

# *2010 Roth Conversion Seminar*

## **IRA Owner's Guide to Understanding Roth Conversions**

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## **IRA OWNER'S GUIDE TO UNDERSTANDING ROTH IRA CONVERSIONS**

One of the more powerful financial and wealth transfer planning opportunities available today is the ability to convert a traditional IRA into a Roth IRA and, in doing so, convert future taxable income into future tax-free income. Although income tax must be paid on the converted amount, the payment of this initial tax liability can result in significant future tax savings.

In order to implement a Roth IRA conversion, an IRA owner transfers all or a portion of his/her traditional IRA to a Roth IRA. The amount transferred to the Roth IRA is taxable income to the IRA owner for which he/she must pay income tax. When "qualified" Roth IRA distributions occur, the distribution will be tax free to the IRA owner and his/her future beneficiaries.

Currently, an individual's eligibility to convert to a Roth IRA conversion is dependent upon the individual's modified adjusted gross income (MAGI) and his/her income tax filing status. Prior to 2010, many taxpayers were not eligible to convert to a Roth IRA because of the \$100,000 MAGI limitation. However, as a result of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), starting in 2010, the \$100,000 MAGI limitation will no longer apply. Furthermore, Roth IRA conversions during the 2010 tax year will receive special tax treatment—the resulting taxable income may be spread over the 2011 and 2012 tax years.

In 2010, every client will be asking whether he/she should convert to a Roth IRA. In the past, because of the \$100,000 MAGI limitation, most Roth IRA conversions have been rather modest and have posed fairly little financial risk to the taxpayer. However, with the elimination of the \$100,000 limitation, the stakes are suddenly higher. Imagine, for example, a client asking in 2010 if he/she should convert half of his/her very large traditional IRA to a Roth IRA. Unfortunately, the answer of whether or not to convert requires a strong knowledge of the tax law and an even stronger mathematical analysis.

In this client guide, we will review the quantitative aspects of Roth IRA conversions and outline the general principles for deciding whether or not a conversion is prudent and, if so, how much should be converted.

### **Benefits of Converting a Traditional IRA to a Roth IRA**

There are numerous benefits associated with converting to a Roth IRA. First and foremost, Roth IRAs are afforded tax-free treatment for qualifying distributions, which, interestingly enough, includes both lifetime and post-mortem distributions. With Roth IRAs, all income and growth within the Roth IRA are allowed to accumulate and compound tax free, allowing the wealth within the Roth IRA to accumulate faster than assets in an outside taxable investment account. Furthermore, the tax-free character of the Roth IRA distributions can result in tremendous income tax savings to the IRA owner and his/her future beneficiaries.

In addition to the benefit of tax-free growth and distributions, there are other benefits that can be achieved from a conversion to a Roth IRA. These benefits are as follows:

- To take advantage of favorable tax attributes (such as charitable deductions carryforwards, net operating loss carryforwards, investment tax credits, etc.).
- To benefit from the suspension of the age 70½ required minimum distribution (RMD) rules.
- To allow for greater wealth to be transferred to future generations (due to the fact that no income tax deduction is allowed for state death taxes levied on IRAs) from the payment of income tax prior to the imposition of estate tax.
- To achieve greater growth potential, to the extent that outside sources (i.e., taxable brokerage account) are used to pay for the taxes due on the Roth IRA conversion.
- To better utilize an IRA owner's Unified Credit.
- To effectively reduce the taxable estate of the IRA owner.
- To hedge against the projected increase in income tax rates after a first spouse dies.

### **Types of Roth IRA Conversions**

In general, there are four types of Roth IRA conversions. These are described as follows:

- *Strategic conversions* – a conversion performed to take advantage of the long-term wealth transfer objectives of the taxpayer.
- *Tactical conversions* – a conversion performed to take advantage of investor-specific, short-term, federal income tax attributes that may be nearing expiration.
- *Opportunistic conversions* – a conversion performed to take advantage of short-term stock market volatility, rotation in asset classes, and sector rotation.
- *Hedging conversions* – a conversion performed to take advantage of projected future events that may result in the taxpayer incurring higher income tax rates in the near future.

### **Strategic Conversions**

The primary objective of a "strategic conversion" is generally wealth transfer motivations. Considering that Roth IRA owners are not required to take RMDs from their Roth IRA account when they reach at age 70½, converting a traditional IRA to a Roth IRA will allow the assets within the account to experience continued, compounded tax-free growth allowing wealth to accumulate for future generations. An ideal "strategic conversion" candidate is one who: (1) possesses "outside funds" (e.g., non-qualified investment accounts) to pay the income tax on the conversion, (2) anticipates being in the same or higher marginal income tax bracket in the future, (3) does not need to make withdrawals from the Roth IRA to meet his/her annual living needs, and (4) desires to leave a tax-free asset to his/her heirs.

