

SHOULD YOU CONVERT TO A ROTH IRA?

By Brad Rempe

As with any new year, 2010 ushers in a host of changes in our industry which deserve attention and consideration. One of these changes for 2010 is the elimination of income limits for Roth IRA conversions.

Any time the government eliminates a restriction like this, it's worthwhile to explore the issue and determine whether it has merit for you. Understandably, this issue has been receiving a lot of recent attention from the financial media. However, many of the articles regarding the Roth conversion opportunity have been presented in a manner that suggests this should be beneficial to just about everyone. That is simply not the case, and before you consider converting, it's important to understand the math.

A Roth conversion allows you to shift assets from a traditional IRA to a Roth IRA, gaining the benefit of *tax-free* distributions after age 59½ for the rest of your life and the lives of your beneficiaries. However, there is a cost to converting which could far outweigh the benefit. Every pre-tax dollar converted will be reported as earned income and taxed at your marginal rate (the tax bracket at which your last dollar of income is taxed). If your tax rate upon conversion is *higher* than you expect it will be when you eventually receive distributions from your traditional IRA, converting would be a mistake.

Before this year, taxpayers with a Modified Adjusted Gross Income (MAGI) in excess of \$100,000 were prohibited from converting a traditional IRA to a Roth IRA. This income limitation (which is being permanently removed) has actually been in the works since 2006, when Congress passed the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). From the government's perspective, the potential tax revenue from Roth conversions is significant, and the motivation for Congress enacting this portion of TIPRA was for exactly this reason. There were other provisions of TIPRA which reduced taxes, including a two-year extension on reduced capital gains and dividends tax rates. The Roth conversion change was put in place to help "pay" for these tax cuts.

As stated above, the math behind the analysis is actually fairly simple. What *isn't* as simple is the development of all the assumptions necessary to do the math. Many of these assumptions are based on long-term future expectations, and even slight variations can have a dramatic effect on the benefit that's ultimately received.

One of these assumptions is tax rates. For many, a Roth is attractive because of an expectation that future tax rates *will* be higher than current tax rates. This may not necessarily be the case, and certainly not for *all* taxpayers. The current administration has alluded to the idea of raising taxes only on high wage earners. It's important NOT to assume that because you are a 'high wage earner' today, you will continue to be in a 'high tax bracket' when you take distributions from your IRA.

Another assumption that may not ultimately prove true is that Roth IRA assets will be *forever* tax-free (Social Security benefits used to be tax-free too). In a March 5, 2007 article published in *Barron's*, Edward F. McQuarrie, Ph.D., professor at Santa Clara University's Leavey School of Business, explained that there are a variety of ways Congress could "chip away" at the Roth's tax-free status – especially for high-net-worth taxpayers. He suggested that the government could impose a tax on "excess" Roth accumulations. In addition, a change to a National Sales Tax...or a flat consumption tax would indirectly 'tax' Roth distributions if used for consumption.

To be sure, there are situations where a conversion can prove to be a significant opportunity. Some of these include the following:

- If you own a business with a large operating loss which you could use to offset the income realized from converting.
- You have significant passive activities with suspended losses which can be disposed of in 2010-2012.
- If you have significant itemized deductions which temporarily place you in a low tax bracket.
- If you are relatively young, are in a lower tax bracket, and will have 30 to 40 years before distributions will be needed.
- Any year in which your income is negative or at a historically low level.

Also, if the following are all characteristics of your situation, there is a strong likelihood conversion could be beneficial:

1. You have accumulated more assets than you will need for your lifetime.
2. You are able to pay the tax due from converting out of non-IRA funds.
3. Your children are likely to be in a high tax bracket upon inheritance.

Summarizing, the complexity of making this decision can be significant. For most people (especially if you are currently earning an income), converting to a Roth will not be beneficial – the math is just too hard to overcome. However, your situation may be unique and present an opportunity to consider this. If you are unsure or would simply like to discuss this further, we are available and would be happy to meet with you.