

Roth IRA; Should You Convert Your IRA?

Starting January 1, 2010 investors with an adjusted gross income of more than \$100,000 will be able to convert their traditional IRA to a Roth IRA. This change in Roth rules is because of the Tax Prevention and Reconciliation Act of 2005.

The major three differences between a Roth IRA and a traditional IRA are:

- Money taken out of a Roth is not taxed
- You are not required to take distributions at 70 ½ from a Roth IRA
- After death, beneficiaries of a Roth IRA, receive the money free of federal income tax

The process of converting is simple. You sign paper work and pay the taxes over two years. Your assets transfer as is, so you don't have to liquidate them to make the conversion. The Act also has a recharacterization provision allowing you to undo your conversion under certain circumstances. This protects you against a drastic drop in account value during the year after conversion.

A number of do-it-yourself websites have popped up to help you make the decision whether you should convert or not. It is not as straight forward as these websites make it sound. There are many variables that need to be taken into consideration not talked about on these websites. Everyone's situation is unique.

For example, how will you pay the taxes when you convert? The tax bite can be large. If your IRA is worth \$100,000 you could pay as much as \$33,000 in federal income taxes. As mentioned above, the act allows you to pay the federal income taxes over 2 years, but if you plan on taking the money out of your IRA to pay these taxes it probably doesn't make sense to convert.

Future taxes play a roll in the decision making process also. Converting your IRA means paying taxes today in hopes that it will pay off at some distant point in the future. Unfortunately, you won't know for sure if the conversion was the right move until you're ready to withdraw the money in

retirement. Many expect tax rates to be higher in the future. But this does not guarantee that your tax rate will be higher. Your retirement income could put you in a lower tax bracket making your tax rate the same or lower than it is today.

Besides knowing what your tax rate will be in 20 to 30 years, you also have to hypothesize your future income needs, and your IRA's growth rate over this time. A small change in any of these factors will affect your decision. For instance, a 1% change on your investment return can change your breakeven point by 3-5 years.

Another aspect you need to consider is succession planning. For instance, if the assets are to be left to non-spouse beneficiaries, such as children, the assets transfer free of federal income taxes and you can stretch the distributions over the beneficiary's life expectancy. This preserves the tax advantage of the Roth for years. On the other hand, if you are planning on leaving the money to charity converting today does not make sense. The charity will not have to pay taxes on your bequest, so why pay taxes today and leave them less. Not only do you need to decide if converting makes sense on an investment basis but you may also have to review your estate plan.

The Act also allows you to do a partial conversion. This added flexibility can complicate your decision. Depending on your individual situation, a partial conversion might be better than a full conversion.

There are many more examples I could give showing how complicated the decision making process can be for deciding whether to convert your IRA or not. It is important not to look at conversion in a vacuum but to consider all of the variables. My suggestion is to seek advice before converting. Not just from your investment professional but also from your estate planner. We would be more than happy to assist you in the process.

Greg Robinson CFA, President
greg@msinvest.com