, through a variety of holding structures such as trusts. The WFS uses historical data, Bernstein research, and sophisticated modeling software to create a vast range of potential market returns, taking into account the underlying drivers and linkages in the capital markets, as well as a degree of randomness. It generates 10,000 possible outcomes, which we show as a probability distribution. All portfolios are allocated 60% globally diversified stocks (35% US value, 35% US growth, 25% developed markets, and 5% emerging markets) and 40% intermediate-term bonds (diversified municipals in personal accounts and taxable bonds in IRAs).

Let's look for a moment at the first advantage. Although it may be tempting to pay the tax using funds from the IRA, as this is what generated the tax liability in the first place, by doing so an investor loses out on what is likely *the biggest potential advantage of the conversion*—the ability to shift a greater percentage of one's total assets into a tax-free account. This has the same effect as making an additional, sizable contribution to your IRA, something you would not otherwise be allowed to do.

Now for the second advantage of a Roth. To ensure that Uncle Sam eventually gets his take, the rules for traditional IRAs stipulate that investors start taking required minimum distributions at age 70½. That's the equivalent of withdrawing between 4% and 5% of the IRA's balance each year between the ages of 71 and 80, and over 6% of the balance annually between ages 81 and 90. But that law doesn't apply to holders of Roth IRAs, who need never draw from the account during their own lifetimes (although the owner of a non-spousal inherited Roth IRA does have to take RMDs).

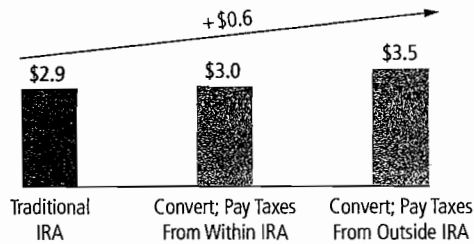
To see these two advantages in action, let's consider a 65-year-old investor who has \$1 million in a traditional IRA and a blended federal/state tax rate of 45%.<sup>3</sup> Let's also assume he has enough in personal assets to pay the tax bill of \$450,000, that his effective tax rate will not change in the future, and that he doesn't need to spend from the account. Should he convert to a Roth? To arrive at an answer, we analyzed the following three scenarios, tracking in each the wealth created from his IRA and from his taxable assets (both allocated 60% to stocks and 40% to bonds):<sup>4</sup>

- ☒ Maintain the assets in the traditional IRA;
- ☒ Convert to a Roth IRA, paying the \$450,000 in conversion taxes out of his IRA assets;
- ☒ Convert to a Roth, going outside the IRA (to his taxable assets) for funds to pay the taxes.

Display 2

**Roths have a built-in advantage (if you pay conversion taxes from outside the IRA)**

Median Wealth After Taxes, Inflation-Adjusted (Yr. 20, \$ Mil.)  
 \$1 Mil. IRA, \$450K Taxable Account  
 No Spending



*Analysis assumes initial account values of an investor at age 65; tax on converting a \$1 million traditional IRA to a Roth IRA totals \$450,000; payment of any estate taxes out of assets that are not the subject of this analysis; and required minimum distributions (RMDs) from traditional IRA based on participant's age until age 85, when the IRA is liquidated and all taxes are paid. Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System at the end of this paper for further details.*

If the investor converts and foots the tax bill from his tax-deferred assets, \$550,000 of the original \$1 million IRA is left to grow tax-free over the next 20 years. We project that, in the median case, this would yield a \$100,000 inflation-adjusted advantage versus simply keeping the traditional IRA (Display 2).<sup>5</sup> The benefit is modest because in this case we're leveraging only one (and the smaller one) of a Roth's two advantages—the avoidance of RMDs. If, however, the investor funds the tax payment for the Roth conversion from assets outside his IRA, allowing the full \$1 million to grow in the Roth tax-free, the numbers improve substantially. In this case, in 20 years we'd project a median inflation-adjusted advantage of \$600,000.

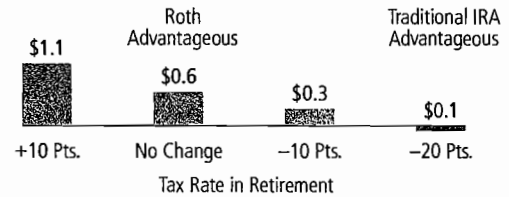
If an individual is unable (or unwilling) to pay the taxes from his taxable portfolio, conversion is not as compelling an option, and it becomes less compelling the lower his expected tax rate is in retirement. In fact, as we'll see, the investor's expected bracket will play a critical role in almost any conversion decision.

<sup>5</sup>Throughout this paper, all figures are adjusted for inflation unless stated otherwise.

