

Should you convert your Traditional IRA to a Roth? Yes, definitely! Unless you shouldn't. This is not a black or white issue, but rather one I view in shades of Technicolor.

These days it is hard to go anywhere without hearing people discuss their plans for a Roth conversion, which they believe is a slam dunk decision because of the concept known as "2010." What we know about 2010 is that the conversion opportunity applies to many more investors since the \$100,000 AGI cap, currently in place, will be eliminated. On the surface, this means that many investors who previously were ineligible to convert to a Roth would become eligible to do so. Further examination, however, demonstrates that eligibility alone is not an adequate reason for converting. I saw this as an opportunity to reach out to clients and help them understand what effect, if any, the changes occurring in 2010 would have on them.

Generally speaking, it may make sense to convert funds from a Traditional IRA to a Roth IRA and pay current income tax on the amount converted under the following conditions:

- You anticipate being in the same or a higher tax bracket when you plan to withdraw the funds
- You generally have a long time horizon AND
- You can pay the taxes resulting from the conversion from a source other than your IRA and without creating additional capital gains, which I will address later in greater detail

Or

- You do not need to use the IRA funds to support your lifestyle and wish to leave an income tax-free asset to your heirs as part of your estate plan

It is important to note that this article focuses on the decision process surrounding Roth IRA conversions and not the decision whether to contribute to a Roth in place of making a deductible contribution to a Traditional IRA in a particular year.

Though there are a number of differences between Traditional and Roth IRAs, the most pertinent points concerning Roth conversions relate to withdrawals and the taxation thereof.

In the case where deductible contributions were made to a Traditional IRA, withdrawals of these pre-tax dollars and the earnings would be taxed at the owner's marginal tax rate. Contributions to Roth IRAs are not deductible, but withdrawals from a Roth IRA are tax-free. Moreover, Traditional IRA owners must take annual Required Minimum Distributions (RMDs) beginning at age 70 ½ while there are no RMDs for Roth IRA owners during their lifetime.

Before we proceed, let's clarify one important point. Converting to a Roth IRA primarily involves speculation that your marginal tax rate will be higher in the future than it is now. While this may seem likely, it remains but a guess until the tax laws are actually changed. I certainly agree that marginal tax rates are currently low relative to historical levels and that they are likely to increase for certain taxpayers in the future, but I must base my Roth conversion analysis on the facts as they stand today, arming clients with the information they need to make their decision.

In researching Roth conversions, we concluded that there was no available resource to help IRA owners analyze this decision in its entirety. Sure, there are a multitude of IRA conversion calculators available on the Internet, but invariably they focus on answering the simple question of which gives the client a higher dollar value in the future. While this is certainly a relevant factor in the analysis, we believe that the conversion must be evaluated within the context of a client's overall financial circumstances.

Admittedly the Roth conversion can be a delicate subject for many advisors because frequently the recommendation to convert Traditional IRA assets to a Roth may be in conflict with the advisor's business model. A Roth conversion and the resulting taxes due may significantly decrease the amount of assets under management, thereby reducing management fees, the sole revenue source for fee-only advisors. I emphasize that it is the duty of a fiduciary to acknowledge this conflict of interest to the client and that recommendations either for or against should be properly supported within the context of a client's particular circumstances.

In our experience, we recognize that the conversion decision can be a complex one, with multiple factors affecting the outcome. Below are a few of the main advantages, disadvantages and important considerations to keep in mind when evaluating the conversion decision. This is by no means a comprehensive list, but is meant to exhibit the potential complexities involved in the decision:

Advantages:

