

ROTH IRA CONVERSION

ASSESSING SUITABILITY OF THE STRATEGY FOR INDIVIDUALS AND THEIR HEIRS



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Executive Summary

A Roth IRA conversion may benefit individuals during their retirement years by potentially reducing income taxes, increasing retirement assets, and enhancing retirement income and estate planning flexibility.

Further, conversion may benefit Roth IRA owners' beneficiaries by potentially increasing their inheritance, decreasing estate taxes and providing a tax-free source of income.

However, this is a case where "one size does not fit all." Individuals should consider all the factors outlined in this white paper and complement that consideration by quantifying the impact and consulting with their financial, tax and other advisors prior to making this important decision.

Beginning this year, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) enables more individuals to convert their Traditional IRA or other eligible retirement plan¹ assets to a Roth IRA. Roth IRAs provide a vehicle for potentially generating tax-free retirement income for individuals and their heirs. Prior to 2010, income restrictions had prevented many from taking advantage of a Roth IRA conversion.

In 2010, the modified adjusted gross income ("MAGI") limitations for Roth IRA conversions (but not contributions) are lifted, making this strategy available to all investors. This change presents an opportunity for investors to reassess their retirement plans and an opportunity to more effectively manage their assets for retirement income and legacy planning purposes.

This Merrill Lynch white paper explores the potential benefits of employing a Roth IRA conversion strategy in the context of an individual's overall financial goals and resources and outlines the variety of factors that need to be considered to determine whether a Roth IRA conversion makes sense. Because everyone's circumstances are different, it is critical for you to consult with your financial advisors and tax and estate planning professionals to thoroughly consider the options this tax-law change may present to your individual retirement strategy.

Roth conversion in 2010 and beyond

Roth IRAs have numerous, somewhat complex, rules for contributions, withdrawals, distributions, rollovers and conversions from Traditional IRAs or other eligible retirement plans. In the past, there were significant

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limitations that prevented high-income taxpayers from converting assets from a Traditional IRA or other eligible retirement plans to a Roth IRA.

Contributions

Under current law, single taxpayers with MAGI in excess of \$105,000 (married taxpayers filing jointly with MAGI in excess of \$167,000)² are not eligible to make full annual contributions to Roth IRAs. As a result, many taxpayers are prohibited from establishing and contributing directly to Roth IRAs. TIPRA does not affect the current income threshold for funding a Roth IRA or the annual contribution limits. Rather, it affects the rules governing the conversion from a Traditional IRA or other eligible retirement plans to a Roth IRA.

Conversions

Previously, many taxpayers have not been eligible to roll over or convert their Traditional IRAs or other eligible retirement plans to Roth IRAs, due to the following income eligibility limitations:

- Married couples filing jointly and individuals filing as single taxpayers with MAGI in excess of \$100,000.
- Married couples filing their income tax returns separately.³
- For other eligible retirement plans, the same conversion rules listed above apply as far as income limitations and tax rules.

In addition, when assets are converted from a non-IRA eligible retirement plan, there must be a “distributable” event: Leaving an employer; retiring; if permitted, taking an in-service withdrawal from an eligible retirement plan (note: individuals and their tax and/or legal advisors must review retirement plan documents to determine whether an in-service distribution is permissible.) If the distribution goes directly to a Roth IRA, there is: no mandatory 20% withholding and no 10% penalty assessed if certain conditions are met. A modified pro rata rule applies to direct conversion to a Roth IRA from employer sponsored retirement plans.

The income limitations were repealed effective January 1, 2010, allowing anyone with a Traditional IRA or other eligible retirement plans to convert to a Roth IRA, regardless of their MAGI, which may have several potential advantages as discussed in the following pages.

Income and tax implications

Any assets converted from a Traditional IRA or other eligible retirement plans to a Roth IRA are treated as a reportable distribution to the individual. Any portion of the converted amount that has not yet been taxed is generally subject to ordinary income tax rates in the year of the conversion. Medical, charitable and other income tax deductions may offset the income created by the conversion. Additionally, a Roth IRA conversion can possibly affect the taxability of Social Security benefits if the income due from the conversion moves the individual into a higher tax bracket.