### ***Tactical Conversions***

This type of Roth IRA conversion is done primarily to take advantage of unused, short-term, special tax attributes that may otherwise not be utilized. A non-exhaustive list of these types of tax attributes includes: net operating loss carry-forwards, current year ordinary losses, unused charitable contribution carry-forwards, and non-refundable tax credits. Because typically, taxable income is required to utilize these special tax attributes, converting to a Roth IRA will generally “free up” these unrealized favorable tax attributes. If planned effectively, it is possible to convert to a Roth IRA and pay little or no income tax on the conversion.

### ***Opportunistic Conversions***

The main purpose behind this type of Roth IRA conversion is to take advantage of current unfavorable economic conditions that are expected to reverse soon. For example, a conversion to a Roth IRA may be advisable if the traditional IRA has a particular asset in it that is expected to rebound and grow substantially within the near future. In this case, the technique could shift a significant amount of growth from a “tax-deferred” environment into a “tax-free” environment in a short period of time.

### ***Hedging Conversions***

This type of Roth IRA conversion is generally done to “hedge” against future tax increases. Hedging conversions can be further subdivided into: (1) income tax hedging conversions and (2) estate tax hedging conversions. In both cases, these conversions are done to hedge against some future event that may result in the individual incurring higher income taxes or estate taxes.

### **Factors in Deciding Whether to Convert**

The many variables presented with a Roth IRA conversion requires the development of several spreadsheet analyses before arriving at an "optimum" scenario. Nevertheless, it has generally been found that the following key factors need to be identified and addressed in order to best analyze whether a Roth IRA conversion is appropriate:

- Current marginal tax rate vs. projected future marginal tax rate
- Ability to pay the income tax with non-qualified funds
- Time horizon
- Asset mix (i.e., qualified vs. non-qualified, liquid vs. illiquid)
- Traditional IRA balance
- Current and future cash flow needs
- Estate planning objectives

## Mathematical Principles of Roth IRA Conversions

***Principle #1:*** *A Roth IRA conversion within an IRA owner's same tax bracket, using funds from the IRA itself to pay the income tax on the conversion, is tax neutral.*

***Example 1:*** David, age 40 and married, is considering converting \$100,000 to a Roth IRA. At the present time, David and his wife are in the 25-percent tax bracket and expect to be in that tax bracket for all future tax years. Given these assumptions, the amount of IRA assets available for David in 30 years is as follows:

	Traditional IRA	Roth IRA Conversion
Current value of traditional IRA	\$100,000	\$100,000
Less: Income tax on conversion (@ 25%)	0	(25,000)
Net IRA balance after conversion	\$100,000	\$75,000
Growth factor	300%	300%
Future value of IRA	\$400,000	\$300,000
Less: Income tax on distributions (@ 25%)	(100,000)	0
After-tax balance	\$300,000	\$300,000

***Principle #2:*** *Paying the income tax liability on a Roth IRA conversion using funds from "outside funds" (i.e., non-qualified investment assets) is generally more tax favorable.*

A critical factor in analyzing strategic conversions is the ability to use "outside funds" to pay the income tax liability on a Roth IRA conversion. If the IRA owner has "outside funds" from which to pay the income tax liability on a Roth IRA conversion, he/she will be in a stronger economic position than if he/she had retained the funds within the traditional IRA.

***Example 2:*** Olivia, age 60 and single, has a \$2,000,000 traditional IRA and \$700,000 in a taxable brokerage account (i.e., "outside funds"). Olivia is normally in the 35-percent tax bracket each year and in 2010 is eligible to convert to a Roth IRA. Assuming an income tax rate on the conversion of 35 percent, a pre-tax growth rate in the IRA of nine percent and an after-tax growth rate of 7.5 percent in the taxable brokerage account, the amount of wealth Olivia will have in 10 years under both scenarios is as follows:

