



To Convert or Not to Convert: That is the Question

At the FPA of Puget Sound's Annual Symposium last week, Joe, Therese, and I had the pleasure of attending a presentation by attorney Kaye Thomas, who is a nationally-recognized expert on Roth IRAs, and the author of the book "Go Roth!", a comprehensive guide to Roth IRAs, Roth 401(k)s, and Roth 403(b) plans.

Kaye's presentation focused on Roth conversions: taking dollars from a traditional IRA and converting them to a Roth IRA (paying all tax due as if there had been a full distribution of the funds from the IRA). The topic is timely, as this option to convert will become available to many more taxpayers starting in 2010.

As background, a quick review of the key difference between traditional IRAs and Roth IRAs. Typically, when you make a contribution to your IRA/401(k)/or 403(b) plan you are making contributions on a pre-tax basis. That is, you are not paying income tax on the amount of money you contribute into the plan -- a great deal! The kicker, of course, is that when you take a distribution from this account (presumably at age 59 ½ or older) you are taxed at ordinary income tax rates on the entire distribution. Contrast this with a Roth IRA/Roth 401(k)/ or Roth 403(b). In Roth plans, you get no tax break upfront when you make your contributions -- all contributions are made with after-tax dollars. But when you take a qualified distribution from your Roth, you pay no income tax on the withdrawal -- tax-free distributions!

The inherent differences between traditional IRAs and Roth plans have always generated tax planning opportunities and triggered interest on the part of taxpayers in converting their traditional IRAs to Roth IRAs. However, the income limitations have been fairly strict: conversions were only available to taxpayers with adjusted gross incomes less than \$100,000. Well, in 2010, this income limitation is scheduled to be removed, and the tax planning opportunity door will swing wide open for those individuals who are paying attention.

Who will benefit from converting? There's no generalized rule that applies to everyone, but there are factors that can guide the decision. Taxpayers who may benefit from conversion include:

- Those who don't plan to take withdrawals from their IRA for 15-20 years, or ever. This means younger people, and older people who don't need their IRAs to fund living expenses and are planning to leave large IRA balances to their heirs.
- Those whose expect that their marginal tax rate will rise in retirement, not fall. For example, if you are currently in the 33% marginal tax bracket but you believe

you will be in the 39.6% tax bracket in retirement, a Roth may be right for you. Prevailing wisdom is that tax brackets are likely to head higher in the future.

- Those who can pay the tax due on the conversion with funds outside the IRA. The math doesn't work if you have to take an IRA distribution to pay the tax due on conversion.

Taxpayers who are unlikely candidates for Roth conversion include:

- People with charitable intent in their estate plan, as a traditional IRA will be received tax free by a charity anyway.
- People whose heirs are likely to deplete an inherited IRA in the near term, rather than stretching that inherited IRA over their lifetimes.
- Retired people who are likely to spend their assets down significantly before life expectancy.

The analysis of whether to convert or not is complex, and requires a great deal of thought. We can evaluate your personal circumstances, and assumptions about the future, to determine if you should consider a Roth conversion, and can help model the potential impact using our long term projection software. We'll be talking to many of our clients about this issue this year in preparation for the tax law change next year, so stay tuned.

--Karen O'Brien. Posted 02/16/2009.