EXAMPLE 1

BILL CONVERTS TO A ROTH IRA, ALL PRE-TAX FUNDS

Traditional IRA value	\$500,000
Federal income tax rate in 2012	35%
Tax due on conversion	\$175,000

Bill's Traditional IRA was valued at \$500,000 at the time of the conversion. Bill has no after-tax basis in the Traditional IRA, or in any other IRA he owns, which means he has not yet paid tax on those assets. Bill converts all of his Traditional IRA to a Roth IRA in 2012. Bill will have to recognize \$500,000 in income in 2012. If his effective federal income tax rate is 35% on all converted assets, the tax on conversion (“conversion tax”) will be \$175,000.

This is a hypothetical example meant for illustrative purposes only.

As stated above, income needs to be recognized upon conversion. On occasion, Traditional IRAs may have an after-tax basis in the account because the taxpayer made prior nondeductible contributions that may be commingled with their tax-deductible contributions. All distributions from Traditional IRAs that include such after-tax assets are subject to the Internal Revenue Service basis recovery rules. This means that all IRAs that the individual owns must be aggregated to determine what portion of the distribution/conversion is a recovery of the after-tax basis. Individuals should discuss conversions and the tax implications with their tax professional.

EXAMPLE 2

BILL CONVERTS TO A ROTH IRA, SOME AFTER-TAX FUNDS

Traditional IRA value: Post-tax basis	\$200,000
Federal income tax rate in 2012	35%
Tax due on conversion	\$0
Traditional IRA value: Pre-tax basis	\$300,000
Federal income tax rate in 2012	35%
Tax due on conversion	\$105,000

Assume the same facts as Example 1; however, assume that Bill has a total after-tax basis of \$200,000 in all his IRAs. In this case, Bill would recognize \$300,000 of ordinary income (i.e., \$500,000 less \$200,000 of tax basis), and his conversion tax would be \$105,000 (i.e., 35% of \$300,000).

This is a hypothetical example meant for illustrative purposes only.

Special rule for 2010 conversions

For conversions occurring in 2010 specifically, the taxpayer may elect to have the taxable portion of the conversion for federal tax purposes equally split between tax-year 2011 and tax-year 2012, and no tax liability occurs in 2010. The ordinary income tax rates in place during these years will apply. It is important to note that the value of deferring tax liability over 2011 and 2012 may be offset in part by any increase in tax rates.⁴ The taxpayer may elect to opt out of this deferral of tax liability and recognize all of the taxable conversion in 2010 as ordinary income (and pay the taxes in 2010 based on 2010 tax rates).

EXAMPLE 3

Let's assume the same facts as Example 1, except that Bill converts in 2010 (instead of 2012). Bill will have the option of (1) recognizing one-half of the income (\$250,000) in each of 2011 and 2012 or (2) electing to recognize the \$500,000 of income in 2010, again at his effective federal tax rate of 35%.

This is a hypothetical example meant for illustrative purposes only.

Generally speaking, deferral of income tax could be better—the assumption being that income tax rates will stay relatively static. However, in a rising-tax-rate environment and with a short period of deferral, that wisdom may not yield the desirable result. Individuals considering a Roth IRA conversion must determine whether it is better to (a) defer recognizing the income to 2011 and 2012 or (b) recognize the income in 2010.

If staying within a certain income tax bracket or incurring a large tax bill are concerns, another possibility is to gradually convert. The IRA owner can

choose to do a series of partial conversions over several years in order to limit the income tax liability in any given year. Individuals should always consult with their tax and other advisors to discuss their specific situation. Partial conversions have other considerations that will be addressed later in this paper.

Potential benefits of conversion

The obvious question is: “Why pay income tax now to convert to a Roth IRA?”

Paying income tax today for the future opportunity of tax-free withdrawals may generally be perceived as not economically beneficial. However, with respect to the Roth IRA conversion, this thinking may not apply. Sometimes the net after-tax value of the individual's IRAs and other non-IRA assets will be greater with conversion as compared with nonconversion.

Over the short run, conversion may benefit Roth IRA owners during their retirement years by potentially reducing income taxes, increasing retirement assets, increasing flexibility and diversifying tax liability. Further, conversion may benefit the Roth IRA owner's beneficiaries by potentially increasing his or her inheritance, decreasing estate taxes and/or providing a tax-free source of income.

