

Roth IRA Conversion

RETIREMENT

What is a Roth IRA conversion?

A Roth IRA conversion occurs when you distribute assets from a Traditional IRA or employer retirement plan and roll them into a Roth IRA either directly or within 60 days of the distribution. Through the conversion, the assets become after-tax assets that may create tax-free retirement income for you and potentially for your beneficiaries.

What are the benefits of a Roth IRA?

Roth IRAs offer a number of benefits:

- Can generate tax-free income in retirement for you or your beneficiaries after your death
- Do not require taking required minimum distributions beginning at age 70½*
- Withdrawals are not subject to federal income tax, provided any Roth IRA account has been funded for five or more years and you are age 59½ or you meet another exception

How does a Roth IRA conversion work?

Starting in 2010, the income and tax-filing limits on who can convert from a Traditional IRA or employer plan account to a Roth IRA are eliminated, so anyone can make a conversion.

When you convert, you must pay ordinary income tax on any pre-tax assets that you transfer. To maximize the benefits of conversion, the money to pay those taxes should come from a source outside the account you are converting. If you take a distribution of your retirement assets to pay conversion taxes, that distribution would itself be subject to income taxes and possible penalties.

What types of accounts are eligible for conversion?

Traditional, Rollover, SEP and SIMPLE** IRA accounts can be converted. In addition, assets in tax-qualified retirement plans, including 401(k), 403(b), 457(b), profit sharing and money purchase plans are eligible.

Why might you consider a Roth IRA conversion?

There are several tax and estate planning considerations, pro and con, to be evaluated when deciding whether to convert to a Roth IRA. Possible factors that may favor conversions are listed below.

Personal Retirement Income reasons

- Anticipate a higher tax bracket in retirement or want to diversify your tax liabilities
- Are temporarily in a lower tax bracket
- Have adequate funds outside of retirement accounts to pay conversion taxes
- Have tax deductions that cannot be used based on current levels of income

Event and Portfolio reasons

- Having substantial assets invested in IRAs or employer-sponsored retirement plans may provide an opportunity and incentive to diversify the tax status of a portion of those assets
- Want to increase your tax-free income as part of your overall portfolio strategy
- Current portfolio has declined in value, so converting sooner could lower the tax obligation based on lower asset values
- Expect your portfolio value to increase in the future, allowing you to pay taxes on the current value and distribute future gains potentially tax-free

Remember, conversion accelerates the payment of income taxes which may not be desirable.

January 1, 2010

The first day that conversions can take place under new regulations.

December 31, 2010

The last day that conversions can take place and have two years to pay taxes owed.

October 15, 2011

Last day to recharacterize 2010 conversions (includes extensions).

April 16, 2012

Taxes due on 50% of the converted assets (for 2010 conversions).

April 15, 2013

Remaining taxes due on 50% of the converted assets (for 2010 conversions).

*Original Roth IRA account owners are exempt from taking RMDs. Beneficiaries are required to take RMDs upon inheritance.

**Must have been in existence for two years.

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Why might you consider a Roth IRA conversion? (continued)

Legacy Planning reasons

- Want to leave tax-free assets to your children and heirs
- Have sufficient income from nonretirement accounts to support you in retirement
- Want to potentially reduce the taxable value of your estate

What are the conversion rules for employer sponsored retirement accounts?

Plan assets can be rolled into a Roth IRA either directly or within 60 days of the distribution with the following stipulations:

- There must be a “distributable” event, such as leaving your employer, retiring, or if permitted, you take an in-service withdrawal from your plan.
- If the distribution goes directly to a Roth IRA, there is:
 - No mandatory 20% withholding
 - No 10% penalty assessed if under age 59½
- A modified pro rata rule applies to direct conversion to a Roth IRA from employer-sponsored retirement plans.

How does the special tax treatment work for Roth IRA conversions in 2010?

You generally must recognize the full taxable income from your conversions in the conversion year. However, under a special rule for conversions you make in 2010, unless you elect complete recognition in 2010, you will recognize the taxable income equally in 2011 and 2012. Taxes on income you recognize in a particular year must, generally, be included in your quarterly estimated tax payments for the year. However, if you qualify for an exception from making estimated tax payments for that year, you may be able to pay the tax on April 15th of the following year.

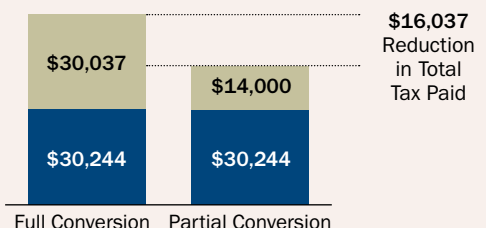
Roth IRA partial conversion example

A married couple has \$150,000 of taxable income for 2010, and they file a joint tax return. Their estimated 2010 taxes are \$30,244 based on a 28% marginal tax rate—the tax bracket this income places them in—and a 20% effective rate—or the actual percentage of gross income that they pay in taxes. One spouse, David, has a \$100,000 all pretax rollover IRA that he is considering converting to a Roth IRA.