Display 3

**Tax rate changes have an outsize impact on the conversion decision**

Median Wealth Advantage, After Taxes, Inflation-Adjusted (Yr. 20, \$ Mil.)  
 \$1 Mil. IRA, \$450K Taxable Account  
 No Spending



*Analysis assumes initial account values at investor age 65; tax on converting a \$1 million traditional IRA to a Roth IRA totals \$450,000; payment of any death taxes out of assets that are not the subject of this analysis; and required minimum distributions (RMDs) from traditional IRA based on participant's age until age 85, when the IRA is liquidated and all taxes are paid. A change in the effective tax rate of 10 points means, for example, we move from an effective blended rate of 45% to 35%, and not a 10% change (from 45% to 40.5%). Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System at the end of this paper for further details.*

**A Moving Target: The Impact of Tax Rates on the Decision**

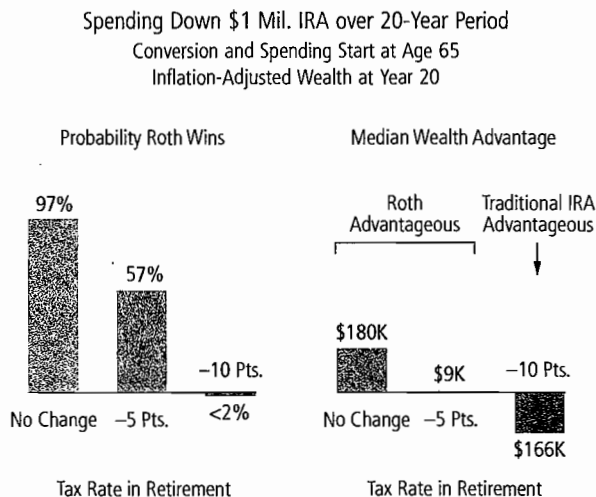
Thus far we've assumed the investor's tax rates stay constant and that he doesn't need to spend from the account, but those assumptions may not be realistic for some. Suppose an investor expects to see his tax rate decline substantially once he exits the workforce. Or maybe he lives in a high-tax jurisdiction now but plans to retire to one of the nine states with no state income tax, thereby eliminating any state and local income-tax burden in the future. How does the prospect of lower taxes affect the decision to convert?

Let's stay with our example of a 65-year-old investor with \$1 million in a traditional IRA and \$450,000 in taxable assets (both allocated 60/40). We've already seen that with no change in his effective tax rate in retirement, the median advantage of a Roth amounted to \$600,000. In the unlikely event his tax rate were to rise 10 points, the Roth advantage would almost double, to \$1.1 million (Display 3). But if his effective tax rate

dropped 10 points, that advantage is halved, to \$300,000. Only with a very large, 20-point drop in future tax rates do we eliminate the benefit of a Roth conversion.

Now let's add spending to the mix. This time let's assume that our investor's retirement budget requires him to spend aggressively from the portfolio, drawing the entire IRA down over the next 20 years (with conversion taxes paid from his taxable assets). When an investor experiences no change in his tax status but spends at this rather rich rate from the account, our

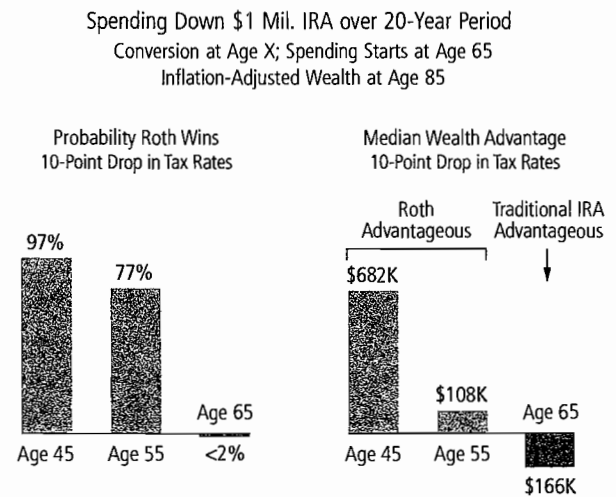
Display 4  
**For those spending down their IRAs, the conversion question hinges on tax-rate differentials**



Analysis assumes the investor pays 45% blended federal/state tax rate upon conversion; taxes on Roth are paid out of a taxable account; investor owns IRA between ages 65 and 85; any estate taxes are paid out of assets that are not the subject of this analysis; distribution and spending of 1/20 of Roth IRA in year one at age 65, 1/19 of remaining Roth IRA in year two at age 66, and so on, until 100% of the Roth IRA is distributed and spent in year 20 at age 85; the identical dollar value of distributions and spending from the traditional IRA scenario; and any traditional IRA assets remaining after 20 years are liquidated, resulting in an income tax liability. Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System at the end of this paper for further details.  
 Source: AllianceBernstein

analysis shows that the Roth still has a very high likelihood of beating the traditional IRA, but the wealth advantage drops to \$180,000, down more than two-thirds from our base case of \$600,000 when no spending was included (Display 4).<sup>6</sup> If our aggressive spender's tax rate in retirement drops just five points to 40%, the Roth has only a slight advantage. And if we move further along the tax bracket continuum and postulate a 10-point decline in future tax rates, the picture reverses entirely: It is far more likely that not converting would be the better choice, with a median wealth advantage for the traditional IRA

