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To Roth or Not to Roth?

Over the past 12-18 months, there has been a significant downturn in the financial markets. IRA accounts and other investment accounts do not have the same value they did at the end of 2007. With the devaluation of these accounts, especially IRA accounts, many people are wondering, “Should we convert part or all of our traditional IRA to a Roth IRA?”

An excellent question but the answer may not be as straightforward. Under current law, to be eligible to convert a traditional IRA to a Roth IRA there is an income limit of \$100,000 that you cannot exceed. If you are eligible and you do convert the IRA, you must pay the tax in the year of conversion.

Now jump forward to 2010. Beginning in 2010, Congress will remove the \$100,000 income limit for traditional IRA conversions to Roth IRAs. Your income will not be a determining factor as to whether you are eligible to convert a traditional IRA to a Roth IRA. In addition, unless you elect otherwise, you will be able to spread out the tax payments on the conversion over a two-year period beginning in 2011.

Now, the question; To Roth or Not to Roth? Although determining whether a Roth conversion is the right move for you depends on your individual facts and circumstances. Following are some guidelines in weighing the costs and benefits of a Roth conversion.

1. Does the cost of the conversion outweigh the benefits? This question also touches on “why do you want to convert to a Roth IRA?” For individuals in retirement, this becomes more an issue of estate planning and leaving tax-free money to heirs. There are two factors to consider:

First, if you do not foresee a need for the money in your traditional IRA you could convert the IRA to a Roth IRA. You are not required to take Minimum Required Distributions (MRD) from a Roth IRA so the Roth IRA would grow tax-free and allow your beneficiaries to receive the amounts income tax-free. However, if you may need to make withdrawals from the IRA within a shorter period, such as five to ten years, it is best to continue with the traditional IRA because the short time horizon will not allow you to recoup the taxes paid for the conversion.

A second factor is your tax bracket at the time of the conversion compared to your tax bracket at the time you expect to take distributions. When you make a conversion, you are choosing between paying taxes now on the balance of the IRA rather than paying taxes at the time of distribution, if the IRA were to remain a traditional IRA. Thus, if you have a traditional IRA and you expect to take distributions from the IRA during retirement, and if you are likely to be in a substantially lower tax bracket at that time, you should probably continue with the traditional IRA.

2. Will the tax liability arising from the conversion be so large that it becomes impractical to make the conversion?

Even if you determine the benefits outweigh the costs you will not want to make an IRA conversion if the tax liability resulting from the conversion will be so large that you cannot pay it. An important factor in making a conversion decision is whether you have the necessary funds outside of the IRA to pay the tax liability. In other words, you should not take money from the traditional IRA or the conversion amount to pay the taxes on the conversion. If you are over 59 ½, the extra funds withdrawn from the IRA will be considered part of the taxable distribution. If you are under 59 ½, the cash used to pay the tax will be treated as a withdrawal and will be subject to the 10 percent penalty tax. In addition, you will have less funds working for you in the IRA and this will lessen the benefit of the conversion.

In general, the greatest benefits to Roth conversions are available to those who will leave the money in the IRA for the longest time as this maximizes the tax benefits of the Roth IRA.

For those in retirement, the Roth conversion may be a worthwhile estate-planning tool. If you convert an IRA and you do not take distributions from it, this asset will pass to your heirs income tax-free at your death. It does not escape death and estate taxes but it does escape income taxes for your heirs.

If you want further information or to discuss whether you should convert your current traditional IRA to a Roth IRA, contact Dennis A Suckstorf, CFP[®], ChFC, AFC, at 410.715.9200.