

## **Should You Convert All or Part of Your Traditional IRA to a Roth IRA?**

Prior to 2010, anyone with adjusted gross income of more than \$100,000 could not consider converting their Traditional IRA to a Roth IRA. Now, every taxpayer has this option available to them. Why the hype?

- **Major Benefit** – 100% of earnings within a Roth grow completely tax-free!
- **Major Downside** – There is a hefty tax bill which will need to be paid as the amount converted from a Tradition IRA to a Roth IRA is current taxable income. The Federal tax could range from 15-35% (2010 tax rates) of the amount converted. Plus there is the potential of State income tax for non-IL taxpayers. IL doesn't tax retirement income.

**Note** – The tax rules are different for those making Roth contributions than for those wanting to convert money from a Traditional IRA to a Roth IRA. Anyone can convert money from a Traditional IRA to a Roth IRA, but only those with earned income (wage or SE income) can consider making a contribution (which is subject to limitations) to a Roth IRA.

### **Should you Convert?**

This is a complex question as there are a bunch of wild cards. To quote financial planner Michael Kitces, "In sum, estimating the client's future tax rate involves a lot of personal prognosticating, economic prognosticating and political prognosticating, and none of it is very easy." The deciding factor might come down to your feelings about assumptions and forecasts. For two people with the same set of circumstances, one might convert and one will not, and both will feel they have made the best decision. And there is the risk of the unknown – What if the government changes the rules down the road?

### **It's All About the Tax:**

Since you can own exactly the same investments within a Traditional or a Roth IRA, for most account holders the issue primarily comes down to questions about income tax (there are also estate tax implications for those subject to that tax). The decision to convert is totally driven by the tax rates when money comes out of the Traditional IRA versus the tax rate you will pay in making the conversion. Rule – Pay your tax whenever you feel your rate will be the lowest.

Consider the following points:

1. When you convert from a Traditional IRA to a Roth IRA, you pay taxes in the year of conversion based upon your personal tax situation. Conversion can protect you from future tax rate increases as withdrawals from Roth IRAs typically are 100% tax-free.
2. Paying tax now on something that could be tax-deferred goes against the conventional wisdom that one shouldn't pay a penny of tax sooner than necessary, and the idea of writing large checks to the IRS for an uncertain future benefit can feel uncomfortable.
3. In the past it was very difficult to determine if your income or taxes would be higher in the future than what they are now; however, with Bush's tax cuts being eliminated after 2010, the odds are excellent that future tax rates across the board for the same level of income will be higher unless our country goes to a flat or value-added (consumption) tax.

4. Since the beneficiaries of IRAs can withdraw money over their own IRS assigned life expectancy, the tax-deferred or tax-free earnings growth can continue for many years after the IRA owner is deceased.

#### **Traditional IRA Basic Rules:**

1. **Tax-Deferred** Earnings -- In all situations, the account grows tax-deferred (meaning there is no taxation until money is withdrawn from the account). All money withdrawn is taxable income except for those who have made non-deductible contributions.
2. **RMD (required minimum distributions)** – In the year in which a taxpayer turns 70 ½, a RMD must annually be withdrawn from the account to avoid significant IRS penalties (50%). In rough terms, the annual RMD starts at approximately 4% of the IRA account value and goes up over subsequent years as life expectancy goes down. This annual withdrawal causes the account owner to incur taxable income.

#### **Roth IRA Basic Rules:**

1. **Tax-Free** Earnings – All earnings grow tax-free which is substantially better than tax-deferred earnings. After age 59 ½, earnings can be withdrawn tax-free after the Roth IRA has been in place for a 5-year time period.
2. A Roth IRA is not subject to annual RMD's.
3. A conversion from a Traditional IRA to a Roth IRA creates taxable income for Federal purposes. This conversion is not taxable to IL taxpayers or states that do not have an income tax. Be aware, not all states treat a conversion the same way.
4. There is a 10% early withdrawal penalty for withdrawing earnings and the account owner is under age 59 ½. This does not apply to the amount converted.
5. Roth contributions and converted amounts can be withdrawn free of income tax and penalties if the account owner is greater than age 59 ½. For those under age 59 ½, withdrawals of converted amounts would be subject to an IRS penalty if the Roth account had not been open for 5 years.
6. Roth IRA conversions do not have to be an all or nothing conversion. **Just part of a Traditional IRA can be converted.**

#### **Benefits of Having a Roth IRA:**

1. If a taxpayer has both tax-free accounts (Roth IRA) and tax-deferred accounts (Traditional IRA or 401k), the taxpayer will have flexibility that might be beneficial during retirement to manage their personal taxable income.
2. If taxes are paid on a conversion and if tax rates go up in the future, you will have paid income taxes at the current lower tax rate.
3. Roth IRAs provide a significant tax shelter for those who do not need to fully withdraw from their IRAs and plan on passing their account value to heirs.

#### **General Rules to Consider:**

1. If your income is low for whatever reason (unemployment or other large tax losses), it might be advantageous to convert now provided you have non-IRA cash to pay the tax bill on the conversion.
2. If you convert in 2010, the taxes on the converted amount might be lower than what your tax rate will be in the future.
3. If you've made non-deductible Traditional IRA contributions in the past, that portion of your conversion to a Roth IRA will not be taxable.

#### **Benefits for younger people holding Roth IRA accounts:**

1. If you convert to a Roth and five years have elapsed since the conversion was made, amounts converted plus any regular Roth contributions can be withdrawn prior to age 59

½ and there will not be any taxes or penalties on the amount withdrawn (this rule is not true for earnings).

2. The amounts converted to a Roth IRA can be used for other than retirement purposes.
3. There are significant long-term benefits to having tax-free income in later years.

