



### Roth IRAs: “To convert or not to convert, that is the question.”

Roth IRA conversions have become a hot topic, due to a change in the tax code that will take effect in 2010. Previously, only taxpayers with adjusted gross incomes of less than \$100,000 were eligible to convert traditional IRAs into Roth IRAs. Beginning in 2010 that income cap has been removed. The question is no longer whether it is possible to convert, but whether it makes sense.

To briefly review, with a traditional IRA, qualified pre-tax funds are contributed and the investment is allowed to grow tax-deferred. Minimum distribution requirements begin at age 70 ½. All traditional IRA withdrawals are taxed at your marginal tax rate.

With a Roth IRA, after-tax funds are invested, and there is no additional tax at the time of withdrawal. This extends to your Roth IRA heirs. Roth IRAs have no annual withdrawal requirement. Roth IRAs have the same early withdrawal penalty, before age 59 ½, as do traditional IRAs.

When a traditional IRA (traditional, rollover, SEP, and SIMPLE IRAs are all eligible) is converted to a Roth IRA, tax is due on the entire amount of the conversion. If you have made nondeductible (after tax) IRA contributions, tax is due only on the earnings of those funds.

#### **Conversion, under the right circumstances, can bring significant advantages:**

- If you do not need to live off of your IRA assets in retirement, avoiding annual withdrawal requirements will preserve the full amount of the IRA for your heirs. If this is your situation, Roth IRA conversion can be viewed as an estate planning/wealth transfer strategy – the tax you pay will give your heirs the full benefit of your IRA investment, tax free.
- If you believe tax rates will increase post 2010, converting now will subject your IRA assets to a lower tax rate – but if your tax bracket in retirement will be lower than it is today, conversion would be less attractive. Note, also, that conversion may bump you into a higher current tax bracket, as converted funds are included in your gross income the year of conversion.
- Even if you do plan to take full IRA withdrawals upon retirement, converting now will permit your IRA assets to grow tax free, rather than tax deferred. You can think of it as amortizing your current tax bill over the future years of tax free growth. Your tax advisor should have an IRA conversion table to help determine the economics of conversion.

#### **However, there are a few meaningful caveats:**

- If you must pay the tax due upon conversion out of your IRA assets, conversion probably does not make sense.
- If you have committed your traditional IRA to charity, than conversion would not be appropriate.

#### **There are additional factors to consider:**

- Taxes due on conversions in 2010 may be spread over two years. However, it may not be advantageous to do so if marginal tax rates rise in year two.
- A traditional IRA need not be converted all at once. It may be advantageous to make a partial

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conversion or to spread the conversion over future years, depending on the impact conversion would have on your tax bracket and the availability of funds to meet the tax liability. But, again, bear in mind that tax rates are likely to rise in the future.

- Once you convert to a Roth IRA you can change your mind for any reason and revert back to traditional IRA form at any time up to the extended tax filing date for the first year the tax is due. This might be advantageous if the value of your IRA assets declines post conversion, leading to a lower tax liability upon reconversion.
- If you intend to convert in 2010, consider adding the maximum allowable in 2009 to maximize your conversion potential.
- Conversion when the value of your IRA is cyclically depressed is more advantageous than when the value is at a cyclical high, as the current tax liability will be lower as well.
- Finally, we would be remiss if we did not raise one further question: what is the probability, however small, that some future Congress decides to levy a “small” tax on Roth IRA withdrawals?

While conversion is a complex question, it could be one of the most important tax driven financial decisions you will have the opportunity to make. To summarize, you are an especially good candidate for Roth IRA conversion if:

- You can pay conversion taxes from non-retirement assets.
- You will not begin withdrawing IRA funds for some considerable period of time, or better yet, you will not need to spend the majority of your IRA funds and wish to pass the investment on to your heirs.
- You expect your effective tax rate in retirement to be the same or higher as it is today, assuming you plan to take meaningful withdrawals.

This paper provides only an outline of the complex issues that are involved. Please consult with your investment advisor and your tax advisor or accountant before proceeding.