

Sponsoring Organization Name

Continuing Professional Education

Roth, Roth & Roth

(IRA, 401(k) & Conversion)

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IRS Circular 230 Notice:

To the extent that this presentation concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.

Today's Agenda

- ✓ Pre-tax and Roth IRA
- ✓ Pre-tax and Roth 401(k)
- ✓ Retirement Plan In-service Withdrawals
- ✓ Pre-tax to Roth Conversions
- ✓ Roth Impact on Estate Taxes
- ✓ Where to Save for Retirement
- ✓ Case Studies

Pre-tax IRAs

2009 Contribution Limits:

- The lesser of qualifying income¹ or \$5,000
- Catch-up²: \$1,000 / total: \$6,000

Is the contribution deductible? Yes, if...

- Not an “active” participant in a qualified plan; you’re not active if:
 - ✓ No employer plan
 - ✓ If SEP or Profit Sharing/401(k), no “cash basis” employer or employee contribution, and no forfeiture allocation in the applicable tax year
 - ✓ SEP or Profit Sharing Plan funded in tax year following

¹ Earned income as reported on W-2, self-employment income or alimony; or Spouses qualifying income over and above amount considered for spouse’s IRA; cannot be 70½ by end of applicable tax year

² Catch-up available to those who are age 50 or older at anytime in 2009

Pre-tax IRAs

Is the contribution deductible? Maybe, when...

- Not active, *no* income *limit*; if active then:

Filing status	Full Contribution	Contribution Phased Out	No Contribution
Single Filer	< \$55,000	\$55,000 - \$65,000	> \$65,000
Married Joint Filer	< \$89,000	\$89,000 - \$109,000	> \$109,000
Married Joint Filer, and (1 spouse not active)	< \$166,000	\$166,000 - \$176,000	> \$176,000

Pre-tax IRAs

Distributions

- Withdrawals taxed as ordinary income; subject to 10% additional penalty tax, unless...
 - ✓ Distributed after attainment of age 59½
 - ✓ Distributed to beneficiary post death of IRA owner
 - ✓ Rolled over to retirement account within 60 days compliant with 60-day rules
 - ✓ Distributed if totally or permanently disabled
 - ✓ Distributed if unemployed to pay health insurance premiums
 - ✓ Distributed to pay college expenses for yourself, spouse or dependent
 - ✓ Distributed compliant with the rules for first-time homebuyers
 - ✓ Distributed to pay medical expenses in excess of 7.5% of AGI
 - ✓ Distributed to satisfy an IRS levy against a retirement account
 - ✓ Distributed compliant w/rules for a series of substantial equal periodic payments

Pre-tax IRAs (Distributions Cont'd)

- If Non-deductible IRA Contribution, distributions are taxed on a *pro-rata basis* considering:
 - ✓ Pre-tax amounts are **taxable** (gains on the after-tax investments in the IRA);
 - ✓ The principal contribution amounts ("**basis**") are **tax-free**; and
 - ✓ Must **aggregate any after-tax** (non-deductible) contributions in **all IRA** accounts (not QRPs)

Example 1:

\$20,000 in IRA 1 with \$10,000 after-tax; \$80,000 in IRA 2 with \$0 after-tax; therefore...

Tax due on \$50,000 distribution:

$$\$10,000/\$100,000 = 10\% \times \$50,000 = \$5,000 \text{ tax-free, } \$45,000 \text{ taxable}$$

Example 2:

\$20,000 in IRA 1 with \$10,000 after-tax; \$480,000 in IRA 2 with \$0 after-tax; therefore...

Tax due on \$50,000 distribution:

$$\$10,000/\$500,000 = 2\% \times \$50,000 = \$1,000 \text{ tax-free, } \$49,000 \text{ taxable}$$

- Required Minimum Distributions (RMDs) start at attainment of age 70½ in accordance with applicable rules

Roth IRAs

2009 Contribution Limits:

- The lesser of qualifying income¹ or \$5,000
- Catch-up²: \$1,000 / total: \$6,000

Eligible to contribute to Roth IRA? Yes, if MAGI...

Filing status	Full Contribution	Contribution Phased Out	No Contribution
Single Filer	< \$105,000	\$105,000 - \$120,000	> \$120,000
Married Joint Filer	< \$166,000	\$166,000 - \$176,000	> \$176,000

¹ Earned income as reported on W-2, self-employment income or alimony; or Spouses qualifying income over and above amount considered for spouse's IRA; cannot be 70½ by end of applicable tax year

² Catch-up available to those who are age 50 or older at anytime in 2009

Roth IRAs

Distributions

■ Withdrawals

- ✓ Any withdrawal is deemed to be 1st in (“basis”), 1st out
- ✓ Tax-free withdrawals of contribution “basis” w/o addit’l penalty tax prior to 59½
- ✓ Gains subject to tax and addit’l penalty tax prior to 59½; however, tax-free if the distributions qualifies under both of the following:
 - “5-year” rule; begins on the fifth year of contribution to any Roth IRA
 - Attaining age 59½, death, disability, or 1st time homebuyer
- No Required Minimum Distributions (RMDs) attaining age 70½; RMDs required in year following death of nonspousal beneficiary

Pre-tax and Roth 401(k)

2009 Contribution Limits:

- The lesser of 100% of compensation or \$16,500
- Catch-up¹: \$5,500 / total: \$22,500
- Pre-tax & Roth Combined Limit for All Plans (includes SIMPLE IRAs) is individual calendar year limit (if non-related employer plans, employee responsible for tracking individual limit, not employer)

No AGI limit for Roth 401(k) eligibility

Pre-tax and Roth 401(k) subject to FICA tax and Minimum Distribution Requirements

¹ Catch-up available to those who are age 50 or older at anytime in 2009

Roth, Roth & Roth

Distribution Rules	Roth 401(k)	Roth IRA
Minimum Distribution Requirement	Required at RBD (April 1 post age 70½ except actively employed non-5% owners)	Does <u>Not</u> Apply
1st Time Home Buyer Exception	Does <u>Not</u> Apply	Applies up to \$10,000
Qualified Distribution 5-year Rule	Clock starts 1 st contribution year to 401(k) plan. If participant joins other employer plan, clock ticks based on 1 st contribution year if, and only if, original Roth account rolled into new employer plan.	1 st year of 5-years is year of any contribution to <u>any</u> Roth IRA (RI). If non-qualified Rothk rollover to RI, original year of Rothk contribution not counted; therefore, 5-years <u>begins with year rolled</u> unless rolled into previous RI (or to new RI and previous RI exists). If qualified Rothk rollover to RI, <u>immediately treated as basis</u> ; earnings subject to Roth IRA rules.
Nonqualified Distribution Taxation	Basis/gains taxed proportionate. Considers Rothk account only in determining % of distribution treated taxable.	Taxable based on 1 st money in, 1 st money out (tax-free distribution of contribution principal (the "basis") first, then taxable earnings). Roth IRA rules apply to Roth(k) rollovers.

Pre-tax to Roth Conversions

- Conversion is entire *or portion* of pre-tax roll to Roth IRA; *however...*
 - ✓ To be **eligible**; **MAGI¹** must be **\$100,000** or less for all taxpayers
 - ✓ Taxpayer must report entire or partial pre-tax conversions as ordinary income
 - ✓ No additional penalty tax if completed timely (cross tax yrs if within 60-day roll)
- **2010 forward no MAGI for eligibility**
- *Limited-time offer...* convert in **2010**, pay no tax in **2010**, half in **2011** and half **2012**; *but...*
Watch-out! *If tax rates rise in 2011/12, perhaps better to pay in 2010*
- Conversion can be reversed under recharacterization rules
 - ✓ Transfer back to pre-tax from Roth by due date of tax return, includes extension
 - ✓ Must adjust for applicable gains/losses during transition period

¹ Earned income as reported on W-2, self-employment income or alimony; or Spouses qualifying income over and above amount considered for spouse's IRA

Pre-tax to Roth Conversions (cont'd)

- Converted IRA withdrawals - **separate 5-year** rule for each conversion
 - ✓ Additional penalty tax unless otherwise exception conversions applies
 - ✓ **Penalty applies** to pre-tax IRA **after-tax contributions** yet to satisfy the 5-year rule
- If distribution from now combined Roth IRA/Roth conversion, then...
 - ✓ Roth IRA money out first (FIFO, tax and penalty-free); then
 - ✓ Converted IRA (tax-free subject to separate 5-year rule); then
 - ✓ Roth gains (tax-free if qualified under separate rules for Roth IRA and Roth conversions' earnings)
 - ✓ If multiple Roth conversions then first conversion deemed first distributed