	Do Nothing			Roth IRA Conversion			Difference (\$)	Difference (%)
	Traditional	Brokerage	Total	Brokerage				
	IRA	Account		Roth IRA	Account	Total		
Pre-Tax Account Balance (Current)	\$ 2,000,000	\$ 700,000	\$ 2,700,000	\$ 2,000,000	\$ 700,000	\$ 2,700,000		
Less: Income Tax on Roth IRA Conversion @ 35%	-	-	-	-	(700,000)	(700,000)		
Less: "Built-In" Income Tax @ 35%	(700,000)	-	(700,000)	-	-	-		
After-Tax Account Balance (Current)	\$ 1,300,000	\$ 700,000	\$ 2,000,000	\$ 2,000,000	\$ -	\$ 2,000,000	\$ -	0.00%
Pre-Tax Account Balance (Year 10)	\$ 4,734,727	\$ 1,442,722	\$ 6,177,449	\$ 4,734,727	\$ -	\$ 4,734,727		
Less: "Built-In" Income Tax @ 35%	(1,657,155)	-	(1,657,155)	-	-	-		
After-Tax Account Balance (Year 10)	\$ 3,077,573	\$ 1,442,722	\$ 4,520,295	\$ 4,734,727	\$ -	\$ 4,734,727	\$ 214,432	4.74%

***Principle #3: The longer the time horizon, the better the economic result.***

Another factor in analyzing strategic conversions is the expected time horizon. Obviously, the more time funds can grow in a tax-deferred environment, the better the economic result. Even in cases when the IRA owner expects to be in a lower tax bracket in the future, if he/she has "outside funds" to pay the income tax on a Roth IRA conversion and has a long time horizon, it is possible that a Roth IRA conversion could be beneficial.

**Example 3:** Paul, age 40 and single, has a \$400,000 IRA and \$112,000 in a taxable brokerage account (i.e., "outside funds"). Currently, Paul is in the 28-percent tax bracket and expects to be in the 25-percent tax bracket during his retirement years. Assuming a pre-tax growth rate in the IRA of seven percent and an after-tax growth rate of six percent in the taxable brokerage account, the amount of wealth Paul will have in the future is as follows:

	Do Nothing			Roth IRA Conversion			Difference (\$)	Difference (%)
	Traditional	Brokerage	Total	Brokerage				
	IRA	Account		Roth IRA	Account	Total		
Pre-Tax Account Balance (Current)	\$ 400,000	\$ 112,000	\$ 512,000	\$ 400,000	\$ 112,000	\$ 512,000		
Less: Income Tax on Roth IRA Conversion @ 28%	-	-	-	-	(112,000)	(112,000)		
Less: "Built-In" Income Tax @ 25%	(100,000)	-	(100,000)	-	-	-		
After-Tax Account Balance (Current)	\$ 300,000	\$ 112,000	\$ 412,000	\$ 400,000	\$ -	\$ 400,000	\$ (12,000)	-3.00%
Pre-Tax Account Balance (Year 10)	\$ 786,861	\$ 200,575	\$ 987,435	\$ 786,861	\$ -	\$ 786,861		
Less: "Built-In" Income Tax @ 25%	(196,715)	-	(196,715)	-	-	-		
After-Tax Account Balance (Year 10)	\$ 590,145	\$ 200,575	\$ 790,720	\$ 786,861	\$ -	\$ 786,861	\$ (3,860)	-0.49%
Pre-Tax Account Balance (Year 20)	\$ 1,547,874	\$ 359,199	\$ 1,907,073	\$ 1,547,874	\$ -	\$ 1,547,874		
Less: "Built-In" Income Tax @ 25%	(386,968)	-	(386,968)	-	-	-		
After-Tax Account Balance (Year 20)	\$ 1,160,905	\$ 359,199	\$ 1,520,105	\$ 1,547,874	\$ -	\$ 1,547,874	\$ 27,769	1.83%
Pre-Tax Account Balance (Year 30)	\$ 3,044,902	\$ 643,271	\$ 3,688,173	\$ 3,044,902	\$ -	\$ 3,044,902		
Less: "Built-In" Income Tax @ 25%	(761,226)	-	(761,226)	-	-	-		
After-Tax Account Balance (Year 30)	\$ 2,283,677	\$ 643,271	\$ 2,926,948	\$ 3,044,902	\$ -	\$ 3,044,902	\$ 117,954	4.03%

***Principle #4: Roth IRA distributions, like traditional IRA distributions, can be paid out over the life expectancy of the designated beneficiary. However, Roth IRA distributions retain their tax-free character.***