- Roth conversions may be a valuable strategy to clients who expect to be in a higher marginal tax bracket due to higher taxable income in the future either as a result of changes in tax law or required minimum distributions (RMDs) from Traditional IRAs. Roth IRAs are not subject to RMDs during the life of the owner, providing shelter from income tax in years where additional funds are not needed for cash flow and an RMD will cause unnecessary taxes.
- For those who intend to leave their IRA balance to heirs, converting to a Roth may be an advantage as the expense of the conversion taxes paid reduces the size of the estate while securing tax-free growth of the funds for the remainder of the owner's life as well as for the heirs. For the strategy to be effective, it is important for clients to know whether they will need to use IRA funds during their lifetime, an area of focus between Evensky & Katz advisors and our clients.
- The Roth tax-free income stream may be advantageous because it affects the taxation of benefits from Social Security. Once a client's income exceeds a relatively low threshold, up to 85% of Social Security benefits received may be taxable as ordinary income at the taxpayer's marginal rate. The advantage of Roth IRA distributions is that they are not counted under the category of "tax-exempt income" nor as taxable income that goes into the calculation to determine the amount of the Social Security benefits received that will be taxable at the taxpayer's marginal rate.
- For investors whose IRA accounts have declined in value due to poor investment returns, a conversion at the reduced value allows for lower taxes to be paid on the conversion and would capture any future appreciation in the tax-free Roth vehicle rather than in the tax-deferred Traditional IRA. If a conversion is made and the account value subsequently declines, it is possible to recharacterize the conversion back to a Traditional IRA within the same tax year and attempt to convert again at a later date pending eligibility and provided that converting remains in the taxpayer's best interest.

Disadvantages:

- In general, clients should have sufficient available funds to pay the taxes resulting from the conversion. Paying the taxes through additional IRA distributions may minimize some of the conversion benefits and permanently disrupts tax-deferral on the distributed funds. Additionally, if under age 59 ½, tapping an IRA to pay taxes on the conversion will result in a 10% penalty on the amount withdrawn for taxes, in effect boosting the current tax rate! While paying taxes from the IRA does not universally disqualify the strategy, it presents a significant challenge to overcome.
- A taxpayer's income may drop after retirement and even though tax rates may increase across the board, taxpayers could conceivably find themselves in a lower tax bracket, making taxation of distributions from a Traditional IRA at ordinary income levels less of a problem.
- Distributions from a Roth IRA are not subject to income tax or the additional 10% penalty as long as they meet the criteria for qualified distributions. However, to be considered a qualified distribution to the owner, the distribution must generally occur following a 5-year holding period from when the contribution or conversion was made to the Roth IRA, creating a potential liquidity challenge for the owner should he or she need to access the Roth assets within the holding period.
- Poor investment performance in the years following the conversion may be particularly detrimental to a client's plan as liquidity can become a problem. Already subject to the loss of use of the converted Roth

assets during the 5-year holding period and having covered a potentially large expenditure for taxes, clients may be forced to sell assets at the wrong time to fund living expenses unless they use an effective cash flow reserve strategy. In a perfect world, clients would have substantial other assets to use in funding living expenses, but in the real world, we find that there is no substitute for good planning.

Important Considerations:

- A taxpayer who converts a Traditional IRA to a Roth IRA in 2010 may elect to spread the resulting conversion income in equal parts over the tax years 2011 and 2012. However, these taxes in 2011 and 2012 would be assessed at the current marginal rate in effect for that year. In essence, the taxpayer is risking the possibility of facing higher taxes on the conversion amount than would have been due had the taxes been paid in 2010. If the taxpayer's conversion was based on the anticipation of higher taxes in the future, spreading the tax payments over 2011 and 2012 may cause the unintended consequence of higher taxes due from the conversion.
- Roth conversions can be applied to whole IRA account balances or only to a portion of the account. Withdrawals of pre-tax contributions to Traditional IRAs or pre-tax contributions that were rolled over from a qualified retirement plan are taxable as ordinary income along with the earnings on these contributions. However, non-deductible contributions from a Traditional or rollover IRA can be withdrawn tax-free while only the earnings are taxed as ordinary income. Be sure to consider aggregation rules if considering conversions of rollover IRAs that contain after-tax contributions.
- Aside from the \$100,000 AGI cap in place through the end of 2009, eligibility is limited to taxpayers who file their returns as Single, Single Head of Household or Married Filing Jointly. Excluded are those who file under Married Filing Separately.
- Assuming that the taxpayer has sufficient non-IRA funds available to pay the conversion taxes, it is important to understand the opportunity cost of paying the taxes upfront rather than investing those funds in a tax-efficient manner.
- Some taxpayers may have net operating loss carry forwards, charitable contribution carry forwards, unused tax credits or Alternative Minimum Tax (AMT) credits that may impact their decision. In some of these cases, the income generated by the Roth conversion may be beneficial in utilizing certain of these carry forwards and credits.
- For taxpayers facing AMT exposure, income recognized from a Roth conversion may help them avoid AMT liability depending on the taxpayer's individual circumstances.
- There is a degree of legislative uncertainty in the years to come. Future legislative changes may someday enhance or reduce the benefits of Roth conversions.