Access to Assets for Conversion In-service Withdrawals

SEPs and SIMPLEs

- Funds contributed to pre-tax IRA; therefore, *if eligible participant*, can convert to Roth; *except... 2-year restriction on SIMPLE IRA¹*

Qualified Retirement Plans

- Pensions more restrictive than Profit Sharing
- Additional restrictions apply to 401(k) monies

Access only if permitted by law and plan documents

¹ Must be *participant for two years* before eligible for rollover to another pre-tax or Roth IRA

Access to Assets for Conversion

In-service Withdrawals from Pension Plans

Money Purchase, Target Benefit or Defined Benefit

- Typically permitted only at normal retirement age (NRA; e.g., age 65); however, must be “reasonable” if NRA lower than 62
- Post 2006 permitted at age 62 even if NRA greater than 62
- Hardship withdrawals prior to age 62 not permitted

Access to Assets for Conversion

In-service Withdrawals from Profit Sharing Plans

- Permitted while employed after a stated event
 - ✓ Attainment of **age "x"** (may be earlier than NRA)
 - ✓ After **"x" years funds have accumulated** ("x" must be \geq 2years)
 - ✓ After stated number of **years of service or participation** in plan (typically at least 5 years)
 - ✓ Due to **disability, illness or financial hardship** (more liberal than "k" hardship permitted)
 - ✓ Permitted at **normal retirement age** (NRA); however, does not need to be **"reasonable;"** (e.g., need not coincide w/customary industry retirement age)

Access to Assets for Conversion

In-service Withdrawals from Profit Sharing Plans (Cont'd)

- Additional restrictions for 401(k) monies
 - ✓ In-service withdrawal of employee elective deferrals (401(k)) not permitted, unless...
 - Participant attains age 59½
 - Financial Hardship as defined in the 401(k) rules
 - ✓ Above "401(k)" restrictions also apply to:
 - Qualified nonelective and matching contributions (QNECs and QMACs)
 - "Safe Harbor" nonelective and matching contributions
 - ✓ Access to employer nonelective and matching contributions permitted in accordance with Profit Sharing rules

Estate Taxes

Income in Respect of a Decedent (IRD)

- In general, Federal Estate Taxes typically *do not impact* pre-tax v. Roth analysis since IRC §691(c) permits the beneficiary to an **income tax deduction equal to estate tax paid** attributable to the tax due on the receipt of assets from an IRA or other qualified plan; *however...*
 - ✓ IRD rules (the applicable deduction) do not apply to state estate taxes
 - ✓ In general, IRD deduction will not offset all income tax due if IRA or other pre-tax assets are significantly greater than other assets subject to fed. estate tax
- **Therefore...** a pre-tax IRA to a Roth IRA, does not typically result in the efficient pre-payment of income taxes for beneficiaries. However, since a Roth IRA is not subject to RMD, it does facilitate the “Super-Stretch” payments to nonspouse beneficiaries

See examples that follow and applicable Case Study

Estate Taxes - IRD Example 1

	Pre-tax IRA		Converted to Roth	
IRA Assets	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000
Other Assets (35% tax)		<u>\$4,000,000</u>	(700,000)	<u>\$3,300,000</u>
Total Estate		\$6,000,000		\$5,300,000
Estate Tax (45% xs \$3.5M)	\$2,500,000	<u>(\$1,125,000)</u>	\$1,800,000	<u>(\$810,000)</u>
Net Estate		\$4,875,000		\$4,490,000
IRD Deduction (Estate tax on IRA)	(\$900,000)		\$0	
35% income tax on remaining IRA assets	\$1,100,000	<u>(\$385,000)</u>	\$0	<u>(\$0)</u>
Value Net after-tax		\$4,490,000		\$4,490,000

IRD deduction applies to Federal estate tax, not typically for State estate taxes; therefore, outcome will differ if State Estate Taxes apply.

Estate Taxes - IRD Example 2

	If Pre-tax IRA		Converted to Roth	
IRA Assets	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000
Other Assets (35% tax)		<u>\$2,000,000</u>	(1,400,000)	<u>\$600,000</u>
Total Estate		\$6,000,000		\$4,600,000
Estate Tax (45% xs \$3.5M)	\$2,500,000	<u>(\$1,125,000)</u>	\$1,100,000	<u>(\$495,000)</u>
Net Estate		\$4,875,000		\$4,105,000
IRD Deduction (Estate tax on IRA)	(\$1,125,000)		\$0	
35% income tax on remaining IRA assets	\$2,875,000	<u>(\$1,00,6250)</u>	\$0	<u>(\$0)</u>
Value Net after-tax		\$3,868,750		\$4,105,000

Estate Taxes - IRD Example 2

Example 2 demonstrates that the benefits of converting increase when all IRA assets do not yield an IRD deduction (also feasible when State estate tax applies).

In this instance, the amount subject to estate tax is only \$2.5M. This means that \$1.5M of the IRA assets do not benefit from the IRD deduction (equal to the 45% estate tax, or \$675,000).

Therefore, the net to heirs differential between leaving the assets in the pre-tax IRA or converting them to a Roth IRA and prepaying the income tax on the pre-tax IRA assets is calculated as follows:

$$\$1.5M \times 45\% (\text{F}_{\text{ederal}} \text{E}_{\text{state}} \text{T}_{\text{ax}}) = \$675,000 \text{ (lost IRD deduction)}$$

$$\$675,000 \times 35\% (\text{F}_{\text{ederal}} \text{I}_{\text{ncome}} \text{T}_{\text{ax}}) = \$236,250 \text{ conversion advantage}$$

Estate Taxes - IRD Example 3

	Pre-tax IRA		Converted to Roth	
IRA Assets	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000
Other Assets (35%)		<u>\$10,000,000</u>	(700,000)	<u>\$9,300,000</u>
Total Estate		\$12,000,000	\$7,800,000	\$11,300,000
Estate Tax (45% xs \$3.5M)	\$8,500,000	<u>(\$3,825,000)</u>		<u>(\$3,510,000)</u>
Net Estate		\$8,175,000		\$7,790,000
IRD Deduction (Estate tax on IRA)	(\$900,000)		\$0	
35% income tax on remaining IRA assets	\$1,100,000	<u>(\$385,000)</u>	\$0	<u>(\$0)</u>
Value Net after-tax		\$7,790,000		\$7,790,000

IRD deduction applies to Federal estate tax, not typically for State estate taxes; therefore, outcome will differ if State Estate Taxes apply.

Estate Taxes - IRD Example 4

	If Pre-tax IRA		Converted to Roth	
IRA Assets	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000
Other Assets (35%)		<u>\$8,000,000</u>	(1,400,000)	<u>\$6,600,000</u>
Total Estate		\$12,000,000		\$10,600,000
Estate Tax (45% xs \$3.5M)	\$8,500,000	<u>(\$3,825,000)</u>	\$7,100,000	<u>(\$3,195,000)</u>
Net Estate		\$8,175,000		\$7,405,000
IRD Deduction (Estate tax on IRA)	(\$1,800,000)		\$0	
35% income tax on remaining IRA assets	\$2,200,000	<u>(\$770,000)</u>	\$0	<u>(\$0)</u>
Value Net after-tax		\$7,405,000		\$7,405,000

Optimal tax environment for retirement savings?

Three Choices:

Savings Account (after-tax)

401(k)/403(b)/IRA Account (pre-tax)

Roth 401(k)/403(b)/IRA Account (after-tax)

4th Choice (not considered): IRA or Annuity (after-tax)

Optimal tax environment Variables:

- Marginal Tax Rate (MTR) when contributing impacts amount and tax savings (or tax) now
- MTR when receiving distributions may impact tax later
- Age impacts how long assets grow
- Gender life expectancy impacts # and amount of payments
- Rate of Return (ROR) and Taxation on invested assets
- Payment Method: equal periodic or required minimum distribution
- Financial Means impacts amount of annual contribution
- Estate taxes due at death and applicable beneficiary deductions (IRD)

UNKNOWN: Changes in Tax Laws

Marginal Tax Rate (MTR)

Pay Uncle Sam Now or Pay Him Later?