Retirement income flexibility

Qualified distributions from a Roth IRA are generally federal income tax-free. Many individuals hold the majority of their retirement assets in a 401(k) or other employer retirement plans. Distributions from these plans are subject to ordinary income tax. By converting a portion of the taxable amount held in a qualified or tax-deferred plan to a Roth IRA, owners will be able to diversify their retirement money from an income tax perspective. Part of the money they intend to receive during their retirement years, whether it comes from a pension, Social Security or tax-deferred plan, will be subject to income tax, while the qualified distributions they receive from their Roth IRA will be tax-free.

Roth IRAs offer greater withdrawal flexibility than Traditional IRAs. Roth IRAs are not subject to the required minimum distribution rules at age 70½, unlike Traditional IRAs. If you are age 70½ the Internal Revenue Code requires the owner of a Traditional IRA or

employer-sponsored retirement plan such as a 401(k) to take a Required Minimum Distribution (RMD) each year, beginning with April 1st of the year following the year you attain age 70½. (The required beginning date may be later, depending on when the owner retires for employer-sponsored retirement plans). Ineligible funds converted to a Roth IRA will be subject to penalties and will be required to be removed as excess. You should review any planned financial transactions or arrangements that may have tax or accounting implications with your personal professional advisors. There is a 50% penalty if a withdrawal of the required minimum distribution isn't taken or if less than the required amount is taken.

A Roth IRA does not require any distribution prior to the owner's passing. Because there is no requirement to withdraw assets from a Roth IRA, prior to the account owner's death, the account owner can choose whether the money withdrawn from their retirement accounts should come from taxable or tax-exempt sources, depending on his or her tax situation for that year. There are certain situations in which you can take a distribution under age 59½ and it will be exempt from the 10% penalty. Distributions from Roth IRAs after five years and on account of death, disability, attaining age 59½ or for a qualified first-time home purchase are considered "qualified distributions," and any otherwise yet-untaxed amounts (e.g., earnings and deferred conversions⁵) are federally tax- and penalty-free, along with the after-tax principal from the account. If you need to take a premature distribution from your Roth IRA, check with a tax advisor before taking any monies out of your Roth IRA to see whether you are eligible for one of these exemptions.

Reasons to consider a conversion

- Anticipate a higher tax bracket in retirement or are temporarily in a lower tax bracket at the time of conversion, and/or
- Have adequate funds outside retirement accounts to pay conversion taxes, and/or
- Have unused tax deductions that can offset income generated by conversion

Retirement portfolio management

From an asset allocation and diversification standpoint, both Traditional IRAs and Roth IRAs can provide the opportunity to invest in a wide range of investments. However, any taxable income produced by the investments held within a Traditional IRA will be taxed at ordinary income tax rates when distributed, even if the income consists of long-term capital gains or qualifying dividends. Had these assets been held outside of a Traditional IRA, any long-term capital gains generated or qualifying dividends received by most individuals may have been taxed at rates that are currently lower than ordinary income tax rates.

If the individual were to convert assets from a Traditional IRA to a Roth IRA, any growth or income produced by the investments in the Roth IRA would be tax-free when distributed (as long as it is a qualified distribution). Those interested in passing IRA assets to the next generation may be more apt to invest without the concern of how any growth or income from the assets will be taxed.

Reasons to consider a conversion

- Desire for a source of tax-free withdrawals, and/or
- Experienced significant declines in the value of portfolio, and/or
- Expect portfolio to grow significantly in the near future

Legacy planning

Converting to a Roth IRA may benefit estate planning, especially if individuals plan on passing their IRA assets to the next generation. The absence of a minimum distribution requirement allows the opportunity for the assets that would have been withdrawn to meet the minimum distribution requirement had they been in a Traditional IRA, to grow federally tax-free, which may lead to greater wealth accumulation and more assets available for beneficiaries and heirs. Roth IRA assets left to an heir may allow the beneficiary to receive tax-free distributions.⁶ In addition, by paying the income tax liability due to conversion, owners could benefit from reducing their gross estate for estate tax purposes.

If the beneficiaries do not need the money immediately, they may have the option of accepting distributions over an extended period of time, continuing the opportunity for the remaining balance in the account to grow tax-free.