David’s Financial Advisor shows him that by converting his entire rollover, their effective income of \$250,000 would move them up to a 33% marginal tax rate. By conducting a partial conversion of \$50,000 in 2010, however, they can maintain their 28% marginal tax rate and thus positively affect their resulting tax liability. Their income would then be \$200,000, below the threshold of \$209,250 at which the 33% tax rate takes effect.

Based on his Financial Advisor’s analysis, David enacted a partial conversion of \$50,000. Their 2010 tax liability thus increases by only \$14,000, compared with \$30,037 if he converted his entire rollover IRA, and their effective tax rate increases by only 2% from their expected 20% effective rate.

This hypothetical example is for illustrative purposes only. The couple in this example are expecting higher tax rates in 2011 and 2012, and therefore have elected the 2010 income recognition.



Can you convert only part of your IRA?

If your goal is to stay within a certain income tax bracket or incurring a large tax bill is a concern, another possibility is to convert in stages. Converting to a Roth IRA is not an all or nothing proposition. You can choose to do a series of partial conversions over several years in order to limit the income tax liability in any one year.

If you make after-tax contributions to a Traditional IRA, can you roll over only the after-tax funds when you convert to a Roth IRA?

No. A conversion is a reportable distribution from a Traditional IRA or from an employer retirement plan and is a subsequent reportable rollover contribution to a Roth IRA. All distributions from Traditional IRAs are subject to the Internal Revenue Service basis recovery rules. These rules require a calculation each time a distribution is made from a Traditional IRA in which you have both pre-tax and after-tax funds. Even if you have contributed only after-tax funds to a Traditional IRA, any earnings on those contributions have not yet been taxed. The calculation must include the balances of all IRAs you own, and it will tell you what part of your distribution is taxable and what part is nontaxable. See the Internal Revenue Service Form 8606 instructions at www.irs.gov.

What if you want to reverse the conversion?

If your personal circumstances or the value of the account converted changes and you do not wish to incur the tax liability of the conversion, you can “recharacterize” the account by transferring the balance attributable to the conversion to a Traditional IRA. The recharacterization must occur by the tax filing deadline (including extensions) for the tax year in which the conversion took place.

Roth IRA Conversion Estate Planning Example

Jon is 70 years old and his wife, Patricia, is 63. The couple has a 40-year-old daughter, Maria. Jon saved diligently, and his Traditional IRA is now worth \$1,000,000. But because Jon and Patricia have other financial resources, they do not need to use Jon's IRA balance to cover their living expenses in retirement. Instead, they wish to leave the IRA to their daughter as an inheritance.

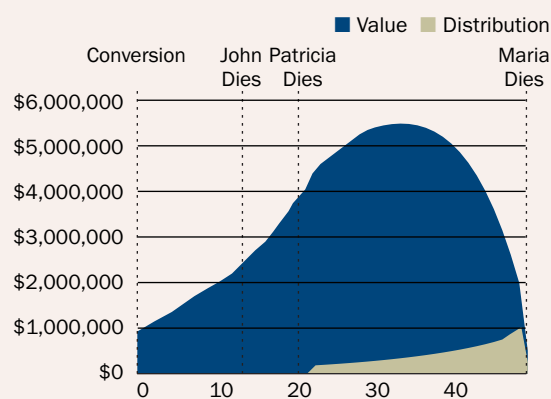
Based on their goals for these assets, Jon and Patricia's Financial Advisor suggests that the couple convert Jon's Traditional IRA into a Roth IRA, which will enable daughter Maria to "Stretch"* the required withdrawals over her own life expectancy, thus enhancing the legacy her parents plan to leave for her.

Jon decides to convert his Traditional IRA to a Roth IRA and pays the \$350,000 in taxes that are due out of pocket. He does not take any distributions from the account during his lifetime. When he passes away at age 84, the Roth IRA passes to Patricia, who elects to be treated as the owner of the Roth IRA and chooses not to take any distributions either. This election postpones distributions until her death five years later at the age of 82.

When Maria inherits the account, she will be able to stretch out the inherited Roth IRA distributions according to the IRS RMD table, depleting the account when she is 85 years old. This allows her to realize an additional \$7,857,120 in distributions, which would be tax- and penalty-free.

Assumptions: Jon and Patricia's current tax rate is 35%. Jon dies at age 84 and Patricia dies at age 82. Maria inherits the Roth IRA at age 59 and takes RMDs for 26 years. Maria takes the RMD as determined by IRS regulations. Invested assets return 7% compounded continuously from conversion until the account is depleted. This is a hypothetical example meant for illustrative purposes only. The projections are not a guarantee of future returns or investment performance and are not intended to replace the calculations that need to occur on a yearly basis for calculating actual required minimum distributions for clients or their beneficiaries.

*The "Stretch" IRA is not a type of IRA, but rather a technique to extend the assets of an IRA beyond your lifetime, possibly to multiple generations. The "Stretch" IRA strategy is designed for individuals who will not need to use assets during retirement. Implementing a "Stretch" IRA strategy can be complicated. That's why it's best to consult your tax advisor and your Merrill Lynch Financial Advisor to assist you in determining whether the "Stretch" IRA strategy can help you enhance your retirement and estate plans.