To answer this question (for most individuals) the key issues to consider are your **tax rate when you contribute** versus your **tax rate when you receive distributions**.

By tax rate, we mean the **marginal tax rate (MTR)**, or the tax rate one pays on the **last dollars earned** in a particular tax year after deductions, etc. (i.e., the **tax rate applicable to your highest level of taxable income** for the year).

Marginal Tax Rate (MTR)

Pay Uncle Sam Now or Pay Him Later?

Your current MTR determines the tax you save now on pre-tax contributions and the tax you pay now on after-tax Roth contributions.

Your future MTR determines the tax you pay later on distributions from the pre-tax account during retirement, and the tax you save when you take Roth distributions tax-free.

Marginal Tax Rate (MTR)

The Roth option is generally beneficial to participants whose *MTR is lower when contributing versus their MTR when receiving distributions* in retirement, since *taxes on contributions were paid at a lower rate*.

Conversely, the pre-tax option is generally beneficial to participants whose *MTR is higher when contributing versus when receiving distributions* in retirement, since *taxes on distributions are paid at a lower rate*.

Where to Save for Retirement?

“Marginal Tax Rate (MTR)” is determined by the Tax Bracket of the last dollars earned after deductions, etc.

Tax Rates for 2009

(Each row represents a “Tax Bracket”)

Tax Rate	Married Filing Joint & Surviving Spouses	Unmarried Individuals	Heads of Households	Married Filing Separate
10%	\$0 - 16,700	\$0 - 8,350	\$0 - \$11,950	\$0 - 8,350
15%	\$16,701 - 67,900	\$ 8,351 - \$33,950	\$11, 951 - 45,550	\$ 8,351 - 33,950
25%	\$67,901 - 137,050	\$33,951 - 82,250	\$45,551 - 117,450	\$33,951 - 68,525
28%	\$137,051 - 208,850	\$82,251 - 171,550	\$117,451 - 190,200	\$68,526 - 104,425
33%	\$208,851 - 372,950	\$171,551 - 372,950	\$190,201 - 372,950	\$104,426 - 186,475
35%	over \$372,950	over \$372,950	over \$372,950	over \$186,475

MTR Analysis

Example: Same Net Pay = Lower Roth Contribution

Participant contributes \$250/week to pre-tax; paycheck reduced by \$250 and deposited to plan. If MTR is 28%, participant *saves \$70 now, pays tax later* (\$250 reduction or contribution x 28% tax rate = \$70 tax savings)

If participant chooses Roth and wants same \$250 reduction in paycheck, only \$180 deposited to the plan, since *pays \$70 tax now, not later* (\$250 reduction x (1- 28%) = \$180 contribution)

MTR Analysis

If participant wants same \$ amount deposited to the plan as pre-tax, then salary reduction is higher and net take home pay is lower.

Example: Roth same as pre-tax = Higher Salary Reduction

Participant wants \$250/week to Roth account; MTR is 28%, reduce paycheck by \$347 (\$250 contribution/1 - 28% tax rate = \$347) to *pay \$97 tax now, not later* (\$347 - \$250 = \$97)

Where to Save for Retirement?

MTR Analysis - *Watch-out!* *If participant elects Roth and wants same net pay...* The lower Roth 401(k) contribution may not qualify for highest available match

Example: Roth may *not qualify* for highest match

George, 15% MTR, contributes 6% or \$1,740 of \$29,000 pay to pre-tax option; Employer matches \$.50 for each dollar up to 1st 6% on pre-tax or Roth; George receives maximum \$870 match on current pre-tax contrib.

Will George receive maximum match if Roth 401(k) contribution based on same salary reduction?

No. Roth(k) contribution is \$1,479 ($\$1,740 \times (1 - 15\%)$)

Match on \$1,479 is *only \$739.50*, not \$870

Determine “optimal” by example considering variables:

- Marginal Tax Rate (MTR)
- Age
- Gender
- Taxation of Assets
- Asset ROR & Taxation
- Payment Method
- Financial Means
- Changes in Tax Laws

Example: Lucy, a female age 40 earns \$100,000;
saves \$10,000/year for retirement

Where to Save for Retirement?

Example: Lucy, a female age 40 earns \$100,000; saves \$10,000 per year for retirement. *What is her MTR when she contributes?*

MTR after deductions

Tax Rate	Married Filing Joint & Surviving Spouses	Unmarried Individuals	Heads of Households	Married Filing Separate
10%	\$0 - 16,700	\$0 - 8,350	\$0 - \$11,950	\$0 - 8,350
15%	\$16,701 - 67,900	\$ 8,351 - \$33,950	\$11,951 - 45,550	\$ 8,351 - 33,950
25%	\$67,901 - 137,050	\$33,951 - 82,250	\$45,551 - 117,450	\$33,951 - 68,525
28%	\$137,051 - 208,850	\$82,251 - 171,550	\$117,451 - 190,200	\$68,526 - 104,425
33%	\$208,851 - 372,950	\$171,551 - 372,950	\$190,201 - 372,950	\$104,426 - 186,475
35%	over \$372,950	over \$372,950	over \$372,950	over \$186,475

What is her MTR when she receives payments?

Consider total distribution outcomes assuming: 1) the same MTR as when she contributes; 2) a lower MTR; and 3) a higher MTR

Where to Save for Retirement?

Example: Lucy, a female age 40 earns \$100,000; saves \$10,000 per year for retirement. *What is the ROR and Taxation on invested assets?*

- **Savings Account:** 60% stocks earn 8% taxed at 15%, 40% tax-free bonds earn 4.0%; blended ROR: 5.68% after-tax
- **401(k) Account:** 60% stocks earn 8% tax-deferred, 40% bonds earn 5.5% tax-deferred; blended ROR: 7% tax-deferred
- **Roth 401(k) Account:** 60% stocks earn 8% tax-free, 40% bonds earn 5.5% tax-free; blended ROR: 7% tax-free

Where to Save for Retirement?

Example: Lucy, a female age 40 earns \$100,000; saves \$10,000 per year for retirement.

- *What is the payment method?*
 - ✓ Equal Periodic Payments
 - ✓ Start age 67 (Social Security Retirement Age)
 - ✓ Receive for 18 years (Social Security Mortality)
- *How to address the **UNKNOWN** (future tax laws)?*
 - ✓ Analyze \$10,000/year for 5 years
 - ✓ Consider only a portion of one's savings for retirement
 - ✓ *"Don't put all of your eggs in one basket!"*

One more critical question...

*Save the \$10,000
pre-tax or after-tax?*

Where to Save for Retirement?

Deposit \$10,000/yr for 5 years (age 40-44) to pre-tax 401(k); distribute 18 equal payments (age 67-84):

Age	Pre-tax 401(k) Contribution	Account @ 7%	After-tax (25%) Distribution
40	\$10,000	\$10,350	
41	10,000	21,425	
42	10,000	33,274	
43	10,000	45,953	
44	10,000	59,520	
45-66	0	\$263,698	
67-83		255,942	-19,661
84	Last payment	0	-19,661
Total			\$353,901

Calculate equivalent after-tax contribution:

\$10,000 salary reduction x (1- 25% (tax rate)) =
\$7,500 after-tax contribution

Where to Save for Retirement?

Deposit \$7,500/yr for 5 years (age 40-44) to pre-tax 401(k); distribute 18 equal payments (age 67-84):

Age	After-tax Contribution	Account @ 5.68%	After-tax (0%) Distribution
40	\$7,500	\$7,713	
41	7,500	15,864	
42	7,500	24,478	
43	7,500	33,581	
44	7,500	43,201	
45-66	0	\$145,661	
67-83		153,935	-13,131
84	Last payment	0	-113,131
Total			\$236,365

Where to Save for Retirement?

Compare pre-tax 401(k) to after-tax Savings

Age	Pre-tax 401(k) \$10,000 for 5 years @ 7%	After-tax Distribution	After-tax Savings \$7,500 for 5 years @ 5.68%	After-tax Distribution
40	\$10,350		\$7,713	
41	21,425		15,864	
42	33,274		24,478	
43	45,953		33,581	
44	59,520		43,201	
66	\$263,698		\$145,661	
67	255,942	-19,661	153,935	-13,131
84	0	-19,661	0	-13,131
Total		\$353,901		\$236,365

“The Magic of Compound Interest” in a pre-tax account; *however...*

Where to Save for Retirement?