Paying Taxes on the Conversion

One of the most frequently debated areas of Roth conversions is the strategy for paying taxes on the conversion. To recap, we know that the conversion is a taxable event and that at least with conversions in 2010, taxpayers have the choice of paying the taxes as part of their 2010 return or deferring them to be averaged between 2011 and 2012. We also know that since the taxes paid will be calculated at the marginal tax rate in the particular year they are paid, there may be some risk of paying higher taxes in 2011 and/or 2012 than in 2010.

General rules of thumb to consider when determining how and when to pay your conversion taxes:

- Taxes paid from a Traditional IRA can be costly as the potential for any tax-deferred growth on the amount paid is lost. Further, taxpayers under 59 ½ incur an additional 10% penalty on the portion used to pay taxes.
- It is recommended that taxpayers set aside cash in advance to pay conversion taxes. If the taxpayer is forced to sell appreciated assets to afford the taxes, the effectiveness of the conversion may be compromised by the additional capital gains taxes generated from the sale of these assets.

One strategy that may help hedge against the uncertainties of both future market performance and potentially higher marginal tax rates in 2011 and 2012 is to perform a conversion early in 2010 and then adopt a "wait and see" approach. By filing an extension for the 2010 return, the taxpayer would have until October 15th of 2011 to decide whether to recharacterize the conversion. Assuming that the taxpayer is in a position to properly observe

the 5-year holding period following the conversion, this allows for a potential investment performance observation period in excess of 21 months and presents the taxpayer with the ability to identify his or her actual tax rate for 2010 as well as to be reasonably certain of the applicable tax rate for 2011 and perhaps even for 2012.

Having assisted a number of clients with Roth conversions, I can tell you that the mechanics are fairly straightforward. The client opens a new Roth IRA account and the assets from the Traditional IRA are placed in the Roth account. The conversion itself does not require securities to be sold so transaction fees are not a factor. However, since the conversion is a taxable event, it is critical for clients to understand how the associated taxes affect them and we recommend that clients review the conversion jointly with their accountant and Evensky & Katz advisor prior to making a decision.

At Evensky & Katz, the cornerstone of our approach is financial planning and empowering our clients to make sound financial decisions. Rather than focusing merely on achieving the higher future dollar amount, we direct our efforts toward identifying the strategies that enhance the probability of our clients achieving their goals.

In evaluating a client’s decision, we model and rigorously stress test each scenario to help clients understand how the conversion fits into their overall financial situation, whether or not it enhances the probability of their achieving their goals, and if it does not, whether they can afford the risk of converting anyway as a hedge should they wish to do so.

For those readers who are already clients, some of you have made the decision to convert to a Roth, some of you decided against it and others are actively evaluating the decision with us. In many cases our collective conclusion was different than you may have anticipated prior to going through the evaluation process. As clients, you are in a far better position than we are to describe the benefits of our focus on financial planning and if you know someone who is curious about how a Roth conversion may affect his or her overall financial situation or who perhaps struggles with questions we can answer, we would be delighted if you would tell them about us.

Traditional IRA vs. Roth IRA

Traditional IRA	Roth IRA
No income restrictions for participating	Income restrictions for contributing: Single MAGI Phaseout \$105,000 - \$120,000 Married Filing Jointly MAGI Phaseout: \$166,000 - \$176,000
Contributions may be tax deductible depending on income level and active participant in a qualified employer sponsored retirement plan (defined as eligible to participate, not limited to those actually deferring into a plan)	Contributions are not tax deductible
Can be funded with pre-tax or after-tax dollars (affects taxation when funds withdrawn)	Funded with after tax dollars
Withdrawals not classified as hardship withdrawals (including principal contributions) prior to age 59 ½ are subject to a 10% penalty	Principal contributions can be withdrawn at any time without penalty
Qualified withdrawals (other than hardship withdrawals) may begin at age 59 ½ and owner is subject to Required Minimum Distributions (RMDs) at age 70 ½	Not subject to RMDs during owner’s lifetime
Taxes on earnings deferred until withdrawn	Earnings can be withdrawn tax-free if at least age 59 ½ and have satisfied 5-year holding period

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