Display 5  
**But a Roth can win even in the face of a tax-rate decline and an aggressive spending rate—if you're young**



Analysis assumes investor pays 45% blended federal/state tax rate; taxes on Roth are paid out of a taxable account; investor owns IRA between the stated age and age 85; any estate taxes are paid out of assets that are not the subject of this analysis; no distributions or spending until age 65; distribution and spending of 1/20 of Roth IRA at age 65, 1/19 of remaining Roth IRA at age 66, and so on, until 100% of the Roth IRA is distributed and spent at age 85; the identical dollar value of distributions and spending from the traditional IRA scenario; and any traditional IRA assets remaining after 20 years are liquidated, resulting in an income tax liability. Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 40 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System at the end of this paper for further details.  
 Source: AllianceBernstein

<sup>6</sup>In all trials, all assets are by definition depleted in the conversion scenario. In trials where converting to the Roth is beneficial, the advantage is calculated as the cumulative spending shortfall in the scenario without the conversion. When not converting is beneficial, the advantage is calculated as the remaining wealth in the scenario without the conversion. At the end of the measurement period, we have accounted for the embedded income tax liability on any remaining assets in the traditional IRA.

of \$166,000. The impact of lower tax rates in the future and a high spending rate from the portfolio tilts the decision away from conversion. But if we adjust some of the other variables involved—in particular, time horizon—the advantage to converting can be restored.

#### Time Horizon: Another Deciding Factor

With a long enough time horizon, the benefit of having more assets compound on a tax-free basis without the eventual drag of RMDs can render the Roth a better choice, even with a 10-point reduction in future tax rates. For example, let's look at someone who converts a \$1 million IRA at age 45 but only begins to spend from it at 65, depleting it over the next 20 years. If we take a snapshot of his projected wealth at age 85 (40 years after converting), we see the Roth would have a very high likelihood of being the better choice, even with a 10-point drop in tax rates, worth \$682,000 more to him than the traditional IRA in the median case (*Display 5*).

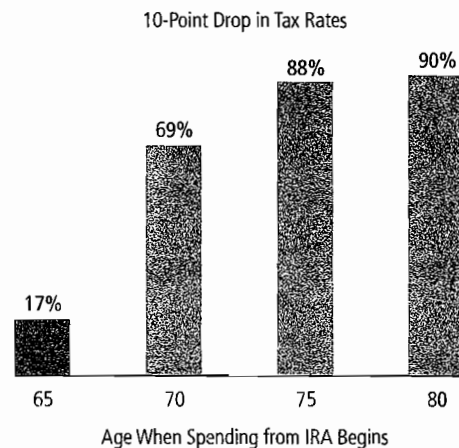
Clearly, the more time the assets have to grow unencumbered by either taxes or RMDs, the more attractive conversion appears to be. But what if the investor doesn't have the luxury of being 45, and his time horizon won't permit 40 years of tax-free compounding? Reducing the rate at which an investor spends from his portfolio, or delaying the date on which he begins spending from the account, can also enhance the appeal of conversion.

Let's assume that instead of spending the IRA down to zero in 20 years, our 65-year-old investor spends only 5% per annum from the account (*Display 6*).<sup>7</sup> That probably won't overcome a 10-point drop in his future effective tax rate. But if he is able to spend first and exclusively from his taxable assets and can postpone the 5% annual withdrawal from the IRA until age 70, the odds tip back in favor of converting. And with each additional five-year delay in spending, the odds of a Roth being advantageous rise further, even with a decline in tax rates of up to 10 points.

Display 6

#### The later you begin spending from the IRA, and the less you spend, the more attractive conversion becomes

Probability of Roth Conversion Winning at Age 85  
5% Spending Beginning at Age X  
\$1 Mil. IRA



*Analysis assumes that investor pays 45% blended federal/state tax rate; taxes on Roth are paid out of a taxable account; any estate taxes are paid out of assets that are not the subject of this analysis; and at the stated age, the investor spends 5% of the value in the Roth IRA, and thereafter, spending increases by the rate of inflation each year, with an identical dollar value of spending in the traditional IRA scenario.*

*Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System at the end of this paper for further details.*

Source: AllianceBernstein

#### Stretching for Dollars

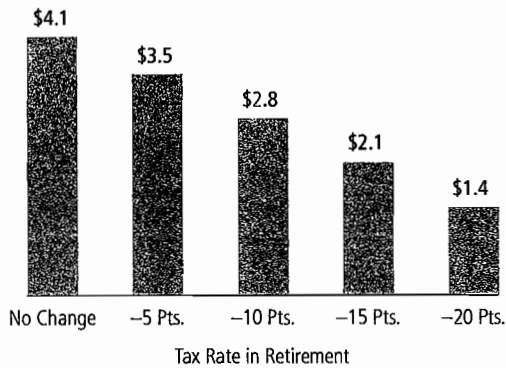
Thus far we've looked at the Roth conversion decision from the perspective of an investor's retirement plan. Let's consider another scenario: What if the investor is quite certain he will not need to spend at all from the IRA, at any age? For him the Roth can become an estate planning vehicle, and the assets in it can then compound tax-free for a much longer period.

