The Grapes of Roth:

Conversion to a Roth IRA in 2010 and Beyond — Sweet Nectar or Sour Grapes

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This article is an overview discussion of when/whether a Roth IRA conversion is advisable. For a discussion regarding the structure and tax treatment of traditional IRAs and Roth IRAs, and the changes in law that will go into effect on January 1, 2010, see the correlating article in this issue, entitled "The Times, They Are a-Changin': Income Limits on Roth IRA Conversion Set to Disappear in 2010".

Introduction

The decision -- to convert or not to convert your traditional IRA to a Roth IRA -- has long been available to some investors. Congress has always restricted who was eligible for both *conversions* and new *contributions* to Roth IRAs. However, absent an unexpected change in federal tax law, restrictions on Roth IRA *conversions* are lifted starting in 2010 -- meaning conversion will become available to everyone. Even though a conversion is available to everyone, it is not a good idea for everyone. Each owner must decide: (1) whether it is preferable in the future to save with "pre-income tax dollars" (traditional IRAs and the like) or "after-income tax dollars" (Roth IRAs); and (2) whether the owner is willing or able to pay the income taxes associated with the conversion. Helping your client understand and anticipate the factors in this analysis will help to save you and your client from "sour grapes" later on.

This article references (traditional) IRA accounts as being eligible for conversion, and refers throughout to IRA account "owners." However, a Roth IRA conversion may be made not only from a traditional IRA, but also from a qualified retirement plan, such as a 401(k), 403(b), 457(b), and a few other plans, subject to specific plan rules and plan requirements (which may, as a practical matter, prevent conversion in some common situations).

The Magic (and the Pain) of Conversion to a Roth IRA

As is true in most of life, there is a tradeoff in deciding whether to convert to a Roth IRA. That is, there is a price to pay to qualify for the tax advantages of a Roth IRA. The price of a Roth IRA conversion is that the owner must generally pay ordinary income tax on the *entire amount* converted to a Roth IRA account.

The magic is that once the IRA account is converted, withdrawals from the Roth IRA account are *generally income tax free*, whether or not those withdrawals comprise the "original" balance converted or growth or income on the original balance.

In substance, Congress is offering a choice (starting in 2010) for *every taxpayer who owns an IRA account*. Each taxpayer can choose: (1) not to convert to a Roth IRA, which saves income taxes currently, but requires income tax payments when withdrawals are made from the account; or (2) convert to a Roth IRA, which requires large income tax payments currently, but which generally requires no additional income tax payments when withdrawals are made from the account.

The magic is in the tax-free nature of the Roth IRA account. The pain is in the income taxes due after conversion is completed. One silver lining: if the IRA account has, like many, suffered in the market downturn, a conversion may be less expensive than in past years because the lower account value will result in a lower income tax bill when the entire converted amount is included in income. Of course, this idea assumes that the market is comparatively low currently and is likely to rise in the future—an assumption I will let you ponder!

The Who and Why -- Who Should Consider Conversion and Why?

Generally, the longer an owner has to take advantage of the tax-free growth offered by a Roth IRA, the more attractive the opportunity to convert to a Roth IRA will be. A good general rule of thumb is that a Roth IRA conversion should only be considered if the owner is planning to defer distributions for at least ten years *and* if the taxes paid as a result of conversion will be paid from a source outside of the converted account.

However, there is not a simple answer because so many factors and future events are in play. (See Figure 1)

Here are some good general rules of thumb for you to consider:

- *The owner's ability and willingness to pay conversion-related taxes from a source outside of the converted account make conversion substantially more attractive.*
- Rising income tax rates make conversion more attractive, falling income tax rates make conversion less attractive;
- Lower income levels now (compared to the owner or beneficiary's income when withdrawals are expected) make conversion

Figure 1: Factors to Consider in Deciding Whether to Convert

- The owner's current marginal income tax rate (without conversion, with conversion, and perhaps assuming partial conversion);
- The owner's expected marginal income tax rate(s) in the year(s) of withdrawal, if the owner expects to withdraw from the account;
- The beneficiary(ies)'s expected marginal income tax rate(s) in the year(s) of withdrawal, to the extent the beneficiary (rather than the owner) is expected to withdraw from the account after the owner's death;
- The owner's expected overall rate of net investment return, both inside and outside the account;
- The number of years expected between conversion and withdrawal(s) (the owner's age may play a large part in this factor);
- Whether the owner has sufficient assets, liquidity, and disposition to pay the income taxes resulting from a conversion -- preferably from sources other than the account being converted;
- The owner's marital status;
- The possibility that the owner (or the spouse of the owner) will be subject to Ohio and federal estate tax at his or her death; and
- The owner's general estate planning goals, including whether charities are significant intended beneficiaries.

more attractive; higher income levels now (as compared to the owner or beneficiary's income when withdrawals are expected) make conversion less attractive;

- Higher rates of investment return generally make conversion more attractive, lower rates of return make conversion less attractive;
- A longer timeframe between conversion and anticipated withdrawals makes conversion more attractive; and
- The owner's likely exposure to Ohio and federal estate tax at the owner's death make conversion substantially more attractive, because the income taxes paid on the conversion are assets "removed" from his or her taxable estate for estate tax purposes.