It is important to note that once a nonspouse inherits a Traditional IRA, it cannot be converted or rolled over to a Roth IRA. This must occur during the original IRA owner's lifetime.

Reasons to consider a conversion

- Desire to leave tax-free assets to children or heirs, and/or
- Have sufficient income from nonretirement accounts to fund retirement, and/or
- Want to potentially reduce the taxable value of estate

Important factors to consider

There are certain individuals who may benefit from the Roth IRA conversion opportunity, while others may not. When considering whether to convert, the following factors should be kept in mind:

- Source of payment for income tax due upon conversion
- Individual's current and estimated future marginal federal and state income tax rates
- Individual's estimated federal and state estate tax liability
- Individual's significant tax-favorable situations (e.g., charitable contribution carryovers) that may affect the federal and state income tax burden of conversion
- Time horizon as well as current and future cash flow needs for retirement
- Estate planning goals
- Life expectancy and current health of the individual
- Anticipated rates of return on all assets (both IRA and non-IRA assets)
- Life expectancy of the beneficiaries, if they are individuals or trusts for the benefit of individuals

Source of payment for income tax due upon conversion

A conversion is most effective when taxable dollars are used to pay the associated income tax. If tax-deferred dollars from retirement savings are used to pay the resulting income tax liability, the benefits of converting to a Roth IRA are substantially diminished. The amount of assets in the IRA would be reduced, and the funds used to pay the income tax liability may be subject to federal income tax and a premature distribution penalty.

Income tax rate differential

As previously noted, income tax rates may be higher in the future than they are today if (a) the government increases income tax rates or (b) an individual's income increases, resulting in a higher tax bracket. Therefore, tax rates now, as well as tax rates when distributions from the Roth IRA will occur, must be taken into consideration to determine whether or not conversion makes sense. Investors may potentially lock in to a lower tax rate if they feel they are going to be in a higher tax bracket during retirement or that tax rates overall are going to increase. If a lower tax bracket is anticipated when distributions from the Roth IRA will occur (most likely during the retirement years), paying income tax now on the converted funds at the present (and higher) income tax rate may not be very appealing. Individuals can pay taxes on a smaller appreciated asset base so any future appreciation has the opportunity to grow tax-free, thus creating a larger asset pool to help fund retirement.

However, if a higher tax bracket is anticipated when distributions from the Roth IRA will occur, converting the assets to a Roth IRA now and paying tax at the present (and potentially lower) income tax rate may be advantageous.

State income tax treatment of Roth IRAs

Although most states follow the federal tax treatment of Roth IRAs, a tax professional should be consulted regarding the tax treatment of Roth IRAs in a particular state.

Time horizon

As a basic rule, the longer the time period between the conversion and withdrawal of assets, the better the conversion may look. In situations where a Roth IRA is being used as an estate planning tool, the extended time horizon generally makes the Roth IRA conversion and subsequent tax-free earnings more attractive.

Cash flow: withdrawal rules

A qualified withdrawal from a Roth IRA, including both contributions and investment earnings, is completely federal income tax-free and penalty-free if made at least five years after any Roth IRA is established and funded and one of the following factors applies:

- (1) owner has reached age 59½ at the time of the withdrawal;
- (2) withdrawal is made due to a qualifying disability;
- (3) withdrawal is made to pay for qualified first-time homebuyer expenses; or
- (4) withdrawal is made by a beneficiary or estate after the Roth IRA owner's death.

If none of these conditions are met, only the portion of a Roth IRA withdrawal that represents investment earnings will be subject to federal income tax, and there is a 10% penalty for withdrawals of earnings taken before age 59½, unless another exception applies.⁷ The portion of a Roth IRA withdrawal that represents contributions, including converted amounts, is never taxable, since those dollars were already taxed. Roth IRA withdrawals are treated as coming from contributions first, followed by converted amounts, and lastly investment earnings.

It is important to note that special penalty provisions apply for converted assets. If a nonqualified withdrawal is made within five years of the conversion, the earnings withdrawn will be subject to income tax, and the entire withdrawal may be subject to an additional penalty unless an exception applies.