<sup>7</sup>We model spending as 5% of the value of the Roth IRA at the given age, which is then increased by inflation each year thereafter. An identical dollar amount is spent in the scenario without the Roth conversion as well.

Display 7

## Conversion really becomes beneficial with a stretch

Median Additional After-Tax Wealth in Roth, Inflation-Adjusted  
\$1 Mil. IRA: 20 Years + 30-Year Stretch  
(\$ Mil.)



*Analysis assumes initial account values at investor age 65; tax on converting a \$1 million traditional IRA to a Roth IRA totals \$450,000; payment of any estate taxes out of assets that are not the subject of this analysis; IRA participant passes away at age 85, at which time the beneficiary of the IRA is 55; required minimum distributions (RMDs) from traditional IRA based on participant's age until his passing, at which point RMDs are calculated based on the beneficiary's age; no distributions from the Roth IRA until the participant's passing, at which point RMDs are calculated based on the beneficiary's age; and any traditional IRA assets remaining after 50 years are liquidated, resulting in an income tax liability.*

*Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 50 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System at the end of this paper for further details.*

*Source: AllianceBernstein*

If our 65-year-old investor can avoid spending from the IRA and if the IRA is then stretched by his heirs to extend the tax-free compounding another 30 years (for a total of 50 years of tax-free growth), we estimate that converting to a Roth would likely be beneficial even with a 20-point decline in tax rates (*Display 7*).<sup>8</sup> So if the beneficiary's tax rate were as low as 25% at the time the funds were withdrawn, the Roth would still provide more after-tax wealth in the median case—and by a margin of \$1.4 million, inflation-adjusted, for every \$1 million converted.

<sup>8</sup>To put the comparison on equal footing, we assume that the RMDs the heirs withdraw are reinvested in a taxable 60/40 account and not spent.

## A Roth in the Estate Plan

Many are concerned about the impact that converting (or not) may have on the amount of estate tax they'll have to pay. How would our conclusions change if estate taxes were factored into the analysis?

Initially, converting to a Roth reduces the size of one's taxable estate by the amount of tax dollars used to pay for the conversion. So it would appear at first glance that converting would be clearly beneficial for retirement assets likely to be subject to estate tax. But the reality is not that straightforward. Although the conversion does reduce the amount of one's taxable estate, there is an adjustment for those who choose not to convert that may put the alternatives on near-equal footing from a federal estate tax perspective.\* Any federal estate tax paid as a result of owning a traditional IRA will result in an income tax deduction for the beneficiaries. This federal income tax deduction has the potential to nullify the apparent estate tax benefit of the Roth conversion. However, in many cases, this deduction may not fully compensate the traditional IRA holder for the payment of estate taxes, resulting in an estate tax savings with the Roth conversion.

This also explains why the Roth conversion offers a clear benefit for those likely to be subject to state estate taxes at death. Payment of these taxes generally does not result in a federal income tax deduction for the beneficiaries, thereby producing more after-tax wealth in the case of the Roth.

Of course, a Roth conversion may result in the payment of more estate taxes to the extent that it helps the family's wealth grow faster over time—the bigger the estate, the bigger the estate tax.

What really matters is not minimizing estate taxes but rather what a family has left net of estate taxes—and the Roth conversion stacks up well here. ☐

\*The IRD deduction is a federal income tax deduction available to the beneficiaries of traditional IRAs for estate taxes paid. It is an itemized deduction not currently subject to the 2% floor of AGI. However, this deduction can be phased out for higher-income earners. The deduction is allowed for alternative minimum tax purposes. This is for federal purposes only—there is generally no income tax deduction for state estate taxes paid.

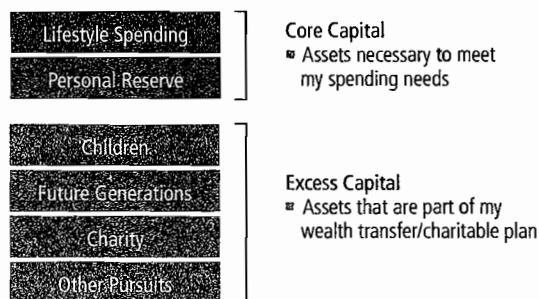
## 2. Core Capital and the Conversion Decision

How can an investor know at what point in his life he may need to begin drawing from his IRA (if at all) to support his retirement spending, and at what rate? We approach this question by projecting the investor's financial future through the lens of a comprehensive analysis generated by our Wealth Forecasting System. This in-depth planning model can help determine how much capital an individual may need at any point in time to maintain his lifetime spending, grown with inflation. We call that amount an investor's *core capital* (Display 8). This portfolio "for life" may include an additional reserve for medical or other life emergencies, as well as any special requirements, such as a cash reserve to pursue new business ventures. Anything more is excess capital, which can be transferred to the next generation, given to charity, or used for some other purpose.

