

private client and trust

Is a Roth Conversion Right for You?

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Beginning January 1, 2010, all owners of traditional IRAs, regardless of income level, will have the opportunity to convert all or a portion of such accounts to a Roth IRA. Despite what you may have heard, a Roth conversion is not for everyone, particularly those who do not wish to pay an up-front income tax and those whose estate plans* include significant charitable bequests. Because a Roth conversion typically will result in some income tax for the IRA owner, the decision to take advantage of the Roth conversion opportunity requires analysis of the tradeoffs, which in turn depends upon a number of factors.

What Is So Great about a Roth IRA?

Like a traditional IRA, assets inside a Roth IRA may accumulate income tax-free for as long as they remain inside the Roth IRA, so the longer funds can stay invested in a Roth IRA, the more earnings can be enjoyed without income tax. Unlike a traditional IRA, however, Roth IRA distributions are also generally income tax-free so long as two criteria are met: (i) the owner waits 5 taxable years from the date of conversion (or the first contribution to any Roth IRA) to take a distribution; and (ii) the owner has reached age 59½. If you already have a Roth IRA, your 5-year period began when you first opened a Roth IRA. If you have never had a Roth IRA, your 5-year period will begin upon the date of your Roth conversion.

A traditional IRA generally requires that the owner take minimum distributions after age 70½. A Roth IRA owner has no required minimum distributions during lifetime; however, after the death of the owner, the designated beneficiaries must take distributions over their life expectancies.

Unlike a traditional IRA, a Roth IRA allows the owner to continue to make annual contributions even after age 70½, so long as the owner (or the owner's spouse) has earned income, subject to certain income limitations.

What Is a Roth Conversion?

A Roth conversion is the process by which the owner of a traditional IRA converts his or her account to a Roth IRA. Owners of qualified plans (e.g., 401(k) plans and 403(b) plans) who are either over age 59½ or have separated from their employer may also convert such plans to a Roth IRA. Generally, the full amount converted to a Roth IRA will be taxed at the owner's highest marginal tax rate.

*On January 1, 2010, both the federal estate tax and generation-skipping transfer tax were effectively repealed (pursuant to a law enacted almost ten years ago). Under that law, both taxes are set to return on January 1, 2011, but at a 55% maximum rate and with only a \$1 million per person exemption for each tax. As reported in the media, however, Congress could act to reinstate both taxes for 2010, and such reinstatement may be retroactive to January 1, 2010. At this point, we think it is wise to wait to see if any action is taken in the near future before making substantive changes to your estate plan. In the meantime, please contact us if you have any questions about your specific circumstances.

For those who complete a Roth conversion in 2010, the income may be recognized equally in tax years 2011 and 2012. For example, if you convert \$100,000 of a traditional IRA in 2010, you could report \$50,000 of income on your 2011 tax return, and the balance on your 2012 tax return. Notwithstanding the time value of money considerations, you have the option of reporting the entire conversion on your 2010 tax return, which you may wish to do if you believe your income tax rate will be greater in 2011 than in 2010, whether due to tax rate increases or your projected level of income and expenses.

Should I Consider a Roth Conversion?

In general, candidates for a Roth conversion share several common characteristics. They may:

- wish to accumulate retirement plan assets during

lifetime and leave retirement accounts to individual heirs at death free of income tax;

- have a long time horizon after conversion (e.g., 10 years or more) during which the Roth IRA can grow in value to “earn back” the tax cost of conversion;
- have sufficient liquidity outside of retirement accounts to pay the income tax due as a result of the conversion;
- not be planning to take substantial distributions from retirement accounts to pay for annual living expenses during retirement;
- believe their income tax rate will be greater in the future than it is now; or
- have significant tax deductions, which would allow them to convert to a Roth IRA at little to no current income tax cost.

The impact of each of these factors needs to be assessed in each individual case.

Note that any income taxes generated by the Roth conversion will reduce the owner's net worth and, accordingly, the owner's taxable estate, thereby reducing federal and state estate taxes upon the owner's death.* Although the Roth IRA will be subject to estate taxes at the owner's death (which has always been the case for both Roth and traditional IRAs), the beneficiaries will receive the Roth IRA free of any income tax liability on future distributions.

Why Not Do a Roth Conversion?

Despite what you may see in the media, a Roth conversion is not for everyone. For example, the following taxpayers either cannot or should not convert:

- those who only have a qualified plan (i.e., no IRAs) and either are under age 59½ or have not yet separated from their employer; or
- those whose goal after death is to benefit a charity, which may be done with retirement accounts, thereby avoiding future income taxation on IRA balances.

In addition, you also may decide that you do not wish to pursue a Roth conversion if you:

- do not have a long time horizon after conversion to offset the present value of the tax cost upon conversion;
- do not have liquidity outside of your retirement account to pay the income tax due upon conversion;

- anticipate needing to take significant distributions from your retirement accounts to pay for your annual living expenses when you retire; or
- believe your income tax rate will decrease during retirement.

Keep in mind that a Roth conversion is not an all-or-nothing proposition. Many people will find that it makes sense for them to convert some portion, but not all, of their retirement accounts to a Roth IRA.

Can I Undo a Roth Conversion?

If you make a Roth conversion in a particular tax year and then change your mind, you may recharacterize your Roth IRA back to a traditional IRA, but you must do so before the deadline for filing your income tax return for that year. This option could be useful if, for example, you convert to a Roth IRA in early 2010, but the account value on which you owe income taxes as a result of the conversion declines significantly by December.

Conclusion

The Roth conversion opportunity may have significant benefits for some; however, the benefits of a Roth conversion should be carefully considered in light of your particular circumstances, and after consultation with your financial and/or tax advisor.

For questions about the information contained in this advisory, please contact any member of the [Private Client & Trust](#) and [Tax](#) Groups, or your usual Goulston & Storrs attorney.

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