Pre-tax 401(k) numbers assume the same 25% MTR when receiving distributions. *What if MTR increases or decreases?*

Age	Pre-tax 401(k) \$10,000 for 5 years @ 7%	Pre-tax 401(k) 25% MTR Distribution	Pre-tax 401(k) 15% MTR Distribution	Pre-tax 401(k) 33% MTR Distribution	Aft-tax Savings \$7,500 for 5 years @ 5.68%	After-tax Distribution
40	\$10,350				\$7,713	
41	21,425				15,864	
42	33,274				24,478	
43	45,953				33,581	
44	59,520				43,201	
66	\$263,698				\$145,661	
67	255,942	-19,661	-22,283	-17,564	153,935	-13,131
84	0	-19,661	-22,283	-17,564	0	-13,131
Total		\$353,901	\$401,088	\$316,152		\$236,365

Where to Save for Retirement?

Deposit \$7,500/yr for 5 years (age 40-44) to after-tax Roth 401(k); distribute 18 equal payments (age 67-84):

Age	Pre-tax 401(k) Contribution	Account @ 7%	After-tax (25%) Distribution
40	\$7,500	\$7,763	
41	7,500	16,068	
42	7,500	24,956	
43	7,500	34,465	
44	7,500	44,640	
45-66	0	\$197,774	
67-83		191,957	-19,661
84	Last payment	0	-19,661
Total			\$353,901

Where to Save for Retirement?

Compare pre-tax 401(k) to after-tax Roth 401(k)

Age	Pre-tax 401(k) \$10,000 for 5 years @ 7%	After-tax Distribution	Roth 401(k) \$7,500 for 5 years @ 7%	Tax-free Distribution
40	\$10,350		\$7,763	
41	21,425		16,068	
42	33,274		24,956	
43	45,953		34,465	
44	59,520		44,640	
66	\$263,698		\$197,774	
67	255,942	-19,661	191,957	-19,661
84	0	-19,661	0	-19,661
Total		\$353,901		\$353,901

Where to Save for Retirement?

Compare pre-tax 401(k) after-tax distributions at same, lower and higher MTRs to tax-free Roth(k)

Age	Pre-tax 401(k) \$10,000 for 5 years @ 7%	Pre-tax 401(k) 25% MTR Distribution	Pre-tax 401(k) 15% MTR Distribution	Pre-tax 401(k) 33% MTR Distribution	Roth 401(k) \$7,500 for 5 years @ 7%	Tax-free Distribution
40	\$10,350				\$7,763	
41	21,425				16,068	
42	33,274				24,956	
43	45,953				34,465	
44	59,520				44,640	
66	\$263,698				\$197,774	
67	255,942	-19,661	-22,283	-17,564	191,957	-19,661
84	0	-19,661	-22,283	-17,564	0	-19,661
Total		\$353,901	\$401,088	\$316,152		\$353,901

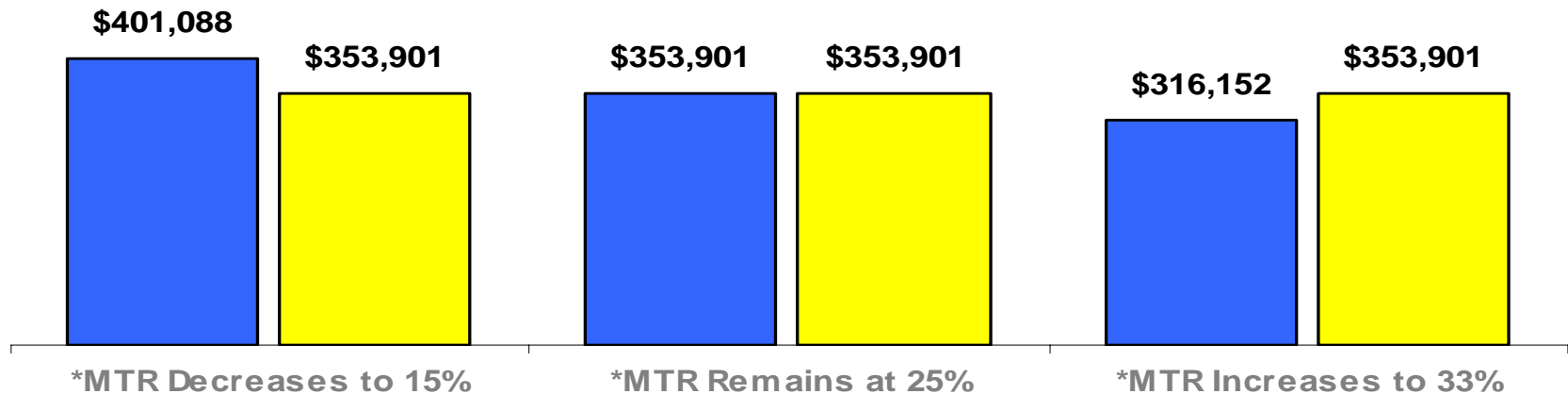
Same MTR, no winner; < MTR, Pre-tax wins; > MTR, Roth wins

Where to Save for Retirement?

■ Pre-tax 401(k) Contribution: \$10,000 ■ Roth 401(k) Contribution: \$7,500

Roth Contribution is Lower than Pre-tax Contribution

Assets are rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA distributions taxed at MTRs indicated; Roth IRA distributions are tax-free



Same outcome if MTR remains 25%; Pre-tax better if MTR decreases; Roth better if MTR increases

Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Where to Save for Retirement?

Deposit \$10,000 to Roth 401(k):

Age	Pre-tax 401(k) \$10,000 for 5 years @ 7%	Pre-tax 401(k) 25% MTR Distribution	Pre-tax 401(k) 15% MTR Distribution	Pre-tax 401(k) 33% MTR Distribution	Roth 401(k) \$10,000 for 5 years @ 7%	Tax-free Distribution
40	\$10,350				\$10,350	
41	21,425				21,425	
42	33,274				33,274	
43	45,953				45,953	
44	59,520				59,520	
66	\$263,698				\$263,698	
67	255,942	-19,661	-22,283	-17,564	255,942	-26,215
84	0	-19,661	-22,283	-17,564	0	-26,215
Total		\$353,901	\$401,088	\$316,152		\$471,869

Roth 401(k) higher than any pre-tax distribution MTR; *however...*

Why the Prior Example is Flawed...

- Comparing outcomes from \$10,000 contribution to both pre-tax and Roth is not sound since Roth costs \$13,333, not \$10,000.
- The 25% tax is payable up front on the \$10,000 Roth 401(k) contribution; *Do the math...*

$$\text{\$10,000 contribution} / 1 - 25\% \text{ (tax rate)} = \text{\$13,333}$$

Solution:

- Establish an after-tax savings account, or "side fund," to invest after-tax proceeds of \$3,333 [(\$13,333 - \$10,000) (1-25%) = \$2,500].

Confused? Consider the following...

Why the Prior Example is Flawed...

Assume that Lucy is paid \$13,333 once per year; she may contribute \$10,000 to either pre-tax or Roth 401(k).

If she contributes \$10,000 to a Roth 401(k) account, her paystub indicates:

Gross pay:	\$13,333
Roth 401(k):	<u>- 10,000</u>
Paycheck before tax:	\$ 3,333
25% tax on \$13,333:	<u>- 3,333</u>
Net Paycheck:	\$ 0

If she contributes \$10,000 to a pre-tax 401(k) account, her paystub indicates:

Gross pay:	\$13,333
Pre-tax 401(k):	<u>- 10,000</u>
Paycheck before tax:	\$ 3,333
25% tax on \$3,333:	<u>- 833</u>
Net Paycheck:	\$ 2,500

A sound way to compare pre-tax to Roth:

