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To Convert or Not Convert: The Roth IRA

Recent tax law changes have many investors salivating over the prospects of converting their individual retirement accounts (IRAs) into Roth IRAs. The primary advantages to holding assets in a Roth over a traditional IRA come from the tax-free nature of qualified Roth withdrawals and the minimum distribution requirements (RMDs) affecting traditional IRAs but not Roth IRAs.

Prior to the recent tax change in tax law, taxpayers could only convert an IRA into a Roth IRA if adjusted gross income was no higher than \$100,000. Under the new act, this adjusted gross income limit is removed in 2010. To encourage taxpayers, taxes due from conversion may be spread over a two-year period; half due in 2011 and half in 2012.

In theory, converting an IRA to a Roth IRA has appeal. If minimum distributions are not needed for income, RMD rules serve no purpose other than to reduce the tax-deferred growth benefits of an IRA. Since RMD rules do not apply to a Roth until after the account owner is deceased, assets in a Roth have longer to benefit from tax-free growth. Furthermore, many investors believe that by paying income taxes now - while in a low bracket - they can avoid paying taxes on IRA withdrawals in the future, when rates could be higher.

In reality, we believe many of our clients will choose not to convert their IRAs into Roth IRAs for the following reasons:

1. If you assume you will be in the same tax bracket when IRA withdrawals begin as you are now (a fair assumption), there is very little benefit to conversion. You must expect your personal tax rate to increase by 15% or more for there to be more than only marginal benefits to conversion.
2. Converted Roth IRA balances must be expected to remain untouched, growing tax-free for 30 or 40 years (or more), for real benefits to accrue from conversion.
3. We doubt many of you will opt to pay large tax bills (\$170,000 for a \$500,000 IRA balance at the 34% bracket) in 2011 and 2012 based on assumptions for tax law changes occurring in 2040 or 2050.

On the other hand, if your goal is to maximize your estate for your heirs AND if you do not anticipate ever needing your IRA assets for retirement, taking advantage of the recent tax law change to convert from an IRA to a Roth may make sense. Please call us if we can help analyze whether this conversion is right for you.