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FRANK ADVICE ON

ROTH CONVERSIONS



TAX FREE INCOME FOR LIFE SOUNDS GREAT, BUT ...

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In 2010 many Americans will have their first opportunity to convert their Traditional IRA and 401(k) assets into a Roth IRA.

Roth IRA's differ from their Traditional cousins in that all qualified withdrawals from a Roth are free of income taxes. On the surface, the decision to convert your retirement savings into a vehicle that could produce tax free income sounds great.

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The Roth Conversion Decision

In reality the Roth conversion decision is complex and there aren't simple rules of thumb that you can use very well. Each person's financial picture is different. Further complicating the decision is that assumptions need to be made about investment returns and future income tax rates. Making the correct decision could save tens or even hundreds of thousands in taxes over the years.

There are simple calculators available that offer a quick answer to the question but these require you to input your current income tax rate as well as the rate you'll pay during your retirement years. If you've ever tried to do your own taxes you know that the tax system is complicated. Predicting how your retirement income will be taxed and at what rates is even more difficult.

If you've done any tax planning you know that the first rule is generally to try to defer taxes into the future. By converting your Roth into an IRA the amount converted is subject to income taxes sooner rather than later, probably much sooner. In order for a conversion to make sense you'll generally need to assume that your tax rate will be lower today than in the future when you would draw the funds from the Traditional IRA or 401(k).

Estate Tax Considerations

Income tax rates are the focus of most discussions of Roth conversions but estate tax rates could be another important factor. At this writing in late 2009 the estate tax rates will differ dramatically over the next couple years. If you have a \$3 million dollar estate and die in 2009 there is no federal estate tax because the exemption amount is \$3.5 million. If you die in 2010 there is no estate tax at all (this will likely be changed before New Year's Day). In 2011 the estate tax exemption drops to just \$1 million so a \$3 million estate could face taxes of \$1.1 million at the 55% rate.

The estate tax comes into play with the Roth conversion because the conversion would result in paying more income taxes and thus reducing the size of a taxable estate. Americans that expect to end their lives as millionaires will want to keep a close eye on the estate tax exemption and factor this into their Roth conversion decision.

Beneficiary IRAs

Another factor often overlooked in the Roth conversion discussion is the ability for your heirs to preserve the tax deferral of your IRA by establishing a Beneficiary IRA. Your heir can decide how much of the IRA they want to spend and they only need to withdraw the Required Minimum Distribution based on their life expectancy. A 40 year old IRA beneficiary would only be required to withdraw and pay income taxes on about 2.5% of the account value each year. The remaining 97.5% can continue to grow tax deferred. This may allow your Traditional IRA to continue to enjoy tax deferral for decades after your death.

State Income Taxes

Yet another factor is your state income tax structure. In Michigan, for instance, a conversion to a Roth would be subject to Michigan income taxes. Normal retirement withdrawals from an IRA are free of Michigan income taxes up to \$43,440 (\$86,880 joint) per year. Most Michiganders would thus incur an additional state income tax by doing a Roth conversion.

The biggest factor in the Roth conversion decision is your income tax rate on the conversion versus the tax rate you'll be subject to during your retirement years when you'll draw out the Traditional IRA funds. Many people feel that tax rates will need to increase in the future in order to service the country's growing debt levels and they may well be right. Making the assumption that you'll be in a higher income tax bracket, though, could be a costly mistake. Most retired Americans drop into a lower tax bracket during retirement today and there's little reason to think that the graduated rate structure will change in the future.

You Need a Plan

The best way to assess whether a Roth conversion could save you taxes is to look at your retirement income plan. What sources of income will you have and how will those be taxed? Today stock dividends, interest income, Social Security, and municipal bonds are all taxed at different rates. By assessing your likely retirement income level and the sources you can better estimate your future tax bracket.

The calculations should also address state income taxes, potential estate taxes, and the likelihood of your beneficiaries utilizing a Beneficiary IRA.

Even if it doesn't make sense to convert your Traditional IRA to a Roth you may want to consider directing some of your retirement savings to a Roth IRA or Roth 401(k).

At Vintage Financial Services we've developed an analysis that addresses all of the above factors to help you make a more educated decision. We've also allowed for different income tax and estate tax rates in the future. We can assume income tax rates remain as they are today, revert to the structure under the Clinton administration or climb even higher for the Obama defined "rich" that earn more than \$250,000. Estate tax rates may revert to 55% or stay at 45% as outlined in two bills, one before the Senate and another before the House. The estate tax exemption could also change from the \$1 million in 2011 under current law to \$2 million in the House bill or \$3.5 million in the Senate version.

The Roth conversion decision is one you'll make actively--or passively by ignoring it. One route or the other could mean a big difference in your tax bills over the years. We can help you make a smart decision and also address your overall retirement planning strategy. Contact us today to learn if you are headed in the right direction.

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About the Author

Frank Moore, MS, CFP has counseled clients on retirement strategies since 1983 and has worked with Roth IRAs since they became available in the 1990's. His firm, Vintage Financial Services, manages retirement assets in many different types of retirement plans.