

Roth IRA Conversions

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June 30, 2010

Introduction

Beginning in 2010 anyone can convert their traditional IRA into a Roth IRA regardless of income level. If you do such a conversion, all of the assets converted will be taxed to you as ordinary income now, for both federal and state income taxes¹. The offsetting benefit is that all of the future earnings and withdrawals in the Roth account will be tax free forever.

If many people take advantage of this option, the government will collect a lot of taxes that would have otherwise been deferred for many years. But should you do it? It turns out to be a more complicated and uncertain decision than you might think at first sight. The two most important factors are the following:

- (1) Present versus future tax personal tax rates - The expected difference, if any, in your personal tax rates now, at the time of the conversion, compared to years down the road when you would have been taking distributions from your traditional IRA had you not converted. Significantly, it is not only how the statutory tax rates may change, but within which tax brackets your own IRA withdrawals may ultimately be taxed that matters.
- (2) Source of funds for paying taxes - Your ability or lack thereof to access the funds needed to pay the conversion taxes from some source other than the traditional IRA itself.

Two more important issues include the amount of money you convert and the length of time before you will be redeeming your IRA assets. There are numerous additional issues affecting this decision depending on one's personal situation. I will touch on them briefly, but this article is not meant to be a comprehensive guide book². The focus is on your decision to convert or not convert. The objective is to provide enough information for you to decide either:

- (1) Possible conversion benefits look interesting enough that you would like to spend the time to do a customized analysis of your personal situation, or
- (2) Your situation does not warrant further consideration of conversion, at least not this year.

If you think you fit in the first group, please let me know and we can discuss next steps for looking into your own situation more fully.

¹ There is a special provision if the conversion is done in calendar year 2010 in which you can defer half the taxable income to tax year 2011 and half to 2012. However, with the top two tax brackets highly likely to increase starting in 2011, this does not appear to be such an attractive option. The special provision applies only to conversions done in 2010.

² I have plenty of other articles about the subject if anyone is interested.

There has been a good deal of sound and fury in the press and in the financial planning industry about Roth IRA conversions. Some of the information is worthwhile, but much of it is unsavory. Numerous types of vendors, consultants, pundits and the like have deemed Roth conversions a potentially lucrative business opportunity. Some want to sell conversion software. Some want to use conversions as a marketing pitch to obtain new advisory clients. And others want to use it to sell marketing or consulting services to financial planners like me. In short, the option of converting traditional IRA's to Roth IRA's has been over-hyped for commercial reasons. Although some spokesmen make conversion sound like a fantastic opportunity, I don't believe that a significant portion of IRA assets have been or will in fact actually be converted this year.

There is a real attraction to conversion. The idea of getting one's tax burden over with and never having to pay taxes again on earnings or withdrawals is alluring. But one thing is for sure. The cost of conversion, which is the tax bill it generates, is certain and will occur now. The benefits, whether they outweigh the costs or not, will accrue years in the future and are uncertain in magnitude.

Lest I sound too negative at the outset, let me acknowledge that Roth conversions can generate significant benefits for some people. In particular, if your personal tax rates in retirement will be as high or higher than your marginal tax rate will be this year (after adding the converted assets to this year's other taxable income), and you have sufficient assets outside of IRA's and other tax advantaged accounts to pay the conversion taxes (without realizing significant capital gains in the process), then the expected present value of a Roth conversion would almost surely be positive for you³.

The Tax Equivalency Principle

To understand why the two issues introduced above are the most important factors affecting the Roth conversion decision we must begin by understanding the tax equivalency principle of traditional and Roth IRA's. I would argue that the tax equivalency principle is the single most important thing to understand in this whole matter.

But before getting into this we must be sure to understand the difference in the two kinds of IRA's. A traditional IRA, as well as numerous other kinds of retirement accounts like 401k's, 403b's, qualified profit sharing plans and others, are tax deferred plans. The individual is allowed to invest pre-tax dollars into the account, but ultimately pays ordinary income taxes on the full amounts that are withdrawn, both principal and investment earnings. The benefit derives from the fact that the account may grow on a tax deferred basis for many years. In particular, the amount of money that would have been lost to taxes in the initial year of the investment is instead allowed to earn investment returns for many years before it is actually collected. All of the after tax returns on that tax deferral amount are a pure benefit to the individual.