Like many financial and legal issues, each family's situation is unique, and the best way to analyze the situation is to work with the family's legal, tax, and investment professionals to gather facts, make some educated assumptions, and then "run the numbers."

Helping Yourself or Helping Your Children?
Another question to consider is whether the owner is making his or her decision based on potential benefit to himself or herself, or based on the potential benefit to his or her children (or others, such as spouses or grandchildren).

Consider that tax paid at conversion reduces the size of the owner's overall estate. Payment of the tax at conversion may save substantial estate tax at the owner's death and will not be considered a taxable gift. The combination of potential estate tax and future income tax savings may make conversion very attractive for owners who are willing to view this decision in an estate planning/wealth transfer context rather than only considering the impact of a conversion on themselves personally.

Clear Cases
Following are some "clear cases" where a Roth IRA conversion should be considered.

1. The owner of a traditional IRA is married, she and her spouse are comparatively young at age 40 and both are professionals, they file income taxes jointly and have a marginal federal income tax rate of 25% presently, they have young children and wish to benefit the children when both of them are deceased, they generally expect their income (and income tax rates) to rise in the future -- even after retirement, and the owner just received an inheritance more than sufficient to pay the income tax liability associated with a Roth IRA conversion without using any portion of the traditional IRA account and without affecting the owner's spending needs.

2. The owner of a substantial SEP-IRA is married, owns and operates a cash basis business with a good track record of earnings. The business is struggling currently due to poor market conditions, and there may be opportunities to influence the timing of some business income and/or business deductions to influence the owner's personal income in 2010. The owner is numbers-oriented and thinks of himself as being highly rational. Historically the owner has been in the top marginal federal income tax bracket (currently 35%) but expects his income to be substantially lower in 2010. The owner and his wife are age 60, file income taxes jointly, and wish to benefit their children when both of them are deceased. The owner has salted away significant savings during his career, both inside and outside the SEP-IRA, and he could raise the cash sufficient to pay the income tax liability associated with a Roth IRA conversion without using any portion of the SEP-IRA account and without affecting the owner's spending needs.

3. The owner of a substantial Rollover IRA is a widow, age 90, in poor health. She wishes to benefit her children and grandchildren at her death, has a marginal federal income tax rate of 25% presently, has a charitable deduction carryforward associated with large past charitable gifts, and has a substantial estate likely to be subject to both federal and Ohio estate taxes at her death. She has significant savings outside of the Rollover IRA that could be used both to pay the income tax liability associated with a Roth IRA conversion and to support her without use of IRA funds. Historically she has taken only the minimum required distributions from her IRA. Her children are all economically successful and her grandchildren are doing well and expect to be economically successful in their own right.

All three of the cases described above present good profiles for Roth IRA conversions. The first two cases present situations where the owner himself or herself will likely benefit from the conversion, but could also benefit beneficiaries after the owner's death. The last case presents a situation where the owner would almost certainly not benefit personally from the conversion, but conversion would likely benefit the intended beneficiaries -- both because it would reduce income taxes due and because, by incurring income tax liability during her lifetime, the owner would reduce the size of her estate for estate tax purposes.

Planning Pointers

1. The 2010 individual income tax returns

will not be due until October 15, 2011 -- with an automatic extension. Because it is generally possible to undo a 2010 Roth IRA conversion with a "recharacterization" in 2011 before the 2010 return is due, account owners may consider converting early in 2010, taking a "wait and see" attitude, and undoing the conversion if investment values plummet in 2010. Alternatively, if investment values soar after conversion, the conversion becomes all the more attractive.

2. The decision of whether to convert is *not* "all or nothing." The owner can convert part of the available account funds each year and still recognize advantages. This partial conversion method may make the situation more palatable to many account owners -- both to "hedge their bets" and to reduce current income tax liability.

Conclusion

Whether a Roth IRA conversion is sweet nectar or sour grapes is dependent upon a number of factors, some of which are particularly difficult to forecast today. While a conversion may be incredibly beneficial to some families (sweet nectar!), the conversion option is neither palatable nor beneficial to everyone (sour grapes!). Our job, in conjunction with our clients' other advisors, is to recognize the issues and help our clients make informed decisions specific to the family involved.

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