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THE PROS & CONS OF ROTH IRA CONVERSIONS

What are the potential benefits? What are the drawbacks?

Provided by Frank DeMaio*

The Bush-era tax cuts could sunset in 2013, and that possibility has prompted some traditional IRA owners to think about Roth conversions. If tax rates go up, going Roth may be smart. The key word in that last sentence is "may," as going Roth may not be for everyone.

Why go Roth? There is an assumption behind every Roth IRA conversion – a belief that income tax rates will be higher in future years than they are today. If you think that will happen – and many people do - then you may be compelled to go Roth. After all, once you are age 59½ and have owned a Roth IRA for five years (i.e., once five full years have passed since the conversion), withdrawals from the IRA are tax-free.[1]

Additionally, you never have to make mandatory withdrawals from a Roth IRA, and you can contribute to a Roth IRA as long as you live, unless you make too much money to do so – in 2012, the contribution limits are $125,000 for single filers and $183,000 for joint filers and qualifying widow(er)s, with phase-outs respectively kicking in at $110,000 and $173,000. (These numbers represent modified adjusted gross income.)[2,3]

While you may make too much to *contribute* to a Roth IRA, that doesn't stop you from being able to *convert* a traditional IRA to a Roth. Imagine never having to draw down your IRA each year. Imagine having a reservoir of tax-free income for retirement (provided you follow IRS rules). Imagine the possibility of those assets passing tax-free to your heirs. Sounds great, right? It certainly does – but the question is, can you handle the taxes that would result from a Roth conversion?

Why not go Roth? Two reasons: the tax hit could be substantial, and time may not be on your side.

A Roth IRA conversion is a taxable event. When you add the taxable income from the conversion into your total for a given year, you could find yourself in a higher tax bracket. Some of these conversions even lead to the IRA owner's Social Security benefits and Medicare being taxed.[4]

If you are nearing retirement age, going Roth may not be worth it. If you convert a sizable traditional IRA to a Roth when you are in your fifties or sixties, it could take a decade (or longer) for the IRA to recapture the dollars lost to taxes on the conversion. Model scenarios considering "what ifs" should be mapped out.

In many respects, the earlier in life you convert a regular IRA to a Roth, the better. Your income should rise as you get older; you will likely finish your career in a higher tax bracket than you were in when you were first employed. Those conditions relate to a key argument for going Roth: it is better to pay taxes on IRA contributions today than on IRA withdrawals tomorrow.

However, since many retirees have lower income levels than their end salaries, they may retire to a lower tax rate. That is a key argument against Roth conversion.

If you aren't sure which argument to believe, it may be reassuring to know that you can go Roth without converting your whole IRA.

You could do a partial conversion. In fact, you could make multiple partial Roth conversions through the years. Is your traditional IRA sizable? This could be a good idea if you are in one of the lower tax brackets and like to itemize deductions.

You could even undo the conversion. It is possible to "recharacterize" (that is, reverse) Roth IRA conversions. If a newly minted Roth IRA loses value due to poor market performance, you may want to do it. The IRS gives you until October 15 of the year following the initial conversion to "reconvert'' the Roth back into a traditional IRA and avoid the related tax liability.[4]

You could "have it both ways". As no one can fully predict the future of American taxation, some people contribute to both Roth and traditional IRAs – figuring that they can be at least "half right" regardless of whether taxes increase or decrease.

If you do go Roth, your heirs might receive a tax-free inheritance. Lastly, Roth IRAs can prove to be very useful estate planning tools. (You may have heard of the "stretch IRA" strategy, which can theoretically keep IRA assets growing for generations.) If the rules are followed, Roth IRA heirs can end up with a tax-free inheritance, paid out either annually or as a lump sum. In contrast, distributions of inherited assets from a traditional IRA or 401(k) are routinely taxed.[5]

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Citations.

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