For a Roth IRA, there is no tax deferral on the amount initially invested. In other words, the account must be funded with after tax dollars. But all of the future earnings on the account, as well as all withdrawals of both principal and investment earnings (be they income or capital gains), are completely tax free. (This assumes that the account has been held for at least five years and that the taxpayer is over age 59.5 when the withdrawals are made.) The two kinds of plans may sound quite different at first, but under certain conditions their benefits can be identical.

³ Notice the qualifier "expected" present value of benefits. You won't know until many years down the road just when you will need to use your retirement assets and what your actual future tax rates will be at that time.

The tax equivalency principle is the following. Compare the case (1) of allocating a certain amount of fully deductible pre-tax income to a traditional IRA, to the case (2) of instead paying tax on that amount of income now and allocating what is left over to a Roth IRA. For example, suppose the individual could allocate \$10,000 of pre-tax income to a traditional IRA, or instead pay taxes on that amount at a 40% marginal rate and invest the \$6,000 that is left over into a Roth IRA. Then if we assume the individual's tax rates do not change over time, the tax equivalency principle is that the two kinds of IRA's would be mathematically identical to one another. This assumes the individual utilizes the same investments in either case and holds the money in the IRA accounts over the same period of time in either case. But the equivalency result does not depend at all upon what kinds of investments are utilized or on their rates of return or upon the length of the holding period. It depends only on the commutative property of multiplication.

It is a very simple algebraic equivalency. We need only 4 variables:

- A = amount of pre-tax income dedicated to a retirement account
- R = annual rate of return earned in the retirement account
- N = number of years the money is held in the account before it is redeemed
- T = income tax rate

Then for a traditional IRA, the value of the account at the time of withdrawal N years from now is:

$$\text{Traditional IRA Value} = A \cdot (1 + R)^N \cdot (1 - T)$$

In the case of a Roth IRA, we pay the taxes on the amount A first, and since the tax rate is by assumption the same as that in the other case, the amount we have left to invest in the Roth is $(1 - T) \cdot A$. There are no further taxes on the Roth assets, so its value N years from now would be:

$$\text{Roth IRA Value} = (1 - T) \cdot A \cdot (1 + R)^N$$

The only difference in the two equations is in the order of multiplication.

The source of benefits of a Roth IRA is easy to see. All investment returns, be they capital gains, dividends or interest, are made completely tax free. The tax equivalency principle means that this is also the benefit of tax deferral. I.e., deferring taxes on one's initial investment and on all earnings until the date of withdrawal is equivalent to simply having all taxes on investment returns in a regular taxable account be forgiven.

The tax equivalency principle applies to a conversion of an existing traditional IRA to a Roth IRA the same as it does to the comparison of where to allocate an initial amount of pre-tax income, if we consider that we would pay the taxes generated by the conversion from the IRA itself. An example is shown in Table 1. We assume the investor has \$100,000 in a traditional IRA and is considering converting it to a Roth IRA. She has a 40% combined federal and state marginal tax rate, and she expects to have the same tax rates indefinitely into the future. Whether she converts or not, she will hold the assets for 20 years before using them, and she will invest in the same investments in the same proportions in either case. We assume she earns just enough to triple her initial balance in 20 years. This turns out to require a compound return of 5.65% per year, but as we have seen, neither the rate of return nor the holding period have any effect on the comparison of accounts in this case, only that the assets are invested the same way in either type of IRA account.

What is important to keep in mind here is that the investor decides to convert only just enough traditional IRA assets (\$60,000) so that she will have enough assets left over in the traditional IRA (\$40,000) to pay the 40% conversion taxes⁴. We see by the bottom line in the table that after all taxes have been paid, the amount left over for her own use is exactly the same in each case, \$180,000.

Table 1 - Conversion Case 1
Tax Rates Constant, Taxes Paid from IRA

	Conventional IRA	Roth IRA
Account Balance	100,000	100,000
Conversion Tax (40% rate)	-----	40,000
Account Balance	100,000	60,000
Growth of Accounts (20 years at 5.6% annually triples the balance)	300,000	180,000
Tax on Withdrawal (40%)	120,000	-----
Account Balance	180,000	180,000

Effects of Changing Tax Rates

The benefits of converting or not converting were identical in the above example. But what if the tax rate our investor paid due to a present day conversion was different from the tax rate she would have paid if she had held her traditional IRA and withdrew the money many years in the future? The quick answer is that if the tax rate is going to be higher in the future, then it is more beneficial to do a conversion now and enjoy today's lower tax rate. But if tax rates are going to be lower in the future, the investor is better off to leave the assets in a traditional IRA.