In the calculation of core capital, the key variables are the maximum allowable rate of spending each year from the portfolio and the investor's age (Display 9). Based on these two data points, we are able to estimate how much capital an individual or couple must have on hand, at any point in time,

Display 8

### To Roth or not to Roth depends in part on your core capital



Source: AllianceBernstein

to maintain their spending for as long as they need with a 95% degree of confidence (meaning it lasts as long as the investor needs it to in 9,500 of the 10,000 capital market trials we run).

One rule of thumb that we explored at length in our blackbook *Retirement: Plan Early and Often* is that investors are best served by spending down their taxable assets first and only then

Display 9

### Conversion questions: Is IRA part of your core? When will you begin to draw from it? And at what rate?

Sustainable After-Tax Spending Rate in Hostile Markets\* (Mortality-Adjusted)

60% Stocks/40% Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.8%	3.0%	3.3%	3.7%	4.2%	4.8%	5.6%	6.7%

#### Core Needs

Spending Needs	\$100,000	\$200,000	\$300,000	\$400,000	\$500,000	\$750,000	\$1.0 Million
	\$3.6 Mil.	\$3.3 Mil.	\$3.0 Mil.	\$2.7 Mil.	\$2.4 Mil.	\$2.1 Mil.	\$1.8 Mil.
	7.1	6.7	6.1	5.4	4.8	4.2	3.6
	10.7	10.0	9.1	8.1	7.1	6.3	5.4
	14.3	13.3	12.1	10.8	9.5	8.3	7.1
	17.9	16.7	15.2	13.5	11.9	10.4	8.9
	26.8	25.0	22.7	20.3	17.9	15.6	13.4
	35.7	33.3	30.3	27.0	23.8	20.8	17.9

\*These spending rates are for couples and assume an allocation of 60% globally diversified stocks (35% US value, 35% US growth, 25% developed foreign markets, and 5% emerging markets) and 40% diversified intermediate-term municipal bonds. Spending is a percentage of the initial value of the portfolio and is grown with inflation; spending rates assume maintaining spending with a 95% level of confidence. Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. Data do not represent past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System at the end of this paper for further details. All information on longevity and mortality-adjusted investment analyses in this study are based on mortality tables compiled in 2000. In our mortality-adjusted analyses, the life span of an individual varies in each of our 10,000 trials in accordance with mortality tables.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

### Working through the conversion framework in four typical investor scenarios

	Enough Personal Assets to Pay Tax	Expected Tax Rate in Retirement	Assets Relative to Core	When Spending from IRA Will Begin	Rate of Spending from IRA	Convert or Not
Multigenerational Family	Yes	Same	Above Core	Never	Zero	Yes
Soon to Retire	Yes	Lower	Below Core	Fairly Soon	Medium to High	No
Retired	Yes	Same	Above Core	Probably Never	Low to Zero	Yes
Young Professional	Yes	Higher	Below Core	Much Later	Unknown	Yes

Source: AllianceBernstein

spending assets in their tax-deferred accounts. This allows the tax-deferred portion of their portfolio to continue to compound tax-free, conferring a powerful growth advantage. Therefore, once we gauge an investor's core capital and identify the size of the tax-deferred portion of his assets relative to core, we can estimate the age at which he will likely need to begin spending from the IRA, and at what rate.

If it's clear that the investor has a good deal more than his core amount, the IRA can be used for other purposes and will likely form part of his estate plan. For the investor who is at or near his core number, the advantage still goes to the Roth: It's possible the investor will not need to draw from the IRA to sustain his lifestyle spending, or if he does he would be able to do so only later in retirement. But for an investor who is a good distance below his core target, the conversion decision will be more complicated, requiring close and custom analysis.

To give some life to the core capital discussion and its role in the Roth conversion framework we've established, let's look at several short but typical scenarios (*Display 10*).

**Multigenerational Family:** A couple, both age 65, with two children and four grandchildren, have \$15 million in total net worth, \$2 million of which is in a traditional IRA, and they spend \$300,000 a year. They are in the highest tax bracket and will remain so in retirement, due primarily to pension income. They have substantially more in assets than their core capital target of \$8.1 million and want to provide a legacy for their children and grandchildren. The case for conversion is clear.

**Soon to Retire:** A couple, both age 60, hope to leave New York and retire in Florida in about three years. Their net worth is \$4 million, of which \$2 million is in a traditional IRA. Apart from Social Security and what their portfolio generates, they don't expect to have much income in retirement. Their spending is relatively high, \$250,000 annually (requiring a core portfolio of about \$7.5 million), so they may need to spend from their IRA fairly soon. In addition, moving to Florida and a drop in income should reduce their tax rate in retirement, presenting a difficult hurdle for the Roth to overcome. Because the benefits of a Roth were marginal in this case, we advised them against conversion.