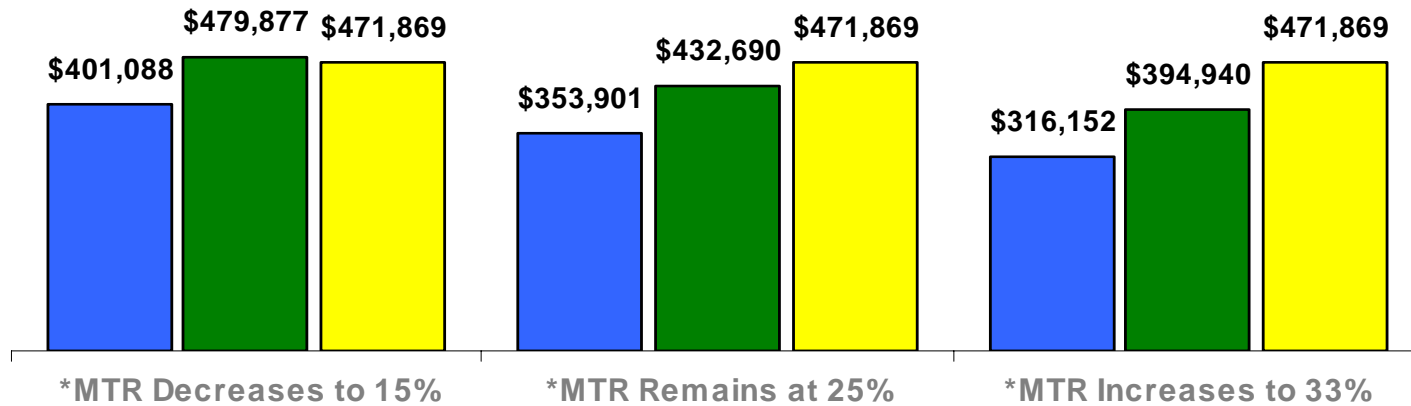
Similar analysis with same assumptions, *except...*

- Side Fund Contribution: \$2,500 for 5 years
- Side Fund ROR: 60% stocks earn 8% taxed at 15%, 40% tax-free bonds earn 4.0%; blended ROR: 5.68% after-tax
- Side Fund Distributions: Distributions start at age 67; add to after-tax pre-tax distributions for 18 years

\$10,000 Pre-tax and \$10,000 Roth 401(k)

■ Pre-tax 401(k) Total ■ Pre-tax 401(k) and Side Fund Total ■ Roth 401(k) Total

Roth Contribution is the Same as Pre-tax Contribution Shown Below
Assets rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA
distributions taxed at MTR indicated; Roth IRA distributions are tax-free



Pre-tax wins if MTR decreases to 15%; Roth wins if MTR remains the same or increases

Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

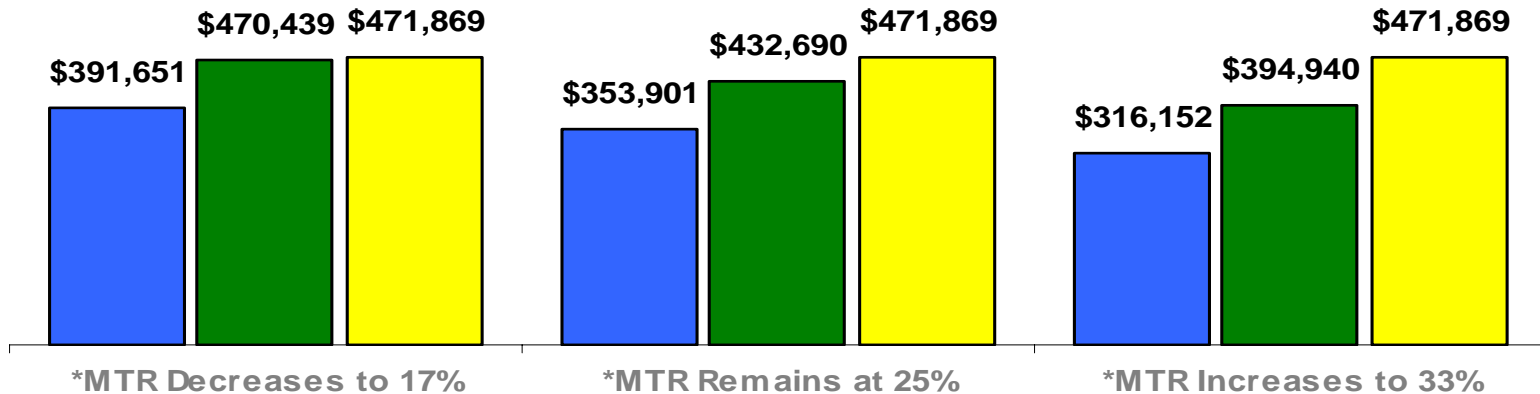
*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Where to Save for Retirement?

\$10,000 Pre-tax and \$10,000 Roth 401(k)

■ Pre-tax 401(k) Total ■ Pre-tax 401(k) and Side Fund Total ■ Roth 401(k) Total

Roth Contribution is the Same as Pre-tax Contribution Shown Below
Assets rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA
distributions taxed at MTR indicated; Roth IRA distributions are tax-free



Roth wins if MTR decreases to 17%; Roth
wins if MTR remains the same or increases

Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Reason for Unanticipated Outcome

- Roth provides *ability to invest in various asset classes within the tax-free environment*. Assuming comparable risk factors on the selected investments, it is virtually *impossible for a taxable side fund to perform* as well as the *tax-free Roth*.
- Example: Compare investing in a **tax-free bond earning 4%** to **taxable bond in Roth 401(k) account earning 5.5%**.

What is the best way for Lucy to save \$10,000 for retirement?

Cross-out:

~~Savings account~~

Pre-tax; or

Leaves two choices:

Roth 401(k)?

The answer depends on other factors we've yet to consider. Perhaps we can find the answer if we explore:

"Who should consider the Roth 401(k)?"

Who should consider the Roth option?

- Savers who are young and in a low tax bracket now
- Savers who anticipate higher tax rates in the future
- Savers who wish to diversify future tax risk
- Savers who wish to maximize retirement benefits
- HCEs whose deferrals are limited by failure of 401(k) "test"
- Savers who wish to create tax-free income for heirs, and prepay income tax to lower estate tax
- Savers who require and/or desire tax free income during retirement (e.g., to mitigate tax on Social Security benefits)

Savers who are **young and in low tax bracket now** (e.g., medical school resident; student working part-time)

Name:	Henry
Age:	27
Annual Income:	\$45,000
Annual Pre-tax 401(k):	\$5,000 x 5 years
Annual Roth 401(k):	\$4,250 x 5 years
Current MTR:	15%
MTR decrease/increase:	5% / 10%
ROR Pre-tax/Roth:	7%
ROR Side Fund:	N/A
Distribution Method:	equal periodic
Distributions start at:	Age 67
Distributions stop at:	Age 81

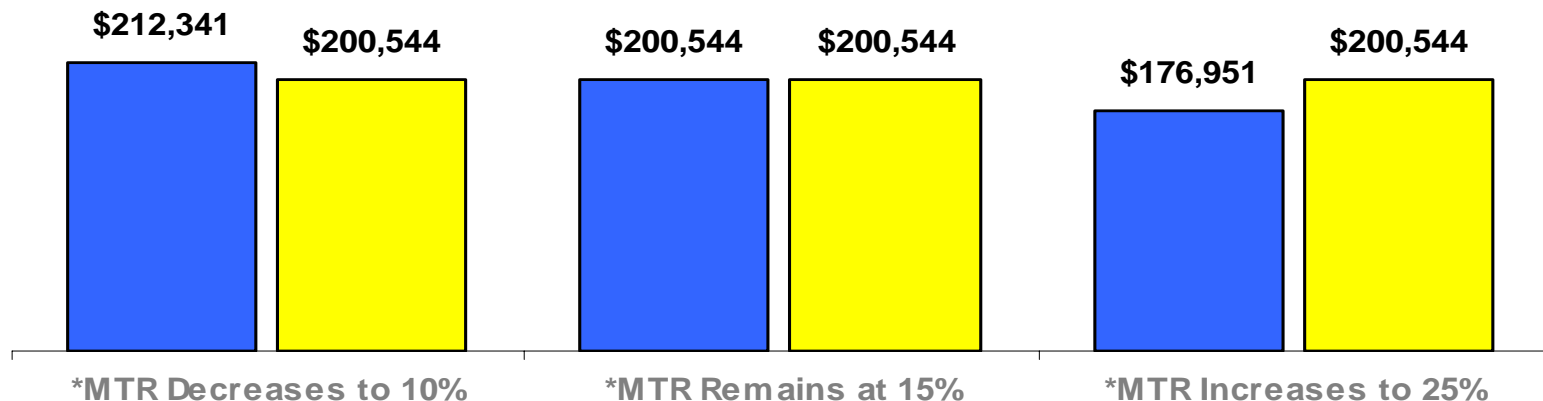
Where to Save for Retirement?

