

2010

# Roth Conversion

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Is it right for you?  
A few things to consider...

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## **Converting to a Roth IRA**

By now most investors with incomes over \$100,000 are aware of the opportunity to convert their Traditional IRAs or workplace savings accounts to Roth IRAs going forward but very few know if they should.

When converting from a Traditional IRA to a Roth IRA, you will owe income tax on any taxable portion of the account. The decision to convert is not clear-cut, it depends on many variables specific to your situation and where you think income tax rates will be in the future. Thus, you should consult your personal tax advisor to determine if the potential benefits outweigh the current costs.

### **Who Should Convert?**

As mentioned above, the decision is rather complex but in general you should consider converting to a tax-free Roth IRA if you meet the following criteria:

#### **1. You expect to be in the same or higher tax bracket in retirement.**

If you think your combined tax rate (federal, state, and local) will go down after you retire you probably don't want to convert and pay taxes now at a higher rate. However, if you anticipate being in the same or higher tax bracket during your retirement years converting at least a portion of your savings would make sense.

#### **2. You can pay the income tax generated by the conversion with cash outside the IRA**

It is advisable to pay the tax with cash held outside the IRA because using proceeds from the conversion reduces the amount that can potentially grow tax-free in the Roth IRA and offsets any tax savings that may be gained by converting. If you must sell appreciated assets to pay the conversion tax, the resulting capital gains diminish the benefits of the Roth conversion.

#### **3. You will not need to withdraw assets from the account for at least 10 years or more, if ever**

The more time you have to let tax-free earnings grow the better, and the more advantageous pre-paying taxes and converting to a Roth may prove to be. Whereas owners of Traditional IRAs are subject to Required Minimum Distribution rules the original owner of a Roth IRA is not, allowing for a longer period of tax-free accumulation.

If you don't need the money in your IRA for living expenses during retirement then converting to a Roth would allow you to pass income tax-free assets to your loved ones. Paying the resulting tax at conversion has the added estate planning benefits of simultaneously decreasing the value of your estate while essentially making a gift that will not be subject to gift tax.



## **How Much To Convert?**

If you conclude that you are a good candidate for a Roth conversion, the next thing to figure out is how much of your retirement assets to shift to the new account—it doesn't have to be all of them. A partial conversion can provide the flexibility of having both taxable and tax-free income and “hedge” against uncertainty in your future tax bracket. A conversion doesn't have to be made all at once either. Structuring a series of smaller conversions over a period of several years can help to keep you in your current tax bracket and may also make it easier to pay the taxes with funds outside your retirement accounts.

## **How and When To Pay For The Conversion?**

As previously discussed, the greatest benefit from converting is achieved when cash from outside the IRA is used to pay the taxes. Especially if you are under the age of 59.5 because using funds from inside the IRA to pay the tax is considered a premature withdrawal and will be subject to an additional 10% penalty.

There is also a special rule to keep in mind that applies to conversions taking place in 2010 only. Instead of recognizing 100% of the conversion amount as taxable income in 2010 you can spread the liability over two years by including half of the taxable conversion amount in your 2011 income and the other half in 2012.

Splitting the income and deferring the payment is an attractive option, but if your tax rate increases during that two-year window it may be better to recognize the income and pay the tax up front. Fortunately, that decision does not have to be made until April 15, 2011, and new tax rates may be announced by then.

## **Reversing a Conversion**

If you convert to a Roth then find that your circumstances change significantly you can unwind the conversion through a process called “recharacterization.” For example, if your account balance drops substantially you can switch it back to a traditional IRA, then reconvert to a Roth at the lower account value to reduce your taxes.

There are deadlines, waiting periods, and other requirements to be aware of so be sure to talk to your tax advisor before recharacterizing your account.

## **Additional Considerations**

### **Converting Is NOT the Same as Contributing**



Income limits were eliminated for converting to a Roth IRA but not for directly contributing to one. Strange enough, you can make a non-deductible contribution to your traditional IRA each year and then turn around and convert it to a Roth...for now anyway.

### **Non-deductible Contributions**

When it comes to taking distributions from IRAs, which technically is how a Roth conversion is treated, the IRS “pours” all the assets from your IRAs into one “bucket” and looks at how much is taxable and non-taxable, or “tax-free.” The tax-free portion being the non-deductible contributions you made (and hopefully kept track of) to your traditional IRA(s) over the years. The amount you decide to convert then will be a proportionate distribution of taxable and tax-free dollars.

### **Potential Side Effects**

You should be aware that a Roth conversion could create some unintended consequences as the additional income you recognize can cause your Medicare premiums to increase and/or bump up the percentage of your Social Security benefits that are taxable. Financial aid could also be impacted by the extra income.

### **Closing Thoughts**

Clearly, the decision to convert to a Roth IRA should be made only after carefully weighing the potential benefits and costs. Just because you’re eligible doesn’t mean it’s the smart thing to do. And when talking about tax laws, change is about the only constant you can expect—adding another degree of complexity to effective long-term planning. We look forward to helping you evaluate your options and encourage you to seek the advice of your personal tax advisor before taking action.