

Roth IRA Conversion: What We're Thinking

We've been reading, analyzing and thinking about Roth conversions since 2006 when Congress enacted the Tax Increase Prevention and Reconciliation Act. Congress' motive was to snag tax dollars sooner than later to offset the spending provisions in the Act.

Tax and financial planning involves making assumptions. We're used to that. But the gravity of assumptions required for Roth conversion calculations are significant. Even the smallest change can have a dramatic impact on the perceived benefits. Therefore, the perceived benefit should be multiple times greater than the tax cost to entice you to pay tax on the funds now instead of in 20, 30 or more years from now.

The greatest value from the conversion comes from the longest deferral. We're talking between 30 to 50 years – a very long time. If the Roth funds are spent sooner, the perceived benefit evaporates.

Three situations collectively offer a strong chance of a long-term benefit from converting to a Roth IRA:

- You have more overall wealth than you will need for your lifetime
- You should be able to pay the tax from non-IRA funds.
- Your children are likely to be in high tax brackets when they receive their inheritance.

If this sounds like you, take your unneeded IRA money and create a Roth IRA - then forget about it and never touch the money again. The Roth will be for your heirs alone to spend.

But beware; if you were to spend the Roth funds before 30 years pass, you would most likely erase the benefit. The tax you paid to convert would become a cost, a loss to your net worth, a mistake ... and the IRS will thank you.

You need to be fairly certain that your children won't be tempted to withdraw and spend the Roth money quickly. To attain the perceived benefit, they should withdraw only the minimum required amount over their life expectancy. At age 60 this would amount to 4% of the Roth IRA value. Will they have meaningful wealth of their own or have other sources of inherited wealth from you? ^[1]

Are you relatively young - under 40? If so, you too might benefit from a Roth conversion in 2010. But, once again, only if you don't need the Roth funds for *at least* 30 years. You also need to be fairly certain that you'll be in a higher tax bracket 30 years from now.

But wait, there's more. A Roth conversion could make sense in *any* year when your taxable income is negative or below 15% so long as your future tax bracket is likely to be the same or higher. Here are a couple of possible situations that would produce a tax benefit from making a Roth conversion:

- If you move to an assisted living facility or a licensed retirement home and receive a large medical expense deduction resulting in low or negative taxable income. These deductions can be over \$100,000 for a couple.
- If you own a business that has a large ordinary loss creating low or negative personal taxable income.
- If you have large amounts of itemized deductions that create low or negative taxable income.

Under one of these low income situations, the Roth funds don't have to be left untouched for 30 or 50 years to be beneficial. But the longer you leave the funds alone, the greater the benefit becomes.

Many are tempted to make a Roth conversion in 2010 without fully understanding the math. Paying the taxes now is like digging a very deep hole. The hole gets filled in slowly with the long, drawn-out benefits of not paying taxes on the Roth IRA withdrawals and earnings for the next 30 to 50 years. It takes about 30 years just to fill up the hole. Don't be lured by a calculation that shows a large dollar benefit. Instead, look for a benefit that is eight or ten times greater than the tax cost. As an example, if the tax cost of conversion is \$50,000, the perceived benefit should be \$400,000 to \$500,000.

We all feel certain that tax rates are going up in the future. Our analysis takes higher rates into consideration. We also considered that in 30 years, the tax laws will be very different than today. There's no guarantee that Roth IRAs will always be untaxed. After all, Social Security used to be tax-free too. If money is needed, the government will find a way to increase revenue and the individuals with means and resources are always a prime target.

After reading this if you're not a candidate for conversion of some or all of your IRA to a Roth, let's review how you will pay tax on your regular IRA. It may not be as bad as you think.

You will take a minimum required distribution (MRD) from your IRA beginning at age 70-1/2. That required distribution starts out at about 4% and climbs very slowly each year. At age 80 you're required to withdraw 5%. It's likely that your IRA will grow faster than the MRD withdrawals for at least the first ten years. Let's put some numbers behind that:

If you have \$1 million in an IRA at age 70 1/2, your MRD will be \$36,496. Depending on your tax bracket and the tax rates, you could pay tax of \$9,000 (~25%) to \$12,000 (~35%). By age 80, if your IRA grows at 7% on average per year, its value will be around \$1.4 million – even after ten years of withdrawals. For that year, your MRD will be \$74,866 and you would pay tax of \$18,000 (~25%) to \$26,000 (~35%.)

Very few with income over \$100,000 are likely to benefit from the Roth conversion. We are prepared to discuss this and address your specific situation if you feel you may be a candidate.

[1] *A couple of technical comments: an inherited IRA is not eligible for a Roth rollover; and minimum required distributions from inherited IRAs are based on single life expectancy instead of joint life expectancy like regular IRAs.*

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