#### **Benefits for older investors:**

1. There is no required minimum distribution (RMD) on Roth IRA balances.
2. Converting to a Roth could reduce the tax you pay on your Social Security income in the years after the conversion. That's because future Roth distributions don't factor into the calculation that the IRS uses to determine how much SS income is taxable.
3. Lower future income could mean lower Medicare premiums which are currently based on your prior years' total income.

#### **Benefit for those with larger estates:**

“The Roth conversion makes the most sense for high-net-worth clients who have the bulk of their assets outside of a retirement account,” and “The conversion is a great strategy for the client who doesn't think they'll ever need to take money out of the IRA to cover living expenses.”

(David Polstra, partner at advisory firm Brightworth Wealth Counsel)

1. RMD's do not start until at least a year after the primary account holder and his/her spouse dies.
2. Estate tax – Because you've already paid income tax on Roth assets, the overall nest egg you pass to your heirs will be smaller and can therefore reduce your estate tax liability. The Traditional IRA by contrast will be included in your estate-tax liability, even though your heirs will have to pay income taxes on these assets. Both Estate and Income taxes will have to be paid on the Traditional IRA account value. The beneficiary does obtain an offsetting Estate tax deduction due to the IRA money being treated as IRD (income with respect to decedent), but many taxpayers miss or don't take this option into future consideration. This is a reasonably complicated area of tax law.

#### **Risks related to Converting:**

A conversion can make sense for individuals in many different situations; however, there are a few situations in which the conversion would be less beneficial:

1. It is best if you can pay the tax associated with the conversion from non-IRA assets.
2. If you pay the income tax from the Traditional IRA and you are under age 59 ½, the amount going towards paying the tax will be subject to a 10% IRS early withdrawal penalty.
3. A conversion is not advisable for those who know they'll be in a lower tax bracket during retirement.
4. Since the amount being converted becomes taxable income, in the year of conversion there is a risk the conversion could disqualify you for tax benefits such as credits and deductions that you would otherwise be eligible for.
5. If your investments tank in value, you will have paid taxes on something that would not have otherwise been taxable. If the investments deteriorate within a year or so, there is a “do-over” any time until October 15<sup>th</sup> of the year after you did the conversion.
6. Will your **state tax** the amount converted. Illinois doesn't tax this type of transaction. Wisconsin has not dropped the \$100,000 AGI threshold limit, meaning unwitting residents over that limit face a penalty for Roth conversions.
7. Extra income – due to conversion – and if you are currently in a lower tax bracket, may cause more of your social security income to be taxable.
8. For those under age 59 ½ who have converted money to a Roth, withdrawals of the converted money prior to a required 5-year wait will cause the amount withdrawn to be taxable. Any withdrawal of earnings (as opposed to contributions or the amount converted) will be subject to income tax and IRS 10% penalty.

9. IRA owners with Medicare Part B who convert to a Roth may subject themselves for a year or two of higher premiums (which are now tied to income in prior years).
10. Investors under age 59 ½ who convert to a Roth would pay an early-withdrawal penalty on that portion of the IRA assets that are used to pay the income tax.

### **Traditional IRA Benefits lost if 100% of Traditional IRA is converted to a Roth IRA:**

In the following situations it has been beneficial to have Traditional IRA balances:

1. If charitable giving is part of your estate plan, contributing from Traditional IRA accounts is significantly more beneficial to your heirs than giving through your non-retirement assets. The same is true if a Charitable Remainder Trust is the beneficiary of the Traditional IRA account. In these situations, the gifted amount of Traditional IRA value is never taxable to anyone. Taxation is totally avoided.
2. Over the past few years, those age 70 ½ were able to make charitable contributions directly from their Traditional IRAs to charitable organizations without incurring any taxation on the withdrawal. Currently this benefit will expire at the end of 2009, but it has been extended or resurrected in the past.
3. Some taxpayers incur significant medical bills related to nursing home stays, etc., and there is an excess amount of tax deduction which will be lost without offsetting income. At times like this a taxable withdrawal from a Traditional IRA can wind up being effectively not taxable.

### **Special 2010 Conversion Tax Rule:**

Only for conversions done in 2010, the law gives you a choice of when to pay the tax. The tax can be fully paid in 2010 (with the filing of your tax return or by making estimated tax payments), or the income can be equally divided and reported over the following 2 years (50% each in 2011 and 2012) and pay taxes in effect for each of those years. If tax rates go up, it might be best to pay the full tax with your 2010 tax return. But if the conversion is large, reporting all of the income in one year could cause higher taxes for 2010.

### **Recharacterization Rule:**

There are situations where something could happen in the near future that would cause you to reconsider the amount you converted from a Traditional IRA to a Roth IRA.

- If the converted Roth assets fall in value, or if tax rates do not go up, or for whatever reason you wind up having lower taxation in the subsequent year, you are allowed to “recharacterize” the amount converted back to a Traditional IRA and no longer owe the tax. You have until October 15<sup>th</sup> of the year after you do the conversion.
- Risk – If you used IRA assets to pay the tax man it reduces the amount available to “recharacterize”.
- To gain the ability to potentially recharacterize the conversion, you will have to extend the filing of your 2010 tax return. We do not believe amending a 2010 tax return will allow for “Recharacterization”.

### **Recommendations:**

- If you convert, convert some, not all of your traditional IRA to a Roth IRA.
- Convert the investments that have the greatest potential for future growth to a Roth.
- Convert the portion of the IRA not needed to live on which is “planned” for your heirs.
- If your taxable income could be lower in the future due to retirement, be very cautious converting now and paying what might be a higher tax rate now versus later.

**Caution** – The information provided is a general summary of the issues related to converting a Traditional IRA to a Roth IRA. Our recommendation is you obtain professional advice pertaining to your situation.