INTEGRIS WEALTH MANAGEMENT

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To Roth or Not To Roth, That is the Question

with apologies to Shakespeare

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Under current law, high income earners are prohibited from converting an existing traditional tax-deferred IRA to a tax-free Roth IRA. Starting with tax year 2010, the income limit is going away, which creates a significant opportunity for many people. We will be evaluating this opportunity for our clients over the coming months, but would also like to provide everyone in our newsletter community with some background and helpful considerations.

The decision to convert or not is a complicated one. In this newsletter we are deliberately oversimplifying things so you can focus on one important question – is a Roth conversion potentially beneficial to you. If it is, we encourage you to talk further with your financial planner or tax professional.

Why Should I Care?

First, just a bit of background. Traditional IRAs grow tax-deferred. Ultimately you or your heirs will pay ordinary income tax rates on your traditional IRA. Roth IRAs grow income tax-free. Neither you nor your heirs will pay a dime of income taxes on Roth assets. Compounded, tax-free growth over longer periods of time is a powerful wealth building tool.

Traditional IRAs require you to take distributions starting at age 70½. Roth IRAs do not require distributions until they are inherited by your heirs. This adds to the Roth's wealth building capability.

Most IRAs have not fully recovered from the market crisis of last year. Converting to a Roth while valuations are lower reduces the income taxes to pay for converting, and allows recovery growth to be tax-free.

Scenarios in Which a Roth Conversion Can Be Highly Beneficial …

1. A Roth conversion can be very attractive if you pay the income taxes for the conversion from sources other than your IRA (or other tax deferred accounts). REASON – When you make withdrawals in the future, every $1 in a Roth will be worth $1 – whereas $1 in a traditional IRA will be worth a lot less due to income taxes. By paying the conversion income taxes from other sources, you are allowing a lot more money to grow tax-free.

2. If your estate will be subject to estate taxes, a Roth conversion can lower those taxes. REASON – Income taxes will be paid on the traditional IRA eventually. Paying the income taxes now reduces your estate and the estate tax liability, currently assessed at a 45% rate.

3. There are additional benefits to having a Roth if you don't need to withdraw as much during retirement as required by the required minimum distribution (RMD) rules of traditional IRAs. REASON – If you only take RMDs because the IRS makes you, then moving money to a Roth avoids distributions during your lifetime and keeps the money growing tax-free. If your heirs inherit your Roth, they will have to take distributions over their lifetimes, but this could stretch out the tax-free growth for many more decades!

When a Roth Conversion May Not Make Sense …

1. With very few exceptions, a Roth conversion is probably not worthwhile if you cannot pay the income taxes for the conversion from other sources. REASON – If you pay all the taxes due upon conversion from the assets in the IRA, and your tax rate is the same in the future as it is now, there is no benefit to converting. Further, you will be subject to the 10% penalty if you are not at least 59½, in which case you will *lose* by converting.

2. The benefits of converting are diminished and possibly reversed if your marginal tax rate will be significantly lower during retirement. REASON – Paying higher taxes now when you could pay lower taxes later is to be discouraged. However, in the current tax regime, tax rates don't change that much with changes in income levels, so it is very possible that your retirement tax rate will be the same or similar to your tax rate while working. Even if your retirement tax rate is slightly lower, it may not be enough to offset the benefits discussed. Furthermore, income tax rates are at historic lows now and could increase given the large government deficits.

Balancing the pros and cons of conversion is complicated. If you have any questions about the potential benefits of a conversion, we encourage you to speak with your financial planner or tax advisor.

From all of us at Integris, have a great holiday season and a Happy New Year!

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