Savers who are **young and in low tax bracket now** (e.g., medical school resident; student working part-time)

■ Pre-tax 401(k) Contribution: \$5,000 ■ Roth 401(k) Contribution: \$4,250

Roth Contribution is Lower than Pre-tax Contribution

Assets are rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA distributions taxed at MTRs indicated; Roth IRA distributions are tax-free



Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Savers who anticipate higher future tax rates

Many think they'll be in a lower bracket when retired...

Do you think the government will increase future tax rates?

Suppose that you are in a lower bracket in the future; *does that also mean your tax rate will be lower?*

Example: Lower Future Bracket May Not Mean Lower Tax Rate

Charles (married, \$150,000 after deductions, 28% bracket, tax rate 28%) *believes he'll be in lower tax bracket in retirement.*

Does that mean he'll pay tax at lower rate?

Perhaps not. Table following indicates tax rates for 2009

Where to Save for Retirement?

Savers who anticipate higher future tax rates

Tax Rates for 2009

(each row represents a "Tax Bracket")

Charles' current tax bracket in blue

Tax Rate	Married Filing Joint & Surviving Spouses	Unmarried Individuals	Heads of Households	Married Filing Separate
10%	\$0 - 16,700	\$0 - 8,350	\$0 - \$11,950	\$0 - 8,350
15%	\$16,701 - 67,900	\$ 8,351 - \$33,950	\$11, 951 - 45,550	\$ 8,351 - 33,950
25%	\$67,901 - 137,050	\$33,951 - 82,250	\$45,551 - 117,450	\$33,951 - 68,525
28%	\$137,051 - 208,850	\$82,251 - 171,550	\$117,451 - 190,200	\$68,526 - 104,425
33%	\$208,851 - 372,950	\$171,551 - 372,950	\$190,201 - 372,950	\$104,426 - 186,475
35%	over \$372,950	over \$372,950	over \$372,950	over \$186,475

Where to Save for Retirement?

Savers who anticipate higher future tax rates

Charles retires in 2020, receives \$100,000/year after deductions. *However, based on hypothetical tax rates for 2020, it turns out that Charles was correct; he is in a lower tax bracket; however, he pays federal income tax at a higher rate during retirement than he did in '09.*

Hypothetical Tax Rates for 2020

Tax Rate	Married Filing Joint & Surviving Spouses	Unmarried Individuals	Heads of Households	Married Filing Separate
15%	\$0 - 16,700	\$0 - 8,350	\$0 - \$11,950	\$0 - 8,350
25%	\$16,701 - 67,900	\$ 8,351 - \$33,950	\$11,951 - 45,550	\$ 8,351 - 33,950
33%	\$67,901 - 137,050	\$33,951 - 82,250	\$45,551 - 117,450	\$33,951 - 68,525
38%	\$137,051 - 208,850	\$82,251 - 171,550	\$117,451 - 190,200	\$68,526 - 104,425
42%	\$208,851 - 372,950	\$171,551 - 372,950	\$190,201 - 372,950	\$104,426 - 186,475
45%	over \$372,950	over \$372,950	over \$372,950	over \$186,475

Savers who wish to diversify future tax risk

Prudent planning and investment strategies dictate diversification in accounts or investment vehicles that are taxable, tax-deferred and tax-free.

The Roth environment provides a very attractive alternative to tax-free investing as compared to traditional tax-free investments such as tax-free bonds.

Savers wishing to maximize retirement benefits

If an individual desires / is able to maximize IRA/401(k) contributions, the *Roth environment permits him/her to accumulate greater retirement benefits.*

Savers wishing to maximize retirement benefits

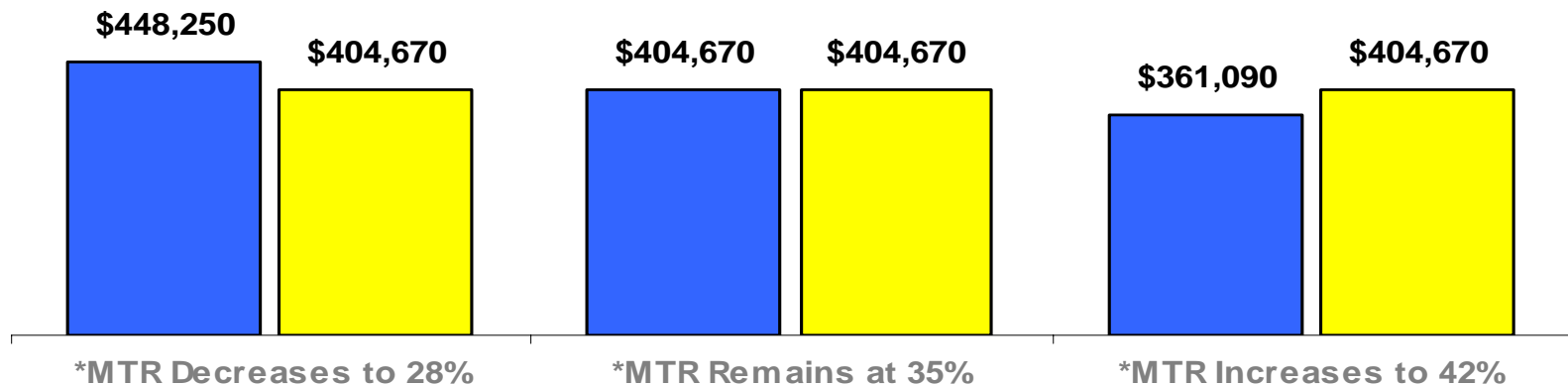
Name:	Sam
Age:	51
Annual Income:	\$350,000
Annual Pre-tax 401(k):	\$22,000 (with COLAs) x 5 years
Annual Roth 401(k):	\$14,300 (with COLAs) x 5 years
Current MTR:	35%
MTR decrease/increase:	7% / 7%
ROR Pre-tax/Roth:	7%
ROR Side Fund:	N/A
Distribution Method:	equal periodic
Distributions start at:	Age 71 (Roth too; but <u>not required</u>)
Distributions stop at:	Age 85 (15 years)

Savers wishing to maximize retirement benefits

■ Pre-tax 401(k) Contribution: \$22,000 ■ Roth 401(k) Contribution: \$14,300

Roth Contribution is Lower than Pre-tax Contribution

Assets rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA distributions taxed at MTR indicated; Roth IRA distributions are tax-free



Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Savers wishing to maximize retirement benefits

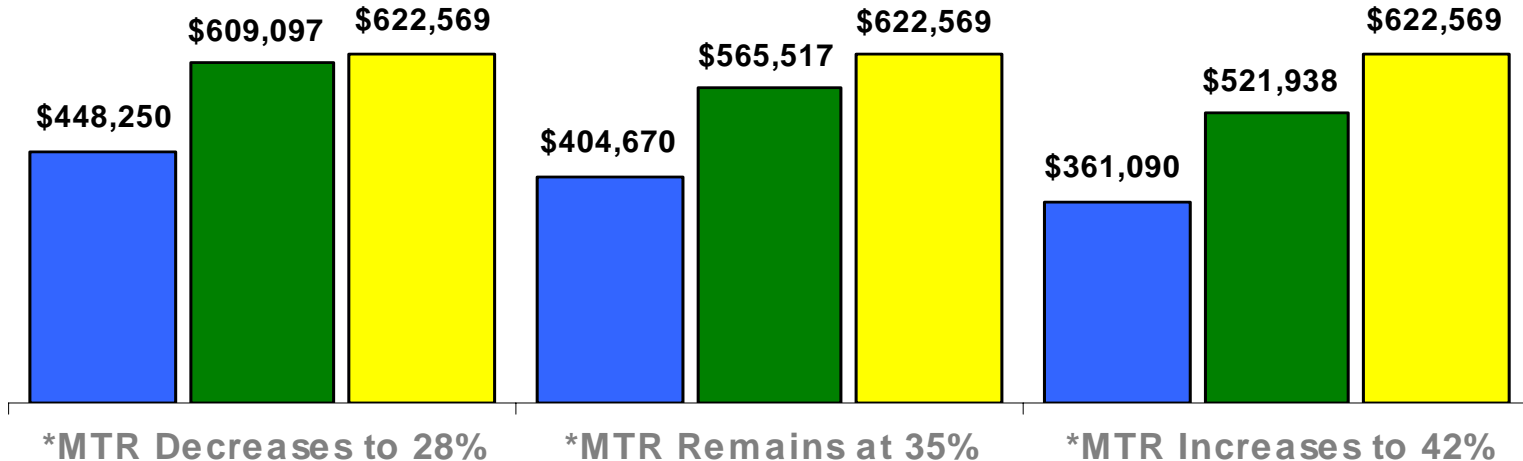
Name:	Sam
Age:	51
Annual Income:	\$350,000
Annual Pre-tax 401(k):	\$22,000 (with COLAs) x 5 years
Annual Roth 401(k):	\$22,000 (with COLAs) x 5 years
Annual Side Fund:	\$7,700 [\$33,846 - \$22,000 x (1-35%)]
Current MTR:	35%
MTR decrease/increase:	7% / 7%
ROR Pre-tax/Roth:	7%
ROR Side Fund:	5.68%
Distribution Method:	equal periodic
Distributions start at:	Age 71 (Roth too; but <u>not required</u>)
Distributions stop at:	Age 85 (15 years)

Savers wishing to maximize retirement benefits

■ Pre-tax 401(k) Total ■ Pre-tax and Side Fund Total ■ Roth 401(k) Total

Roth Contribution is Lower than Pre-tax Contribution

Assets rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA distributions taxed at MTR indicated; Roth IRA distributions are tax-free



Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Where to Save for Retirement?