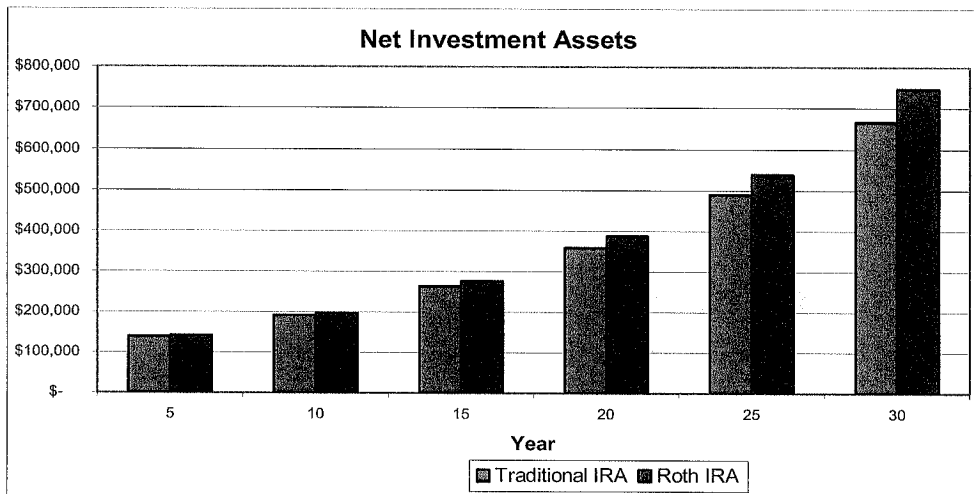
When determining whether to convert to a Roth IRA, the fact that Roth IRAs are not subject to the lifetime RMD rules like traditional IRAs must be taken into consideration. Beneficiaries of Roth IRAs, however, are subject to the RMD rules. Nevertheless, the distributions the beneficiaries take from the Roth IRA will generally not be subject to income tax. Thus, depending on the size of the IRA, the account owner's life expectancy and the ages of the beneficiaries, the total amount of additional wealth that could be created by converting to a Roth IRA can be staggering.

**Example 4:** Mark, age 69 and single, is considering converting \$100,000 to a Roth IRA. At the present time, Mark is in the 25-percent tax bracket and expects to be in the 25-percent tax bracket for the foreseeable future. In addition, Mark has named his son, Chris (age 42), as beneficiary of his traditional IRA. It is expected that Chris will also be in the 25-percent tax bracket when he inherits Mark's IRA.

The following are the other pertinent facts and assumptions:

Mark's assumed age at death:	86
Taxable investment account:	\$25,000
Yield rate (i.e. ,dividends and interest):	2.00%
Growth rate:	5.00%
Ordinary income tax rate:	25.00%
Capital gains tax rate:	15.00%

As evidenced by the chart below, in 30 years, Chris would have over \$80,000 more if Mark were to convert \$100,000 to a Roth IRA during the current year.



### Determining the Proper Amount to Convert

After concluding that a Roth IRA conversion would be beneficial, an IRA owner must then determine how much of the traditional IRA to convert and when to do the conversion. Although there is no bright line rule or "optimum" conversion amount, there are several general rules of thumb to follow when executing a Roth IRA conversion. These include:

- To the extent that the IRA owner's current marginal income tax rate is equivalent to or lower than his/her projected future marginal income tax rate, there is little harm in making a Roth IRA conversion.

- Convert an amount that will allow as much of the conversion income as possible to remain in the IRA owner's current marginal income tax bracket (i.e., the more the taxpayer's marginal income tax bracket increases due to the conversion, the less favorable the conversion may be).
- The ability to utilize funds from outside of the traditional IRA to finance the conversion will allow a more beneficial result (i.e., if at all possible, avoid having to use the IRA funds to pay the income tax liability on the conversion).

Although there is an interplay of factors affecting the decision of whether to convert to a Roth IRA and the amount of the traditional IRA to convert, the driving factors are generally the IRA owner's current and projected future marginal income tax rates and the ability to finance the conversion with funds from outside of the IRA.

The key to finding the "optimum" conversion amount depends on the IRA owner's current and future projected income tax rates. As discussed earlier, to the extent that the owner expects the future tax rate to be the same or higher than the current tax rate, there is little to no harm in converting to a Roth IRA. In many cases, he/she most likely will be in higher income tax brackets in future years because of the RMD rules that apply to traditional IRAs once the IRA owner reaches age 70½. Thus, in choosing the "optimum" amount to convert to a Roth IRA, he/she most likely would convert an amount that would be taxed at a rate that would be the same or less than his/her projected future tax rate.

