INNOVEST

INTEGRITY. BALANCE. OBJECTIVITY.

Should You Consider a Roth IRA Conversion?

An article by Innovest's Scott Middleton, CFA, CIMA®, Principal, Director - Investment Committee, from Innovest's 2nd Quarter 2010 Newsletter, "The Research Report."

Now that April 15's tax reporting is in the past, here is an item worth adding: Find out whether it makes sense to convert part or all of your traditional Individual Retirement Accounts (IRAs) to a Roth IRA in 2010. A change in the tax rules gives more people access to a Roth IRA, one of the most effective vehicles to accumulate money for retirement or to pass along assets to heirs.

Contributions and Conversions

So far, many high income earners have not been eligible to make Roth IRA contributions, much less convert money from a traditional IRA to a Roth IRA. If you make more than $120,000 (single) or $176,000 (married filing joint), you are not allowed to contribute directly to a Roth IRA.

However, the tax law changes having grabbed a lot of attention pertain to converting a traditional IRA to a Roth IRA. Until year-end 2009, if your modified adjusted gross income (MAGI) was over $100,000, you were not eligible to convert any of your traditional IRA to a Roth IRA. However, effective January 1 of this year, most individuals, regardless of income, are not able to convert all or a portion of their retirement savings from their traditional IRA into a Roth IRA.

What's So Attractive About a Roth?

With a Roth IRA, participants are taxed on their contributions and conversions, but any earnings on the Roth are never taxed. With the increasing likelihood that Congress will raise income tax rates, these tax advantages have garnered substantial attention.

For traditional IRAs, starting at age 70½ the IRS requires their owners to take minimum annual distributions, which are taxed at the owner's ordinary income tax rates. However, for Roth IRAs there are no required minimum distributions; assets can continue to grow tax-exempt. And if someone inherits a Roth IRA, the account continues to grow tax-exempt, although the IRS requires the inheritor to take money out of the account over time.

Just because you can convert your traditional IRA to a Roth, doesn't mean you should. The main factors tend to fall into two categories: taxes and time horizon.

Taxes

For most taxpayers, there is a significant cost to converting to a Roth—namely, the income-tax bill. When you convert a traditional IRA to a Roth, you will have to pay income tax on the amount converted. Here are some of the tax factors to consider:

1. Converting may be the right move if you expect your tax rate to increase in the future. While the consensus view is that income tax rates will rise, no one knows how quickly or how high.

2. People who expect to be in a relatively low tax bracket in 2010 could benefit from a conversion. Keep in mind that you don't have to convert your entire IRA. It might be best to convert only parts of the IRA each year, especially to avoid the highest tax brackets on the amounts converted. Especially consider converting amounts that would be taxed at no more than 15% at the Federal level.

3. The income tax on the conversion ideally should be paid from assets other than from the IRA. It's important to recall that if you are under age 59½, you would pay a penalty on that IRA money withdrawn to pay the tax and not rolled over to the Roth.

4. For investors who are already receiving Social Security benefits, the conversion amount may impact whether those benefits are taxable, and whether higher premiums on Medicare Part B will be required. Future distributions from a Roth do not factor into the calculation of whether Social Security benefits would be taxable. If Social Security and Medicare place more emphasis on means testing in the future, less taxable income may be an advantage.

5. Making a Roth conversion may impact your exposure to the Alternative Minimum Tax, either for better or for worse.

6. It's important to check with your tax-preparer in advance of a conversion to discuss the tax impact for your particular situation.

Time Horizon

Because the Roth's major advantage lies in its ability to compound tax-free, the longer you can afford to forego withdrawals from the Roth, the greater its benefits.

1. In general, if you have 10 to 20 years or more before you plan to begin taking distributions from your retirement accounts, the more you are likely to benefit from a Roth's tax-free growth.

2. Roth IRAs can be a very effective estate planning tool for those who do not need to tap the Roth accounts and would like to pass assets to their heirs without the income tax liability of regular IRA assets. When a traditional IRA is passed on to a beneficiary, the beneficiary must pay income taxes over time on all distributions from the IRA at their own tax bracket. With a Roth IRA, however, the beneficiary acquires the account without having to pay income taxes, since the original owner already paid income taxes on the contributions and/or conversions.

3. After making your first contribution or conversion to a Roth, you have to hold those assets in a Roth for five years, or until you turn age 59½, whichever comes first, to make penalty-free withdrawals on your

converted amounts. Each conversion has its own five-year clock. Also, you ordinarily must be 59½ or older to avoid penalties on the withdrawal of any gains on the converted amounts.

Some of the Fine Print

As with most tax laws, there are important items in the fine print.

Traditional, Rollover, SEP and SIMPLE IRAs qualify for conversions. However, you cannot convert an inherited traditional IRA. Check with your current employer to find out if your current 401(k) may allow conversions.

You cannot convert only your nondeductible?contributions in your traditional IRA. With partial Roth conversions, each dollar is treated as a blend of what's taxable and nontaxable based on your total IRA balances.

If you convert in 2010, you may report the whole conversion on your 2010 tax return, or report half of it in 2011 and half in 2012. This pay-over-two-years provision is effective only for conversions made in 2010. One of the big unknowns is how income tax rates may change over the next few years. Under current law, most income tax rates are already scheduled to rise in 2011.

Other Factors

If you decide that converting assets is the right decision, keep in mind the following:

It is best to place the converted holdings into a new Roth account, rather than an existing Roth. That way, if the value of the conversion falls after you've paid the tax bill, you can move the money back into a traditional IRA ("recharacterize" the account) and wipe out your income-tax liability. You have until October 15 of the year following the year of conversion to recharacterize. For a conversion to a Roth made in 2010, you would have until October 15, 2011 to recharacterize it. Later on, you have the option to convert the assets to a Roth again.

Consider opening a separate Roth for each type of investment you hold. That way, you can recharacterize the ones that perform poorly and leave the winners alone.

Conclusion

As with most changes in tax laws, it may take more time and effort than first anticipated when considering the pros and cons of a Roth conversion. Carefully analyze your situation and be sure to consult with your tax preparer. And keep in mind that there's no rush. Most of the conversion laws extend beyond 2010—or until Congress plays political football with the rules. Keeping on top of tax law changes is likely to remain a challenge for the foreseeable future.

Scott may be reached at 303.694.1900 x315 or scottm@innovestinc.com.