Aggregation rules and amounts subject to taxation

Another major drawback to conversions not to be overlooked is the provision under Internal Revenue Code section 408(d)(2) requiring the aggregation of all amounts in an individual's IRAs⁸ in order to determine the taxable portion of a distribution from any of them. Determining the amount subject to income tax may be simple if a Traditional IRA consists only of deductible contributions. In this scenario, the entire amount converted will be subject to income tax. It gets somewhat complicated if a Traditional IRA consists of deductible and nondeductible contributions (and the individual has multiple IRAs with these characteristics). Individuals can calculate their tax liability utilizing the IRS Form 8606.

They may wish to consult with a tax professional if they have any questions or concerns. Here, a tax professional would calculate the ratio of nondeductible contributions to the total balance of any Traditional IRAs (including rollover IRAs, SEP IRAs, SAR SEP IRAs and SIMPLE IRAs). This ratio is then applied to any withdrawal that is made from any Traditional IRA, including conversions to a Roth IRA until such time as all of the after-tax basis has been recovered.

Other applications of the strategy

In addition to the factors mentioned above, there are a few other planning opportunities that individuals should consider in anticipation of conversion.

Partial conversions

Conversion is not an "all-or-nothing" proposition. Individuals may convert any part or all of their Traditional IRAs or other eligible retirement plans in a given year and recognize conversion income based on their particular circumstances. Recall that the ability to convert for high-income earners began in 2010, so anytime thereafter the decision is how much to convert, if anything, each year.

It is important to note that the aggregation rules also apply to partial conversions. This pro rata rule requires that all IRAs be looked at in aggregate and the same ratio of pre-tax and post-tax assets be applied to the conversion amount.

IRD considerations

Another issue that may come into play with a Traditional IRA and estate planning is the tax concept known as income in respect of a decedent (IRD). Basically, IRD is income that is earned, but not received, by an individual prior to his or her passing. This income has not yet been subject to income tax. Taxable distributions from a Traditional IRA are categorized as IRD. Therefore, when a beneficiary inherits a Traditional IRA, any taxable distributions will be treated as income in respect of a decedent.

This in and of itself is not complex. However, another wrinkle comes into play if the owner's estate exceeds a threshold amount and is subject to estate tax. To avoid double taxation on the Traditional IRA assets, the beneficiary is allowed an income tax deduction for the estate taxes attributable to the Traditional IRA. As you may imagine, this is a complex calculation. Had the assets been

converted to a Roth IRA, the distribution to the beneficiary would not be subject to income tax, and the valuable but complex IRD deduction would not be necessary.

Recharacterization: undoing the conversion

What happens if in the year a conversion is made a major market downturn adversely affects Roth IRA account value? Or if a change in personal circumstances makes tax liability onerous? The conversion decision can be reversed if desired and the assets transferred from the Roth IRA to a Traditional IRA. Assets converted from a 401(k) or other employer retirement plans would go into an IRA, not back in the employer plan. This process is known as recharacterization and eliminates the tax liability of the conversion.

Generally, the deadline for recharacterizing a Roth IRA conversion is the due date of the individual's federal income tax return, including extensions, for the year of the conversion. However, if the tax return deadline has passed, individuals still may recharacterize (if the tax return was initially submitted on time) by amending the tax return within six months of the original due date. In addition, individuals may also reconvert an IRA that has been recharacterized. However, this cannot be done within the same calendar year or within 30 days of the recharacterization, whichever is longer.

As with any decision affecting tax implications, individuals should consult with their tax advisor before executing a recharacterization.

Planning with recharacterization in mind: the use of multiple IRAs

In light of the recent turbulent markets, the value of assets within the newly converted Roth IRA may decrease, or certain asset classes within the IRA may decrease while other classes increase. If the portfolio has substantial holdings in various asset classes, it may be beneficial to create multiple Roth IRAs and fund each account with a separate asset class. If the assets decrease in value in one or several asset classes, those can be easily recharacterized if desired.

Taking action

The potential benefits of a Roth IRA conversion are numerous and could be beneficial for many individuals, particularly in 2010. However, as is the case with all financial and tax planning, IRA owners should look at their particular circumstances to determine whether Roth IRA conversions makes sense. Truly, this is a case where “one size does not fit all,” and in making this important decision, individuals should consider all the factors outlined in this white paper, as well as reviewing different conversion scenarios with their financial and tax advisors.