HCEs with deferrals limited by 401(k) “test” failure

HCE contributions are oftentimes limited if plan is in jeopardy of failing 401(k) nondiscrimination test (the “ADP Test”).

As demonstrated in the previous examples, HCEs receive greater retirement benefits by contributing the maximum dollar amount (as permitted by law or testing) to a Roth 401(k) account on an after-tax basis.

This answers Lucy’s question!

(if she is an HCE and her deferrals are limited to \$10,000)

Where to Save for Retirement?

Savers who wish to create **tax-free income for heirs, and prepay income tax to lower estate tax**; individuals who:

- Have **AGI** (adjusted gross income) that **prohibits contributions and/or conversion (not in 2010) to a Roth IRA**
- Do not **expect to outlive their pensions and other assets**
- Are **certain they'll pass a portion of pension assets to heirs**
- Have **substantial assets and intend to defer tax-deferred assets until required beginning date (RBD) for minimum distributions. At death, proceeds are paid to younger spousal or nonspousal beneficiaries who then "stretch" tax-deferred payments over their respective lifetimes to mitigate income tax.**
- Should **roll assets into a Roth IRA to facilitate a "Super Stretch" since there are no required minimum distributions, and distributions to nonspouse beneficiaries are not required until the year following the death of the Roth IRA owner.**

Savers who wish to create tax-free income for heirs, and prepay income tax to lower estate tax

Name:	Ellyn
Age:	62
Annual Income:	\$300,000
Annual Pre-tax 401(k):	\$22,000 (with COLAs) x 5 years
Annual Roth 401(k):	\$14,300 (with COLAs) x 5 years
Annual Side Fund:	N/A
Current MTR:	35%
MTR decrease/increase:	7% / 7%
ROR Pre-tax/Roth:	7%
ROR Side Fund:	N/A
Distribution Method:	"Stretch"/"Super-Stretch" over grandchildren's life expectancies (girls ages 2, 6, boy age 4)
Distributions start at:	RBD for pre-tax; year following death for Roth and side fund

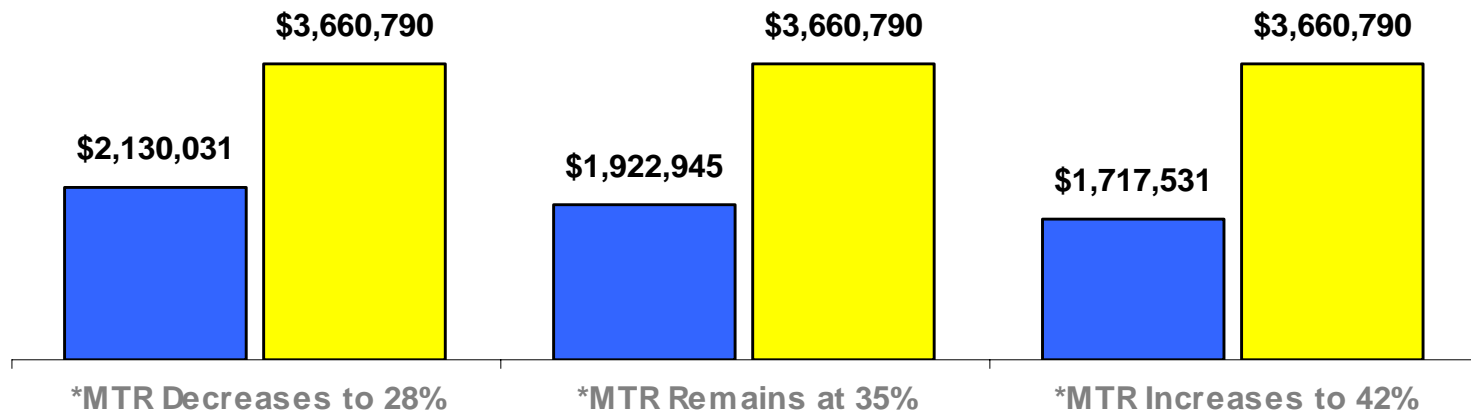
Where to Save for Retirement?

Savers who wish to create tax-free income for heirs, and prepay income tax to lower estate tax

■ Pre-tax 401(k) Contribution: \$22,000 ■ Roth 401(k) Contribution: \$14,300

Roth Contribution is Lower than Pre-tax Contribution

Assets rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA distributions taxed at MTR indicated; Roth IRA distributions are tax-free



Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Savers who wish to create tax-free income for heirs, and prepay income tax to lower estate tax

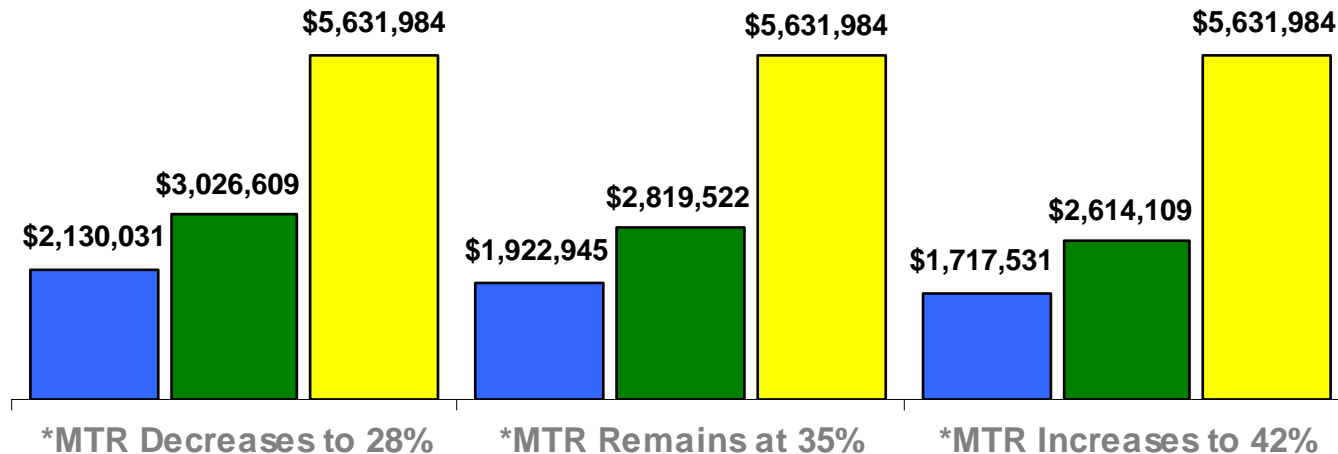
Name:	Ellyn
Age:	62
Annual Income:	\$300,000
Annual Pre-tax 401(k):	\$22,000 (with COLAs) x 5 years
Annual Roth 401(k):	\$22,000 (with COLAs) x 5 years
Annual Side Fund:	\$7,700 [(\$33,846 - \$22,000) x (1-35%)] x 5 years
Current MTR:	35%
MTR decrease/increase:	7% / 7%
ROR Pre-tax/Roth:	7%
ROR Side Fund:	5.68%
Distribution Method:	"Stretch"/"Super-Stretch" over life grandchildren's expectancies (girls 2, 6, boy 4)
Distributions start at:	RBD for pre-tax; year following death for Roth and side fund

Where to Save for Retirement?

