

## ROTH IRA CONVERSION

### Does It Make “Cents” For You?

January 1, 2010, marked a new opportunity for high-income earners to convert tax-deferred dollars held in a traditional IRA or old 401(k) into a tax-free Roth IRA. The up-front cost of converting to a Roth can be substantial, however, as it requires paying income taxes now on dollars that otherwise would have continued to grow tax-deferred. Determining whether the potential benefits justify the cost requires consideration of the important factors outlined here.

As of January 1, 2010, anyone with a traditional IRA (including SEP, SAR-SEP, and SIMPLE) or an old 401(k) is eligible to convert to a Roth IRA. The \$100,000 income limit, which previously prevented many people from making the switch, has been eliminated.

So now anyone can convert to a Roth IRA, but why would they want to? The short answer is tax savings. Once you reach retirement age, withdrawals from a Roth IRA are tax-free. In the right circumstances, converting from a traditional IRA to a Roth could substantially increase the after-tax value of your retirement assets down the road.

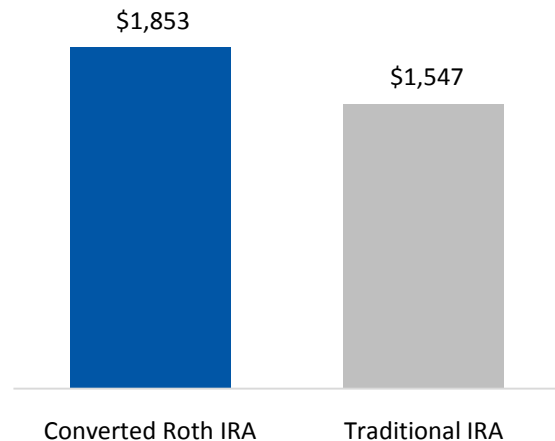
The catch is that converting to a Roth can be expensive. It requires paying income taxes on the amount converted. Deciding whether or not to convert to a Roth comes down to determining if in your circumstances, the future benefits outweigh the current cost.

The analysis is fairly involved and requires making assumptions about the future, such as income needs, tax rates, and returns. Generally, people who meet all of the following three criteria are candidates for a Roth conversion:

- Won't need to withdraw from the account for at least 10-15 years

- Expect to be in the same or higher tax bracket in retirement
- Have cash outside of the IRA to pay the income taxes for the conversion

Conversion may also make sense if you don't expect to need the money in your IRA and want to maximize the wealth you pass to your heirs.



Source: Charles Schwab. Figures represent projected after-tax value of Roth IRA and Traditional IRA after 15 years assuming \$1,000 conversion amount, 25% current tax rate, and 35% future tax rate.

Whether this expanded opportunity to convert to a tax-free Roth IRA makes sense for you depends on a number of factors. Here are some of the key considerations:

**TIME HORIZON**

The further away you are from needing to withdraw from your IRA, the more advantageous pre-paying taxes and converting to a Roth may be. When it comes to tax-free earnings, the more time they have to grow the better.

**TAX RATES**

Your potential tax bracket in retirement is a key variable in deciding whether or not to convert. If you think your tax rate will drop significantly, you probably don't want to convert and pay taxes now at a higher rate. However, if you think your tax rate will stay about the same or rise, converting can net you more after-tax dollars in retirement.

Advantage (Disadvantage) per \$1,000 of Conversion				
Current Tax Rate 25%, 6% Average Annual Return				
Future Tax Rate	Time Horizon (years)			
	5	10	15	20
35%	\$148	\$214	\$306	\$431
25%	\$15	\$36	\$68	\$113
15%	(\$119)	(\$142)	(\$170)	(\$204)

Source: Charles Schwab. Figures represent projected future after-tax difference of Roth IRA minus Traditional IRA. Note that the opportunity cost of the funds used to pay taxes on conversion is taken into consideration.

**PAYING THE TAX**

If you tap into your IRA to pay the tax, you undermine the main purpose of the conversion—to maximize the long-term value of the tax-free Roth. If you're under 59 1/2, paying the tax from the IRA is an even worse idea because it is considered a premature withdrawal and you'll incur an additional 10% penalty. Ideally, you should pay the tax from cash on hand. If you have to sell appreciated assets to pay the conversion tax, the resulting capital gains might offset the benefits of a Roth conversion. The

opportunity cost of what the tax money could have earned had it remained invested in a taxable account must be included in the analysis.

**PARTIAL CONVERSION**

Roth conversion is not an all or nothing proposition. If you are unsure of your future circumstances, a partial conversion can serve as a hedge against possible increases in future tax rates—a tax diversification strategy. Conversion doesn't have to happen all at once either. Smaller amounts can be converted over successive years in order to keep the additional taxable income from bumping you into a higher tax bracket in any single year.