Making a decision about Roth IRA conversion

Deciding whether or not to convert traditional retirement assets to a Roth IRA can be a complex one. Your Merrill Lynch Financial Advisor can help you collect the necessary information and weigh your Roth IRA conversion options in light of the advice you receive from all your other advisors.

Using a Roth IRA conversion to meet asset transfer goals

Converting to a Roth IRA may also deliver benefits from an estate planning perspective, especially if you plan on passing your IRA assets to the next generation. Upon

How a Trusteed Roth IRA supports wealth transfer goals

The Merrill Lynch Trust Company* Trusteed Roth IRA is a retirement and estate planning solution that combines the tax benefits of a Roth IRA with the protection and control of a trust instrument. Establishing a Trusteed Roth IRA rather than a standard Roth IRA can provide you with several important advantages:

- Allows you to control the distributions to your beneficiaries in a trust-like manner
- Ensures that a "Stretch" IRA is achieved under the terms that you specify
- Allows you to conveniently reduce estate taxes using our beneficiary designations forms
- Provides greater flexibility in who receives the assets, while providing many lifetime benefits such as incapacity protection and bill payment services

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inheriting your Roth IRA, your beneficiary will be able to receive tax free distributions. In addition, by paying the income tax liability triggered by the conversion, you are able to reduce your gross estate for estate tax purposes. If your beneficiary does not need the money immediately, they have the option of accepting distributions over an extended period of time, with the remaining balance in the account potentially growing tax free.

How soon can you take distributions?

You can withdraw money from a Roth IRA at any time. However, you may pay tax and/or a penalty if you make a nonqualified distribution. A distribution, including earnings, is considered "qualified" and tax- and penalty-free if you have maintained a Roth IRA for at least five years and you also meet one of the following four criteria:

- are age 59½ or older,
- are disabled,
- are a beneficiary of a deceased previous account holder, or
- are using funds for a first time home purchase (up to a \$10,000 limit over the account holder's lifetime).

The five-year clock begins January 1st of the year when the conversion occurs. That means that if you convert at year-end, you've already got one-year of the five-year requirement met. The Roth IRA Conversion Distribution Rules table on the next page can help you identify whether a distribution would have taxes or penalties assessed. However, Merrill Lynch does not provide tax advice, and any tax information should be consulted with your tax advisor.

What are the Roth IRA distribution rules?

As you start to draw funds out of your Roth IRA, you will be subject to specific rules that dictate the order of withdrawal. The IRS views the assets in a Roth IRA as three separate buckets of money, and for tax purposes, any distributions are to be taken in a modified first-in, first-out manner. First come any regular contributions. These are always tax-free and penalty-free regardless of your age or how long you have held the Roth IRA.

All distributions must initially be from contributions until such time as the total amount of contributions has been exhausted. Next, distributions then are taken from conversions. These are always to be taken in a first-in, first-out order and are always tax-free. If you have held the Roth IRA for at least five years or have reached age 59½ then no penalty would apply. Finally, once all conversion assets have been exhausted, distributions are taken from earnings. Taxes and penalties on earnings distributions are based on whether or not the distribution is considered qualified or nonqualified or meets another exception.

Roth IRA conversion distribution rules*

Order of Distribution Taken	Age of Account Owner When Distribution Is Taken	
	< 59½	> 59½
Contributions	Income tax-free	Income tax-free
	Penalty-free	Penalty-free
Conversions (each block)	Income tax-free	Income tax-free
	10% penalty if within five years	No 10% penalty
Earnings	Taxable as income if distribution is nonqualified	Taxable as income if within five years
	10% penalty	No 10% penalty

*This is a simplified table. In addition to attaining age 59½, there are other possible exceptions to the 10% penalty that are not illustrated.

How can you get started?

If you are interested in rolling over assets from a Traditional IRA or directly from an employer-sponsored retirement plan to a Roth IRA, ask your Merrill Lynch Financial Advisor how a Roth IRA conversion can help you achieve the life you want in retirement. While a Roth IRA conversion can offer many advantages, it is not for everyone. Your Financial Advisor can help assess your financial situation and long-term financial plan to see if converting to a Roth IRA is right for you. Also, Merrill Lynch does not provide tax advice—you should contact your tax professional before executing any Roth conversion. To learn more about other Merrill Lynch services, visit www.totalmerrill.ml.com.

The case studies presented are intended to illustrate brokerage products and services available at Merrill Lynch. They do not necessarily represent the experiences of other clients, nor do they indicate future performance.

Any information presented about tax considerations affecting your financial transactions or arrangements is not intended as tax advice and cannot be relied on to avoid any tax penalties. Neither Merrill Lynch nor its Financial Advisors provide tax, accounting or legal advice. You should review any planned financial transactions or arrangements that may have tax, accounting or legal implications with your personal professional advisors.

You should also consider any potential fees, expenses, sales charges and/or penalties for selling investments before initiating a Roth IRA conversion.



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