



Converting to a Roth IRA - Does It Make Sense For Me?

By: Nicholas Breit, CFP®, Investment Consultant

Prior to 2010, taxpayers could not convert a Traditional IRA to a Roth IRA unless their modified adjusted gross income (MAGI) was below \$100,000. In 2010, the income limitation for Roth IRA conversions was eliminated, thus allowing any taxpayer the opportunity to convert all or a portion of a Traditional IRA to a Roth IRA. While the conversion to a Roth IRA may offer significant long-term benefits, the decision must be weighed against a number of factors.

Before we evaluate the various considerations for a Roth IRA conversion, we should briefly review the differences between a Traditional IRA and a Roth IRA.

	Traditional IRA	Roth IRA
Contributions	Contributions may be deductible or non-deductible, depending on Adjusted Gross Income (AGI)	Contributions are non-deductible
Contribution Limit (2010)	\$5,000 \$1,000 catch-up contribution for individuals who are age 50 or older by year-end	\$5,000 \$1,000 catch-up contribution for individuals who are age 50 or older by year-end
AGI Phaseout Ranges for Contributions (2010)	Distinction between deductible and non-deductible contributions is dependent upon AGI and whether individual (and/or spouse, if married) is covered by a qualified retirement plan	Single: \$105,000 - \$120,000 MFJ: \$167,000 - \$177,000 * MFJ = Married Filing Jointly
Required Minimum Distributions (RMDs) – Account Owner	Withdrawals must begin at age 70½	None
Qualified Distributions	Age 59½	Distribution is qualified if made after a 5-year holding period** and one of the following applies: 1) Owner is at least 59½ 2) Distribution is due to death or disability 3) Distribution is made to a qualified first-time homebuyer
Distributions	Distributions are considered a pro-rata return of non-deductible contributions and taxable earnings	Distributions are considered to come first from regular contributions and then from earnings; no income tax or 10% early withdrawal penalty applies until total distributions exceed total contributions
Distributions – Taxation	The portion of distributions attributable to deductible contributions and earnings are taxed as ordinary income	Qualified Distributions are non-taxable

** Each Roth IRA conversion has its own 5-year holding period and must remain in the Roth IRA for 5 years to avoid the 10% early withdrawal penalty. Once the 5-year holding period has passed for each respective conversion, taxpayers can withdraw conversion amounts (but not earnings) without penalty, regardless of their age.



Ultimately, the benefit of a Roth IRA is that qualified distributions are tax-free. That is, the Roth IRA grows tax-deferred and allows for income tax-free treatment of qualified distributions whereas a Traditional IRA grows tax-deferred but future distributions are taxable as ordinary income. The tradeoff involved with the Roth IRA conversion is the taxes that must be paid today in order to gain the benefit of tax-deferred growth and tax-free distributions.

Quick Note: In 2010, taxpayers have a one-time option (2010 only) of choosing to pay the tax on the amount of the conversion in 2010 or electing to spread the conversion amount evenly between their 2011 and 2012 tax returns, paying any resulting tax when filing for those years. However, if you expect your marginal tax rate to be higher in 2011 and 2012 relative to 2010, you may not want to defer the tax liability.

Roth IRA Conversion Considerations:

- 1) **Tax Bracket** – What is your current income tax bracket versus your expectation for your income tax bracket when you would be required to take distributions from your Traditional IRA? Generally speaking, to the extent taxes at conversion would be less than your expected tax rate on future required minimum distributions (RMDs), the Roth IRA conversion would likely be preferable. Conversely, if the taxes at conversion would be more than your expected tax rate on future RMDs, the Traditional IRA would likely be preferable.
- 2) **Taxes on Conversion** – Can you afford to pay the taxes associated with the conversion out of pocket? If you are under age 59½ and choose to pay the taxes from the Traditional IRA assets, you will incur a 10% early withdrawal penalty. Optimally, you should pay the tax liability from non-IRA assets.
- 3) **Time Horizon** – Do you have a short or long time horizon? How many years do you have until you need to access the account? Simply put, the longer the time horizon, the greater the potential for the Roth IRA to generate tax-free earnings to make up for the tax liability at conversion.