**ESTATE PLANNING**

If you don't expect to need the money in your IRA, converting to a Roth can be a good estate planning strategy. Roth IRAs are not subject to Required Minimum Distributions (RMDs) like traditional IRAs are, once an account owner reaches age 70 1/2. Therefore, a Roth can grow larger than a traditional IRA that starts out at the same size. In addition, the Roth can be passed to your beneficiaries tax-free. Non-spouse beneficiaries would have to take distributions over their life expectancies, but the bulk of the account could continue growing tax-free over their lifetimes. A Roth IRA is one of the most valuable assets you can leave your children or grandchildren.

**THE BOTTOM LINE**

It is worth noting that the main reason everyone was made eligible to convert to a Roth was to accelerate the collection of income taxes that might have otherwise been locked up in traditional IRAs for decades to come. Whether conversion will benefit you (as well as the U.S. Treasury) needs to be evaluated carefully on a case-by-case basis.

All traditional IRAs will be taxed eventually. Deciding whether or not to convert a traditional IRA to a Roth is a question of timing:

- Is it better to convert and **pay taxes now** or **pay taxes later** when withdrawing from my traditional IRA in retirement?
- Given my time-frame, is there a potential advantage to be gained from growing and compounding earnings tax-free in a Roth?

While it is relatively easy to calculate the current cost of conversion, the potential future benefits must be estimated using variables that are subject to change. To convert to a Roth, you have to be confident enough in your assumptions to write a check today for a payoff that won't be fully enjoyed for many years.

We look forward to helping you evaluate all the issues associated with Roth conversion to determine if it is right for you.

## ADDITIONAL CONSIDERATIONS

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### SPECIAL OPTION FOR 2010

There is a special rule in place for 2010 only that allows you to recognize 100% of the conversion income in 2010 or split it equally between the next two tax years (2011 and 2012) and pay the tax then. Note that it is the income that is split, not the tax. You can wait until April 15<sup>th</sup>, 2011, to see what new tax rates, if any, are in effect and then decide which is better for you. The additional income from converting can bump you into a higher tax bracket, so cutting the amount in half could be a big benefit. However, it may be better to recognize the income and pay the tax earlier, if your tax rate is going up.

### CONVERSIONS vs. CONTRIBUTIONS

You are now eligible to convert a traditional IRA to a Roth, but you may not be eligible to make a contribution to a Roth. This is because income limits were eliminated for conversions, but left in place for contributions. Oddly, it is currently permissible for someone who is ineligible to make a Roth contribution to make a traditional IRA contribution and subsequently convert it.

### ROTH CONVERSION DO-OVER'S

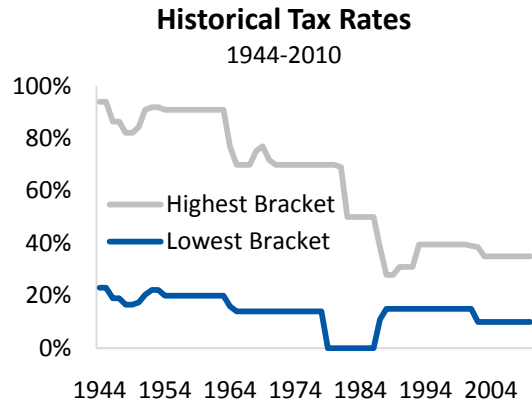
If you convert to a Roth and later change your mind, you have a small window of opportunity to un-do it. It's called a re-characterization and you have up until your tax-filing deadline (plus extensions) for the year to change your mind. For example; if you converted to a Roth and right away the account dropped in value, you could re-characterize the conversion to avoid paying taxes on the higher amount. You could then convert the account again at the lower amount, resulting in lower taxes.

### NON-DEDUCTIBLE CONTRIBUTIONS

Non-deductible contributions you have made to a traditional IRA will not be taxed if you convert to a Roth. The taxable and non-taxable portions of the amount converted from a traditional IRA are calculated based on all your traditional IRA accounts—not just the account(s) you are converting. The portion of any conversion that is not subject to tax would be the total non-deductible contributions made to all your

traditional IRAs divided by the total value of all your traditional IRAs at the time of conversion.

U.S. Congress will do, but it is worth noting that current tax rates are low relative to recent history.



Source: Tax Policy Center. [www.taxpolicycenter.org](http://www.taxpolicycenter.org). "Individual Income Tax Parameters (including Brackets), 1945-2010"

## OTHER IMPLICATIONS

The increase in income caused by a Roth conversion can impact more than just your tax bracket. For example, if you are on Medicare, the extra income can cause your premiums to go up. If you are receiving Social Security payments, it can cause the percentage of your benefits that are considered taxable to increase. The bump in income can also affect eligibility for financial aid.

## FUTURE TAX RATES

Estimating your future tax rate is complicated by the fact that it depends not only on your expected income, but also potential tax bracket changes. Nobody can predict exactly what the

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