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EDUCATIONAL SERIES

Roth IRA Conversions

Executive Summary

Until now, high-income earners have been effectively prevented from using Roth IRAs. Beginning in 2010, the income limits for Roth ***conversions*** are removed and therefore all taxpayers are eligible to convert certain retirement plans into Roth IRAs, including: traditional IRAs; SEP IRAs; SIMPLE IRAs; 401(a) qualified plans; 401(k)s; 403(a) annuity plans; 403(b) annuity plans; and 457(b) plans. Prior to 2010, if income exceeded $100,000 the conversion of an IRA to a Roth IRA was prohibited. In 2010 and beyond, high-income earners still cannot make ***contributions*** to Roth's if their income is over $120,000 if single or $176,000 if married filing jointly.

With traditional IRAs (and qualified plans like 401(k)s, etc.), your money goes in untaxed, and you pay ordinary income taxes whenever you take the money out of the account during retirement. With a Roth IRA the reverse is true. Your contribution is made with after-tax dollars, but then there is no tax when the money is withdrawn. A Roth conversion is accomplished by moving money from a traditional IRA (or qualified plans like 401(k)s) to a Roth IRA. You pay tax at ordinary income tax rates on the amount converted. A Roth conversion may seem counter intuitive because instinctively it seems best to defer tax as long as possible. With a conversion you are volunteering to pay tax now based on the promise that all future appreciation will escape taxation.

So why would anyone do a Roth conversion? Roth IRAs:

- allow more wealth to grow tax-free for a longer period of time;
- provide tax-free withdrawals;
- can enhance the ultimate payout to the taxpayer/beneficiaries;
- are not subject to required minimum distributions, unlike traditional IRA's;
- can continue to receive contributions after age of 70 ½ if you have earned income.

Conversions are complicated and make sense only for certain taxpayers. Like any other planning decision the answer is "it depends". Before deciding on a Roth IRA conversion, taxpayers should consider several critical factors including: age, time horizon, tax rates at conversion & distribution, current & future income, spending needs, asset mix, rate of return & taxation on invested assets,

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estate objectives and future changes in tax laws. While there is no easy answer as to whether you should convert or not, the following factors support conversion:

1) ***Front Loading the Taxes into the Roth***: You can afford to pay the taxes due on the conversion from outside (non-IRA) funds.
2) ***Tax Arbitrage***: You believe/expect to be in the same or higher tax bracket in future years or your beneficiaries who inherit these assets will not have significantly lower tax rates upon withdrawal.
3) ***Tax Diversification***: You are seeking tax diversification across taxable, tax-deferred and tax-free accounts.
4) ***Time Horizon***: You have a long time horizon between conversion and withdrawal.
5) ***Spending Rate***: You don't expect to spend all (or any) of the Roth IRA to meet your living expenses or will begin drawing on it much later in retirement.
6) ***Wealth Transfer Objectives***: You desire to leave a tax-free asset to your beneficiaries who will then stretch withdrawals over their lifetime.
7) ***Charitable Objectives***: If you plan to leave converted Roth assets to non-charitable beneficiaries then a Roth could make sense. If you plan to do any testamentary charitable giving, a traditional IRA or qualified plan is the first asset you should consider donating. By leaving your IRA to charity you all together avoid the inherent income taxes that would be paid by your heirs when funds are distributed. There would be little benefit to convert an IRA to a Roth if it will eventually be given to a charitable organization.
8) ***Opportunistic Conversions***: to take advantage of temporarily available tax attributes or market conditions:
    1) Partial conversions over a several years to utilize lower tax brackets.
    2) Favorable tax attributes such as (1) Net Operating Loss (NOL) carry-forwards (2) Business and other ordinary losses (3) Deductions and exemptions in excess of income (4) Charitable contribution carry-forwards or (5) Non-refundable credits.
    3) After-Tax Assets: If you have non-deductible IRA's or after-tax 401(k) accounts these may make sense to convert, especially if there is a high ratio of non-taxable funds to taxable funds.
    4) Market Correction: short-term economic conditions which are expected to reverse over time.

CONCLUSION

One of the most significant variables in the Roth conversion decision is your income tax rate at the time of conversion compared to your or your beneficiaries' income tax rate at the time of distribution in the future. If the income tax rate will be the same or higher upon distribution in retirement then a conversion could be beneficial. If the income tax rate will be significantly lower in the future then a conversion may not make sense. If you believe that tax rates are going to go up in the future, then paying taxes now and eliminating future taxes provides a net gain.

So will your tax rate be higher or lower? In the short term we are confident taxes will increase but a conversion is a long-term decision that could span many decades. Tax laws constantly change as do your personal circumstances. It is anyone's guess what taxes will look like decades from now, or if our tax system will even exist in its current form. Unfortunately, there is no way of knowing for sure ahead of time if paying taxes now will save taxes later. It is this unknown, of what future tax laws might be, that will cause most taxpayers to pause before writing a large voluntary check to the U.S. Treasury. For those who can work through that uncertainty, the Roth IRA is a powerful retirement and estate planning tool that is worth considering. If you can afford to pay the taxes due from the conversion from other outside assets and have a long time horizon between conversion and withdrawal, a Roth conversion can benefit you and your beneficiaries.

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