Conversion Example

To illustrate the impact of taxes on the Roth IRA conversion, we have included the following example:

Assumptions:

John & Jane Smith	Age 50, both
Traditional IRAs	Valued at \$1,000,000
Taxable Income (2010)	\$200,000 (excluding the amount of any IRA conversion)
Tax Status	Married Filing Jointly (MFJ)
Current Tax Bracket	28%
Time Horizon	Long-Term (both John and Jane are in reasonably good health)
Tax Liability	Able to pay any taxes on conversion ‘out of pocket’

Under this scenario, based on 2010 Married Filing Jointly (MFJ) income tax brackets, if John and Jane convert all of their Traditional IRA assets, the resulting tax implications would be as follows:

MFJ Tax Bracket	Tax Rate	Portion of IRA Conversion w/in Tax Bracket	Conversion Tax Liability
\$137,300 - \$209,250	28.00%	9,250	2,590
\$209,250 - \$373,650	33.00%	164,400	54,252
\$373,650 +	35.00%	826,350	289,223
	34.61%	1,000,000	346,065

In this example, Effective Tax Rate for Conversion = 34.61% (\$346,065 / \$1,000,000 IRA Conversion)



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Alternatively, the Smiths could choose to split the conversion amount evenly between their 2011 and 2012 tax returns; by so doing, less income would be taxed within the highest income tax brackets, though the income tax rates in effect for 2011 and 2012 could be higher than current income tax rates.

As a point of reference, assuming no further contributions to or withdrawals from the Traditional IRA prior to age 70½ and a growth rate of 7.0% per year, the Traditional IRA assets would grow to approximately \$3,870,000 by age 70, with an initial Required Minimum Distribution (RMD) at age 70½ of approximately \$141,230.

In determining whether the Roth IRA conversion would be beneficial, an individual/couple must make assumptions on future income tax rates for RMDs from the Traditional IRA(s), after factoring in the following possible income items during retirement (items below do not represent an all-inclusive list):

- 1) Salary/Consulting Income/Board Income
- 2) Pension Income
- 3) Miscellaneous Income (Alimony, Winnings, etc.)
- 4) Social Security
- 5) Taxable Portfolio Income (Dividends, Interest, Capital Gain Distributions, etc.)
- 6) Amount of Required Minimum Distributions (RMDs)

Under this example, knowing that the Smiths have a long-term time horizon and can currently pay the taxes associated with the conversion out of pocket...

- 1) The Roth IRA would likely be more advantageous if the net effective tax rate at conversion is less than their assumed income tax rate on future Required Minimum Distributions (RMDs). In other words, if the Smiths assumed future RMDs would be taxed at an effective rate of 40%, they would likely prefer to pay the effective tax rate of 34.6% today rather than eventually pay a tax rate of 40%.
- 2) The Traditional IRA would likely be more advantageous if the net effective tax rate at conversion is higher than their assumed income tax rate on future Required Minimum Distributions (RMDs). In other words, if the Smiths assumed future RMDs would be taxed at an effective rate of 15%, they would likely prefer to avoid paying tax on a conversion today and would instead pay the lower rates in the future on their RMDs.

Other Considerations – Estate Planning

For high net worth individuals, the Roth IRA may be attractive from an estate planning perspective, particularly if the account owner does not intend to take withdrawals from the Roth IRA. While the Roth IRA will be included in the account owner's gross estate, the account owner is essentially pre-paying income tax on behalf of the Roth IRA beneficiaries without incurring a taxable gift. The tax paid upon the conversion reduces the account owner's gross estate, while the account owner has created an asset from which future beneficiaries can take distributions tax-free (so long as legislation does not change the current tax-free nature of Roth IRAs).

Conclusion

Given the current deficits domestically and the potential for higher income tax rates in the future, the discussion on Roth IRA conversions has become increasingly popular. Under the right set of circumstances, converting to a Roth IRA could offer significant long-term benefits. However, numerous assumptions must be made when evaluating whether the conversion to a Roth IRA would indeed be beneficial.

Because of the uncertainty concerning future income and future income tax rates, some taxpayers may choose to convert only a portion of Traditional IRA assets as a potential 'hedge' against higher future tax rates. By so doing, the taxpayer retains a portion of the Traditional IRA (with future distributions to be taxed as ordinary income) and a portion in a Roth IRA (with future qualified distributions to be tax-free).

Please contact a consultant in The Wealth Office™ if we can be of any further assistance.



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