**Retired:** This husband and wife are 70 years old and have a net worth of \$4 million, of which \$500,000 is in a traditional IRA. They spend only about \$100,000 a year, which puts them above their estimated core capital of about \$2.4 million. Because most of their wealth consists of taxable assets, and their IRA is relatively small, there's a good chance they'll never need to spend from it. They should consider converting the IRA, even if paying the tax pushes them briefly into a higher bracket. They could use the Roth for themselves much later in retirement or as a vehicle to transfer funds to their children.

**Young Professional:** An up-and-coming 45-year-old professional who plans to work for the foreseeable future has a net worth of \$500,000, \$250,000 of which is in a traditional IRA. She's far from her core target, but her income will likely increase significantly over time, and she'll be able to save more. She has a long time horizon and probably won't need to draw from the IRA for at least 25 years. Also, she's confident she'll be in a higher tax bracket in retirement. She should convert, provided she pays the taxes from her personal account.

### 3. The Matter of Tax

Converting a traditional IRA to a Roth means creating a (large) amount of ordinary income, resulting in a substantial tax bill. That being the case, there are several important issues surrounding the income and resulting tax.

**Not All or Nothing, or Now or Never:** While we have generally considered fully converting an IRA in this paper, in reality the options need not be so black and white. The law (at least as it stands now) allows all investors to convert beginning in 2010, but they may do so in later years as well. As a result, some may prefer to convert a target amount over several years—for example, to avoid being pushed into higher tax brackets by the conversion income. This slow roll may also prove more palatable for those unwilling to pay a large income tax bill all at once. Of course, the delayed income tax liabilities must be weighed against the delayed benefits of converting to a Roth. In addition, since tax rates are expected to rise in 2011, and the investment values of most IRAs are still well off their highs prior to the bear market, it may make sense to convert in 2010. And converting early in 2010 (or any year) will also give you more time—almost two full years—to decide whether to seek a do-over and “recharacterize” the Roth (see *Roth Redo*, following page).

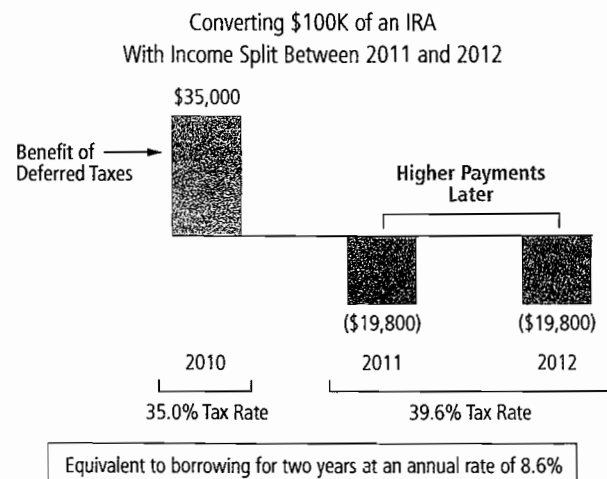
**Special Rule for Conversions in 2010?** The government is allowing those who convert to a Roth in 2010 to split the income in half between the 2011 and 2012 tax years. Deferring taxes is generally advantageous, and this could be beneficial for some who convert in 2010. However, we would caution those who expect to be taxed at higher rates in 2011 and 2012 that this deferral opportunity could be a pitfall. Specifically, the top marginal federal tax rate on income is scheduled to increase to 39.6% in 2011 from 35% in 2010. For someone who will be subject to the top marginal rate from 2010 to 2012, deferring the income on a 2010 conversion can result in paying more taxes in later years. As the display illustrates, this can be the equivalent of borrowing from the government at an annual rate of 8.6% (Display 11).

**Reducing the Tax Bite:** Business owners and others with net operating losses (NOLs) or those with charitable deduction carryforwards may find converting to a Roth to be even more appealing, as these losses and deductions can sometimes be used to offset income generated by the conversion. The resulting tax bill could thereby be reduced, or even eliminated. Those with large capital loss carryforwards, however, may not use these to offset income from a Roth conversion.

**Convert Nondeductible IRAs?** Investors who have nondeductible IRAs (or a mix of nondeductible and deductible) can convert and pay even less in taxes. That is, contributions to nondeductible IRAs (contributions originally made with after-tax dollars) are not taxable when converted to Roth IRAs. In a perfect world, investors would be able to selectively convert just the nondeductible part of their IRAs and pay no tax at all—but the rules don’t work this way. Instead, investors with a mix of nondeductible and deductible IRAs must prorate the conversion, so regardless of which specific account or amount they convert, part will be treated as taxable and part as nontaxable.