**Example 5:** Linda, age 65 and married, has \$100,000 in a traditional IRA that she is considering converting to a Roth IRA. At the present time, Linda and her husband are in the 25-percent tax bracket and expect to be in the 28-percent tax bracket once her RMDs begin. Assuming a brokerage account balance of \$25,000 generating an after-tax growth rate of seven percent and a pre-tax growth rate of eight percent for the IRA, the amount of wealth Linda will have in the future is as follows:

	Do Nothing			Roth IRA Conversion			Difference (\$)	Difference (%)
	Traditional IRA	Brokerage Account	Total	Roth IRA	Brokerage Account	Total		
Pre-Tax Account Balance (Current)	\$ 100,000	\$ 25,000	\$ 125,000	\$ 100,000	\$ 25,000	\$ 125,000		
Less: Income Tax on Roth IRA Conversion @ 25%	-	-	-	-	(25,000)	(25,000)		
Less: "Built-In" Income Tax @ 28%	(28,000)	-	(28,000)	-	-	-		
After-Tax Account Balance (Current)	\$ 72,000	\$ 25,000	\$ 97,000	\$ 100,000	\$ -	\$ 100,000	\$ 3,000	3.00%
Pre-Tax Account Balance (Year 10)	\$ 215,892	\$ 49,179	\$ 265,071	\$ 215,892	\$ -	\$ 215,892		
Less: "Built-In" Income Tax @ 28%	(60,450)	-	(60,450)	-	-	-		
After-Tax Account Balance (Year 10)	\$ 155,443	\$ 49,179	\$ 204,621	\$ 215,892	\$ -	\$ 215,892	\$ 11,271	5.51%
Pre-Tax Account Balance (Year 20)	\$ 466,096	\$ 96,742	\$ 562,838	\$ 466,096	\$ -	\$ 466,096		
Less: "Built-In" Income Tax @ 28%	(130,507)	-	(130,507)	-	-	-		
After-Tax Account Balance (Year 20)	\$ 335,589	\$ 96,742	\$ 432,331	\$ 466,096	\$ -	\$ 466,096	\$ 33,765	7.81%

## Roth IRA Recharacterizations

An investor who is ineligible or otherwise not comfortable with the Roth IRA conversion he/she executed is provided broad relief under the tax law to "recharacterize" (i.e., undo) the entire current year Roth IRA conversion. In this case, a recharacterization provides a IRA owner with the option of transferring assets from the Roth IRA back into the traditional IRA, and in doing so, eliminate the income tax liability associated with the conversion. As the following timetable illustrates, an individual may recharacterize a



current year Roth IRA conversion on or before the extended filing date of the current year's income tax return.

- January 1, 2010** First date in which a 2010 Roth conversion may take place
- December 31, 2010** Last date in which a 2010 Roth conversion may take place
- April 15, 2011** Due date for the 2010 income tax return and the last date in which the tax liability on a 2010 conversion may be paid
- October 15, 2011** Last date in which a recharacterization of a 2010 conversion may be made

Given the above timetable, an IRA owner is essentially able make the final recharacterization decision with the benefit of hindsight. This is especially true if the IRA owner executes a Roth IRA conversion early in the year, waits to determine the effect the market will have on the Roth IRA, and then makes a final recharacterization decision late in the following year. In this scenario, the IRA owner may have more than nine months after the year in which the conversion takes place (potentially 21 months after the conversion takes place) to make the final recharacterization decision.

Once a Roth IRA conversion has been done, invariably some of the investments within the Roth IRA will have increased in value while some of the investments will have decreased in value. In determining whether to recharacterize a Roth IRA conversion, the most favorable approach would be to recharacterize only those assets that have declined in value since conversion. Unfortunately, however, the IRS has curtailed this strategy by issuing the "anti-cherry picking rules" in Notice 2000-39 (2000-2 CB 132). Under this Notice, all gains and losses within the Roth IRA must be prorated over the entire IRA instead of on an asset-by-asset basis, and regardless of the actual fund recharacterized. Nevertheless, with careful planning and the application of the "Roth IRA Segregated Conversion Strategy" (see discussion below), a taxpayer may be able to avoid the application of the "anti-cherry picking rules".