Savers who wish to create tax-free income for heirs, and prepay income tax to lower estate tax

■ Pre-tax 401(k) Total ■ Pre-tax and Side Fund Total ■ Roth 401(k) Total

Roth Contribution is the Same as Pre-tax Contribution Shown Below
Assets rolled over to IRA/Roth IRA at Retirement; Pre-tax IRA distributions taxed at MTR indicated; Roth IRA distributions are tax-free



Contribute only 5 years!

Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) for illustrative purposes only

Where to Save for Retirement?

Savers who require and/or **desire tax free income** during retirement (e.g., to mitigate tax on Social Security benefits)

For **some savers** (or perhaps for those who have difficulty saving enough), the **Roth IRA/401(k)** option **provides a “psychological” push** towards making one's life more secure in retirement. [“Behavioral Finance”]

Lastly, **many pensioners are surprised** when they **receive pension distributions** and they learn that they are **taxable**.

Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)

Eliminates MAGI limits for eligibility to convert pre-tax IRA to Roth IRA starting in 2010.

If conversion in 2010, TIPRA permits option to pay tax due in 2011 and 2012.

Be mindful that 2010 tax rates may be lower than those in 2011 or 12.

What if Ellyn converted \$2M that she has in a pre-tax IRA and other plan accounts to a Roth IRA with her grandchildren as beneficiary?

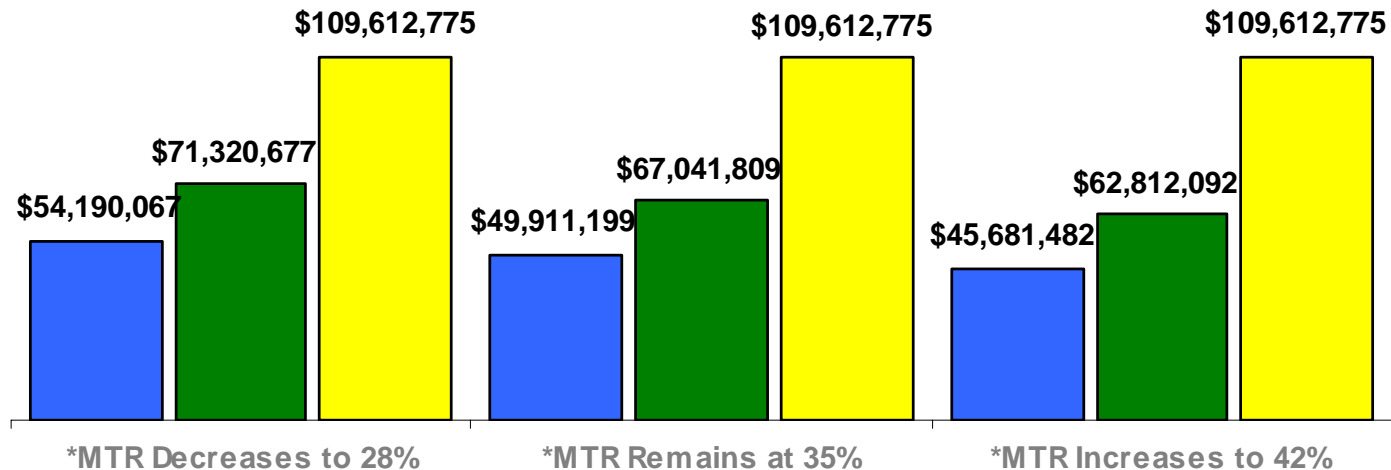
Roth Conversion Estate Planning Strategy

This example does not consider IRD deduction; however it does assume that grandchildren's tax rate is 17.5%

■ Pre-tax IRA Total ■ Pre-tax and Side Fund Total ■ Roth IRA Total

\$2,000,000 Pre-tax IRA and Roth IRA

Pre-tax IRA distributions taxed at Owner's MTR indicated, beneficiary MTR's are 17.5%; Roth IRA and side fund distributions are tax-free



Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) apply to IRA owner only for illustrative purposes only

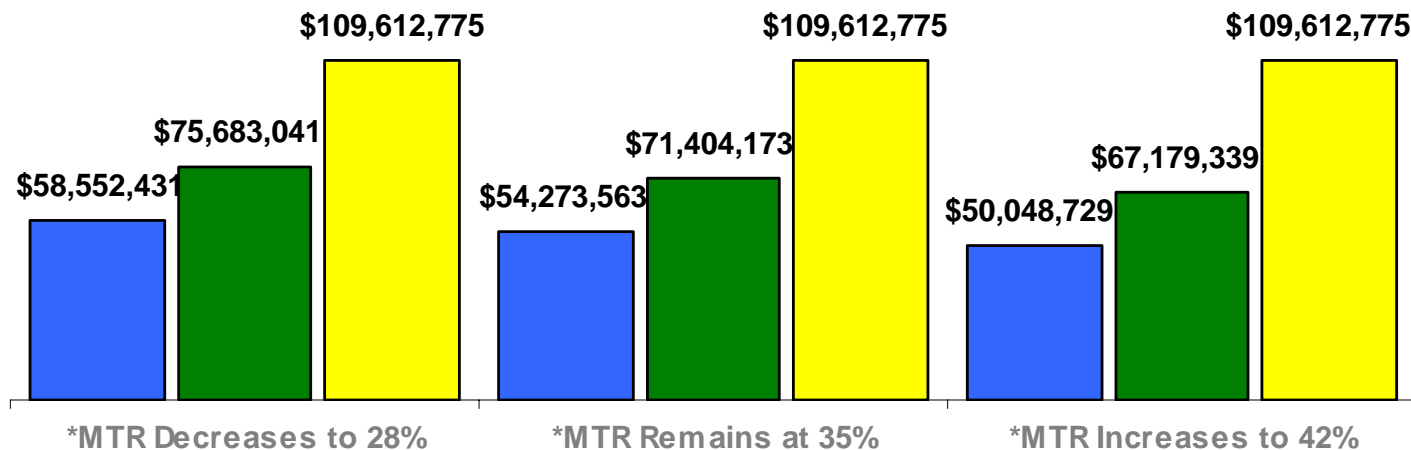
Roth Conversion Estate Planning Strategy

This example does not consider IRD deduction; however it does assume that grandchildren's tax rate is 10%

■ Pre-tax IRA Total ■ Pre-tax and Side Fund Total ■ Roth IRA Total

\$2,000,000 Pre-tax IRA and Roth IRA

Pre-tax IRA distributions taxed at Owner's MTR indicated, beneficiary MTR's are 10%; Roth IRA and side fund distributions are tax-free



Graphic Illustration provided by Roth 401(k) AnalyzerSM Version 3.0

*Hypothetical Marginal Tax Rates (MTR) apply to IRA owner only for illustrative purposes only

Skeptics say: "Future tax rates are uncertain."

Advocates say: "Consider that the outcome of contributing 5 years [or more] to either a pre-tax or Roth will have little, if any, impact on these [high net worth] individuals regardless of future tax rates."

Skeptics say: "One should never pass up an opportunity to save taxes."

Advocates say: "Consider that most of us simply do not save the dollars generated by the tax deduction."

Barry R. Milberg, a 30-year veteran of the pension services industry, is founder of Milberg Consulting LLC, a pension third party administration firm serving small businesses and ERISA Expertise LLC, a publishing, training and software development firm serving advisors and plan service providers. ERISA Expertise developed the Roth 401(k) AnalyzerSM and ERISA_{SVF}TM for storage and secure transmittal of confidential information over the internet.

Mr. Milberg is quoted on the benefits of Roth 401(k) in Forbes and Newsweek Magazines, the Wall Street Journal, Philadelphia Inquirer, Miami Herald, Los Angeles Times, and Forbes.com, Benefitnews.com and RegisteredRep.com. He is the author of numerous articles including: Pension Protection Act of 2006: Retirement and Estate Planning Opportunities (Journal of Financial Service Professionals, March 2008); The Roth 401(k): What a Difference a Year Makes (Journal of Pension Benefits, 2007, Aspen), seminars, and books including: Qualified Retirement Plans for Small Businesses, A Consultative Guide to Plan Design and Compliance (2000, CCH).

Mr. Milberg is a member of the IRS Liaison Group for the Mid-Atlantic Region. In 2009, he spoke on Roth: Running the Numbers at the National Institute of Pension Administrator's Annual Forum & Expo, and on Cash Balance Plans at the PICPA Healthcare Conference.