Display 11

#### With tax rates rising, it's better to pay the tax in 2010



Source: AllianceBernstein

**Diversify Across Tax Baskets:** The prevailing wisdom for some time has been that one's individual income tax rates would be lower in the future because retirees would have lower taxable income. But this basic and long-held assumption is now up for scrutiny. First of all, tax rates are set to rise. Further, with deficits at record levels, some think *even higher* taxes ahead are inevitable. The best counsel is to consult with your tax advisor, who can help you make a reasonable assessment of your income and effective tax rate in retirement. But ultimately your future tax rate is unknowable. That's why one school of thought is to have at least some portion of your retirement assets in both a traditional IRA and a Roth IRA, as this will provide tax "diversification." You might sleep better knowing that the Roth assets can't be touched by any future tax increase, at least according to tax law as it's written today.

**4. Roth Redo: A Money-Back Guarantee?**

If you're not satisfied with your conversion, you may want to take a mulligan. With Roth conversions, you can. For example, say a 60-year-old investor with a 35% effective tax rate converts \$1 million in a traditional IRA to a Roth on January 4, 2010 (the first business day of the new year), resulting in a \$350,000 tax liability. Then he watches the value of his Roth IRA decline by 20% to \$800,000 over the next 21 months, due to poor investment performance. At that point (up to October 15 of the following

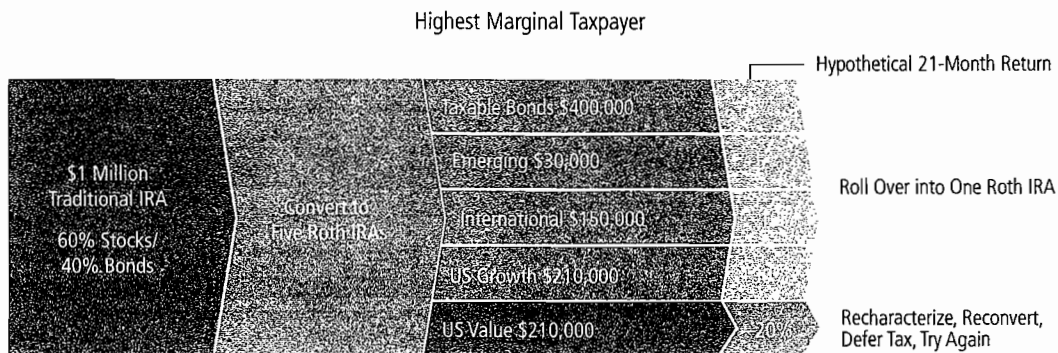
year) he can "recharacterize" the IRA as a traditional IRA and, if he wishes, try the conversion again the following year, at a *lower tax cost*.<sup>9</sup>

From an economic perspective, any decline in the value of the Roth would justify such a recharacterization. However, with the top marginal federal tax rate increasing to 39.6% in 2011, we need to calculate the break-even point beyond which recharacterizing would *not* make economic sense—that is, there may be fewer assets in the portfolio, but they would be taxed at a higher rate. For example, the taxpayer subject to the highest tax bracket in 2010 (35%) would have to suffer a loss of about 12% or more on the Roth portfolio described above to benefit from a recharacterization in the following year, when his tax rate would then be 39.6%.

Of course it's unusual to experience a 12% decline in a well-diversified, balanced portfolio (2008 was a rare and unfortunate example). However, any one asset class could have an off year or two. For that reason, some recommend that, upon conversion, you unpack a fully diversified traditional IRA into a number of individual Roth IRAs, each holding one asset class or type of investment. That makes it easier to monitor individual portfolio performance and recharacterize if necessary.

Display 12

**Convert, split assets, recharacterize (when beneficial), and revert**



Source: AllianceBernstein

<sup>9</sup>A recharacterization can't be reconverted in the same tax year as the original conversion and also can't be reconverted within 30 days of the recharacterization.

For example, a \$1 million IRA invested in US growth, US value, developed international and emerging markets stocks, and bonds could be converted into five separate Roth IRAs (*Display 12*). That way it's easy to undo the conversion if any one asset class doesn't pan out. You can cherry-pick the losing account to get a lower tax cost via recharacterization, while leaving the winners to keep growing and eventually pay out tax-free profits. In this hypothetical case, if only one of the portfolios suffers a decline of 12% or more, you can recharacterize that one, leaving the others intact, or roll them over to a single Roth IRA.

### Conclusion

This paper presents a general quantitative framework for deciding whether to convert a traditional IRA to a Roth. For any individual situation, however, we recommend doing a customized analysis based on the unique issues each investor faces. The basic steps of such an analysis would include ascertaining whether the investor can pay the conversion taxes from a taxable account and whether he might have any nondeductible contributions or net operating losses to cushion the tax impact. Another important question is whether the investor's tax rate may change in 2011 or 2012, and what his bracket may be in retirement. The investor's age at the point of conversion is also key, as it will give an indication of the expected time horizon during which the Roth's tax-free compounding will take place. Related to the question of time horizon, we need to consider the investor's spending relative to his assets, and whether, when, and how much he is likely to spend from the IRA—basing this largely on our estimates for his core portfolio. Finally, who are the beneficiaries of the retirement assets, and will they "stretch" the RMDs? After exploring all these questions, the decision whether to Roth or not to Roth may be taken with greater confidence. ■

## Leave IRA to Charity: No-Brainer, or Think Again?

Donating an IRA to charity has long been an efficient way to make a charitable bequest: It enables you to avoid paying income tax on the funds entirely.