### **"Roth IRA Segregation Conversion Strategy"**

The "anti-cherry-picking rules" discussed above can be avoided by specifically identifying assets to be transferred to newly established Roth IRAs one Roth IRA for each grouping of assets. Typically, the grouping of assets would be a particular fund, particular stock, or particular grouping of stocks within a market sector. Returns for different stocks, funds, or market sectors could vary significantly with some decreasing in value while others increase. Consequently, if the investment performance of one Roth IRA investment is poor, it may be possible to recharacterize this "segregated" Roth IRA back to a traditional IRA to eliminate the ordinary income associated with that conversion, while allowing the other Roth IRAs to remain unchanged. The idea is that the individual would put different types of investments (e.g., Large Cap, Mid Cap, Small Cap, International, etc.) in "segregated" IRAs, convert each segregated IRA to a Roth IRA and, thereafter, recharacterize only those Roth IRAs that underperformed.

**Example 6:** On January 3, 2010, Roger converted \$200,000 of his traditional IRA to a Roth IRA. At the time of conversion, the traditional IRA consisted of \$100,000 in Large-Cap Fund and \$100,000 in Mid-Cap Fund.

As of April 15, 2011, the Large-Cap Fund had declined in value to \$75,000, while the Mid-Cap Fund had increased in value to \$112,500. Thus, the total value of the Roth IRA account declined to \$187,500. Should Roger choose not to recharacterize any of his Roth IRA conversion, he would have to pay income tax on the \$200,000 conversion amount, even though the Roth IRA is only worth \$187,500 currently.

Accordingly, Roger would like to recharacterize all of Large-Cap Fund, but none of Mid-Cap Fund. In this case, in order to determine the amount recharacterized, Roger must first calculate the value of Large-Cap Fund as a percentage of the total value of the Roth IRA as of the recharacterization date. This percentage is 40 percent ( $\$75,000/\$187,500$ ). Once the percentage has been determined, the value of the IRA, as of the date of conversion, is multiplied by the 40-percent figure. Thus, if Roger were to recharacterize the Large-Cap Fund, he could reduce his taxable income by only \$80,000 ( $\$200,000 \times 0.40$ ). This would result in Roger paying income tax on a \$120,000 conversion ( $\$200,000 - \$80,000$ ), despite the fact that the remaining amount in Roger's Roth IRA is only \$112,500.

Now, assume that instead of creating a single Roth IRA, Roger decides to create two separate Roth IRAs, one for the Large-Cap Fund ("Roth IRA #1") and one for the Mid-Cap Fund ("Roth IRA #2"). In this case, Roger would recharacterize Roth IRA #1 because the value of the Large-Cap Fund has gone down since the time of conversion. Provided that Roger recharacterized the entire amount held in Roth IRA #1, he will not owe any income tax on this conversion. Rather, Roger will only recognize ordinary income on the conversion of Roth IRA #2 (\$100,000). The following shows the amount of Roth IRA conversion income that Roger would recognize in the above two scenarios:

	Example 1	Example 2	Difference
Value on date of conversion	\$ 200,000	\$ 200,000	\$ -
Value of Roth IRA at recharacterization	\$ 187,500	\$ 187,500	\$ -
Ordinary income recognized	\$ 120,000	\$ 100,000	\$ (20,000)
Ordinary Income Tax @ 28%	\$ 33,600	\$ 28,000	\$ (5,600)

By segregating the IRA into two separate Roth IRAs, under the above facts, Roger saves over \$5,000 in tax!

What has been described above is commonly referred to as the "Roth IRA Segregation Conversion Strategy" and the steps for accomplishing this strategy are as follows:

1. Identify specific groups of assets and create new Traditional IRAs for each asset "class".
2. Convert the separate Traditional IRAs to separate Roth IRAs.
3. Extend the tax return and pay income tax on the total Roth IRA conversion.
4. Recharacterize specific underperforming Roth IRAs back to the Traditional IRAs
5. File the extended income tax return reporting the Roth IRA conversions and recharacterizations.

The key to making this strategy work is to transfer assets expected to produce different returns into different IRAs. Assets with high correlations to each other would be placed in the same IRA while assets with low or negative correlations to each other would be placed into separate IRAs. This would provide the best chance of segregating the gain assets from the loss assets. As a result, if executed properly, there is the opportunity to make a recharacterization decision with "20/20" hindsight.

### **Conclusion**

Roth conversion planning is very complex. As such, the IRA owner must work with his/her professional advisors to determine whether a Roth IRA conversion is desirable and, if so, what portion of the IRA should be converted. In most cases, the factors that support some level of Roth IRA conversion generally outweigh the factors that favor no conversion.

In 2010, more and more IRA owners will seek professional advice to determine the advantages and disadvantages of a Roth IRA conversion. While arduous, with a good understanding of the basic mathematical principles explained above, the IRA owner will be able to maximize the power of tax-free deferral for his/her future generations.

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