Merrill Lynch has developed a customized analysis tool for our Financial Advisors to help clients determine whether a Roth IRA conversion may be right for them. This analysis will run various scenarios based on a range of assumptions comparing the impact of conversion with remaining in a Traditional IRA or employer retirement plan. This customized analysis provides another key piece of information to help make this personal decision. Individuals should work with their financial advisor and tax advisor to determine not only whether to convert, but also whether or not they may want to convert all or some of their Traditional IRA or other eligible retirement plan assets and when.

- Partner with your Financial Advisor
 - Discuss whether a Roth IRA conversion may be appropriate for you and your financial strategy.
 - Review your retirement goals to identify the kind of conversion that may be appropriate.
 - Locate and organize all current retirement account paperwork from all firms.
 - Calculate the financial impact of conversion.
 - Identify available assets to pay conversion taxes (e.g., maturing CDs, bonds, cash).
- Consult with your tax and other advisors before making a final decision.

Important dates

To take advantage of the tax benefit being offered only in 2010, which allows individuals to spread their tax liability of a Roth IRA conversion equally over two years, the following are some important dates to remember:

JANUARY 1, 2010	First day that conversions could be made under new regulations
DECEMBER 31, 2010	Last day that conversions can be made to have two years to pay the taxes owed
OCTOBER 17, 2011*	Last day to recharacterize 2010 conversions (includes extensions)
APRIL 16, 2012*	Tax-filing deadline (50% of the 2010 conversion amount will be brought into income for 2011 tax year)
APRIL 15, 2013	Tax-filing deadline (remaining 50% of the 2010 conversion amount will be brought into income for 2012 tax year)

* It is usually the 15th of the month, unless the 15th falls on a weekend or holiday, in which case it is the next business day.

At Merrill Lynch, our Financial Advisors can help review whether or not a Roth IRA conversion makes sense while taking into consideration an individual's personal retirement goals and overall planning needs. A Roth IRA conversion is not something individuals should pursue without the appropriate guidance from their tax and other advisors because there are many factors and strategies to be considered. If you are interested in a discussion about a Roth IRA conversion or any other financial planning considerations, please contact a Merrill Lynch Financial Advisor.

¹ Not only are Traditional IRAs and rollover IRAs eligible for conversion, but individuals who are eligible for distributions from plans such as 401(k)s/Inherited 401(k)s, 403(b) and 457 plans, profit-sharing and money purchase plans, SEP IRAs, SAR SEP IRAs, and SIMPLE IRAs (those that have existed for at least two years) are eligible for this planning opportunity.

² These income limitations are subject to IRS review and modification annually. If these criteria are met, currently anyone under the age of 50 can contribute up to \$5,000 to a Roth IRA, whereas anyone age 50 or older can contribute up to \$6,000 to a Roth IRA each year, so long as you have sufficient earned income. The 2010 Roth IRA contribution limits are reduced according to the IRS phase-out schedules, depending upon your filing status. Contributions cannot be made to a Roth IRA for the 2010 tax year for single filers with a MAGI of \$120,000 or more and \$177,000 or more for married couples who file their taxes jointly. Married couples who file their taxes separately are completely phased out at \$10,000 of MAGI.

³ Married couples who file their taxes separately with MAGI less than \$10,000 can make annual contributions to a Roth IRA, subject to the phaseout rules.

⁴ Ordinary income tax rates are scheduled to sunset effective 12/31/2010. It is anticipated that tax rates, in the higher tax brackets at least, may be increased legislatively. Individuals should discuss with their tax professional if considering the two-year spread.

⁵ Deferred conversion amounts distributed prior to age 59½ may be subject to a recapture of the 10% additional income tax penalty, unless another exception to the penalty applied under the Internal Revenue Code.

⁶ Roth IRA distributions due to death are still subject to the five-year rule to determine whether they are "qualified distributions."

⁷ Exceptions include medical expenses, medical insurance premiums while unemployed, substantially equal periodic payments, or higher education expenses. If one of these exceptions is met, there will be income tax due on the earnings, but the 10% early withdrawal penalty tax will not apply.

⁸ For the aggregation rules, individuals must combine balances of all Traditional IRAs, including SEP IRAs, SAR SEP IRAs, SIMPLE IRAs and rollover IRAs. Roth IRA balances are not included for purposes of the aggregation rules.

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