Does the ability to convert to a Roth mitigate the appeal of this strategy? While individual circumstances will vary, our analysis shows that converting to a Roth can leave more wealth for the family beneficiaries while providing an identical amount to charity.

To illustrate the potential advantage of converting and leaving the Roth IRA to one's children and taxable assets to charity, let's look at a 65-year-old investor with more than enough taxable assets to meet his lifestyle needs. Included in his assets is an IRA valued at \$1 million. Would his children be better off if he took only RMDs, gifted the remaining funds in the IRA to charity, and left the children only his taxable assets? Or would they benefit more if he converted the IRA now, left it to the children, and gave an amount equivalent to what would have been left in the IRA to charity from his taxable assets?

The answer ultimately depends on time horizon. If the IRA owner lives 20 years and then his children immediately "cash out" their inheritance, the Roth conversion in 2010 would have been a big mistake. But if his children stretch the Roth for just 10 more years, the Roth conversion has an 83% chance of being the preferred alternative, with a median wealth advantage of \$700,000. Finally, if his children are able to stretch the account for 30 years without spending from it, converting to a Roth would be the better option a staggering 94% of the time, with a median advantage of \$2.9 million.\*

\*This assumes a federal/state blended tax rate of 45% throughout for both the original account owner and the beneficiaries. With lower future tax rates, there could still be a benefit to converting if the assets could be stretched for a sufficient time.



## Notes on Wealth Forecasting System

The Bernstein Wealth Forecasting System<sup>SM</sup> (WFS) is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFS consists of a four-step process: (1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, when to retire, and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: our proprietary model that uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases. Asset-class projections used in this paper are derived from the following: US value stocks are represented by the S&P/Barra Value Index, with an assumed 50-year compounding rate of 9.9%, based on simulations with initial market conditions as of March 31, 2009; US growth

stocks by the S&P/Barra Growth Index (compounding rate of 9.5%); developed international stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged (compounding rate of 10.5%); emerging markets stocks by the MSCI Emerging Markets Index (compounding rate of 8.3%); municipal bonds by diversified AA-rated securities with seven-year maturities (compounding rate of 3.8%); taxable bonds by diversified securities with seven-year maturities (compounding rate of 5.0%); and inflation by the Consumer Price Index (compounding rate of 2.5%). Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

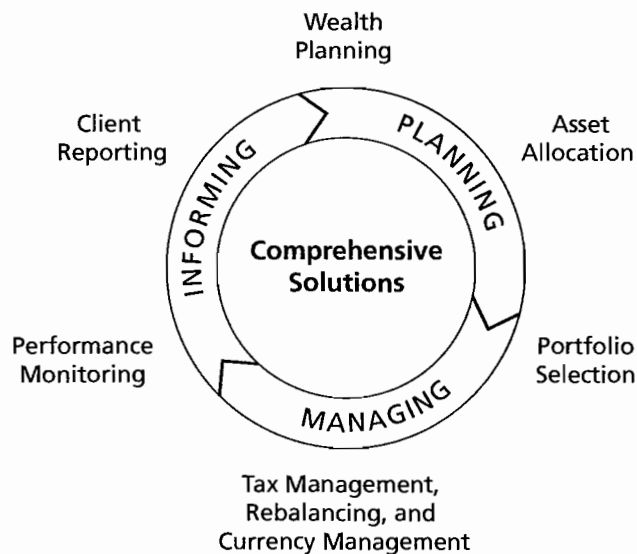
**Mortality Assumptions:** Mortality is modeled using our proprietary simulation model, which creates a range of death ages for a given age. The outcomes of the mortality simulation model are then combined with the outcomes of the Capital Markets Engine on a trial-by-trial basis to produce summarized mortality-adjusted results. Mortality simulations are based on the Society of Actuaries Retirement Plans Experience Committee Mortality Tables RP-2000. ■



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## Client-Centered Wealth Management Solutions

At Bernstein, we are dedicated to providing our clients with wealth management solutions tailored to their unique circumstances. We start with robust *planning*, to identify each client's needs for lifetime spending, retirement, multigenerational wealth transfer, and philanthropic pursuits. We then stress-test a range of investment strategies, including asset allocation approaches, to arrive at a plan for achieving these goals. Then we implement the client's plan through our proprietary platform of investment services, each reliant upon dedicated research teams and managed by dedicated portfolio management teams. In *managing* a client's plan over time, we employ active management within each service, rebalancing to maintain the overall portfolio's profile, and tax management to mitigate the impact of taxes on a client's after-tax returns. We also place a high degree of emphasis on *informing* our clients, providing transparent and real-time performance reporting via our website, and having frequent discussions on portfolio strategy. Throughout, we aim to meet our clients' objectives...and their expectations.



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