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Roth IRA/401(k) Conversion Opportunity: Acting in 2010 May Be Optimal

As you may know, starting in 2010, all taxpayers can convert their regular individual retirement accounts (IRAs) into Roth IRAs. (Before 2010, only lower-income taxpayers could convert.) Legislation enacted on September 27, 2010 will allow some accounts in an employer-sponsored 401(k) plan to be converted to Roth accounts, even if the account holder is still working. The new legislation is subject to a number of limitations and uncertainties, and can facilitate conversion only if the 401(k) plan is appropriately amended. There is more detail about the new law at the end of this memorandum.

Many financial planners think that Roth conversion is a good tax strategy for some wealthy and/or high-income persons who will not need to draw on their retirement accounts for many years, and that converting early will magnify those anticipated benefits. Conversion does trigger a current tax, but converting in 2010 may be cheaper than waiting if income tax rates rise in 2011. This may be known by the end of 2010.

Regular IRAs can be converted to Roth IRAs regardless of the IRA owner's age or employment status.

The chart below presents highlights about the Roth conversion opportunity. Here is a web link to a more detailed PowerPoint presentation about the Roth conversion opportunity and its economics:

http://www.paulweiss.com/files/upload/RothIRA29Oct10.pdf

If you have any interest in Roth conversion for 2010, you should start thinking about it very soon: the conversion decision requires careful consideration of personal and family circumstances, and there is also some administrative lead-time needed in the conversion process.

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ROTH CONVERSION: STRATEGY & OPPORTUNITIES

- **CONVERTING AN IRA OR ACCOUNTS IN AN EMPLOYER PLAN**
  - The IRA owner elects to pay income tax now on his/her regular IRA balances.
    - Optimally, non-retirement account monies are used to pay those taxes.
  - Employer-sponsored tax-qualified plan accounts can generally be converted by first withdrawing the account balances (assuming the plan so permits), rolling the funds over to a regular IRA and then converting into a Roth IRA. A new law lets 401(k) plans offer an in-plan in-service conversion opportunity.
- **BENEFITS OF CONVERTING**
  - Long-term exposure to tax-advantaged investing: Future Roth IRA earnings and distributions are income-tax free. Also, unlike regular IRAs and employer-sponsored tax-qualified plans, Roth IRAs are not required to make distributions during the lives of the owner and a spousal beneficiary.
  - Possible estate tax savings.
- **A KEY RISK OF CONVERTING**
  - That you'll guess wrong about the future income tax rates applicable to you and your beneficiary. Hindsight may show that Roth was not optimal if you and/or your beneficiary become subject to substantially lower income tax rates.
- **SOME CONSIDERATIONS PRO CONVERSION:**
  - Substantial income/assets beyond the IRA balance and conversion taxes.
  - Long time horizon before the funds will be needed.
  - Desire to leave tax-advantaged assets to your beneficiaries.
  - You expect your income tax rate to stay the same or rise.
- **SOME CONSIDERATIONS CONTRA CONVERSION:**
  - You or your beneficiary may need these monies to live on, possibly sooner than later.
  - You or your beneficiary expect your income tax rate to fall significantly.
  - Much of your wealth will be given to charities during your lifetime and at death.

Roth Conversion Inside an Employer Plan

As to retirement accounts held in employer-sponsored retirement plans: Until recently, participants could convert only by withdrawing funds, rolling over to a regular IRA and then converting to a Roth IRA. However, for active employees, this works only if the employer-sponsored plan permits in-service withdrawals. Many employer plans do not permit in-service withdrawals at all because the employer does not want employees to be able to access retirement accounts while working, or allow them only upon reaching a stated age, like 59-½ or 65. Indeed, some types of employer-sponsored retirement plans are forbidden to offer in-service withdrawals before age 62.

The September 27, 2010 law allows 401(k) plans to offer an in-service conversion opportunity inside the plan, but the provision may be of limited utility: The in-plan conversion opportunity is generally available only for amounts that could legally be made available for withdrawal; employee contributions to a 401(k) plan can be withdrawn in-service only after age 59-½, although employer contributions could be made available for withdrawal earlier, for example, after 5 years of participation. The new law does allow employers to condition withdrawals on the employee agreeing to transfer the withdrawal to a Roth account inside the same 401(k) plan. The 401(k) plan must be amended in order to offer this in-plan conversion feature, and the full scope of the new law won't be known until the Internal Revenue Service issues guidance.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Robert C. Fleder 212-373-3107
David R. Sicular 212-373-3082
Alan S. Halperin 212-373-3313

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410