The two cases are illustrated in Tables 2 and 3 using the same assumptions as in the simple example above except for the tax rates. In Table 2, we assume today's combined marginal rate is only 30%, but that the rate when the investor is planning to use her funds (20 years from now) will be 40%. In this case the future value of the Roth IRA is larger by \$30,000.

⁴ Be careful of this assumption! If the account owner is not at least 59 ½ years old at the time of the conversion, the amount of IRA assets held over to pay the conversion taxes would be considered a premature distribution and would therefore be subject to a 10% penalty -- \$4,000 in this case – in addition to the ordinary taxes due. An alternative could be to leave the \$40,000 in the IRA and access the money needed to pay the taxes from elsewhere, as this would avoid the penalty.

Table 2 - Conversion Case 2
Future Tax Rates Higher than Current Rates

	Conventional IRA	Roth IRA
Account Balance	100,000	100,000
Conversion Tax (30% rate)	-----	30,000
Account Balance	100,000	70,000
Growth of Accounts (20 years at 5.6% annually triples the balance)	300,000	210,000
Tax on Withdrawal (40% Rate)	120,000	-----
Account Balance	180,000	210,000

By contrast in Table 3, we assume that today's combined marginal rate is 40%, but that the future rate will be only 30% when the traditional IRA would be redeemed and taxed. In this case the investor would be better off by \$30,000 if she did not convert to a Roth.

Table 3 - Conversion Case 3
Future Tax Rates Lower than Current Rates

	Conventional IRA	Roth IRA
Account Balance	100,000	100,000
Conversion Tax (40% rate)	-----	40,000
Account Balance	100,000	60,000
Growth of Accounts (20 years at 5.6% annually triples the balance)	300,000	180,000
Tax on Withdrawal (30% Rate)	90,000	-----
Account Balance	210,000	180,000

The Effective Rate Is Not Always the Marginal Rate

When thinking about tax rates it is very important to realize that it is the effective rate the taxpayer pays on his or her IRA conversions or redemptions that matters, not what the statutory tax bracket rates are. It is extremely likely that at least the top two statutory tax

bracket rates are going to increase very soon, probably next year⁵. But depending on one's age and current income level, it is quite possible that an individual will be in a lower tax bracket when he is in retirement and beginning to access his IRA assets than he is now.

And there are two other factors that make lower effective future rates even more likely than you might think at first. For one, the rate one would pay on a conversion this year may be affected by the amount of money converted. For example, if a married couple expects to have \$200,000 in taxable income this year, they could look at the tax tables and see their marginal rate would be in the third bracket down, which is currently 28%. But if they convert more than \$10,000 out of a traditional IRA, this additional taxable income would push them into the second tax bracket, which is 33%. All but the first \$10,000 of the conversion would be taxed at a higher rate. In fact, if they converted an IRA worth more than \$174,000, they would be pushed all the way up into the top marginal tax bracket, which is 35% (and slated to go up to 39.6% next year). So the individual has to consider how much extra tax they would have to pay as a result of the conversion, and their effective rate may well be higher than what their marginal rate would be in the absence of a conversion.

The second factor is that traditional IRA assets would almost never be redeemed in one lump sum such as shown in our examples. Rather, the individual would likely take out small portions each year, as needed for living expenses or as required by RMD's. In fact, a financial planner's prescription for retirees trying to choose where to get needed cash flow is usually to consider IRA's as their last source of income; i.e., to stretch out the tax deferral or exemption as long as possible⁶.

Further, in this case especially, we need to look at the average rate of tax paid on the IRA redemption, not necessarily the marginal rate. If one's taxable income in retirement is relatively low, it is quite possible that IRA redemptions could span more than one tax bracket. Consider an example of a married couple that has \$40,000 of taxable income aside from any IRA redemptions. This places them (using 2010's tax tables) in the fifth bracket down, which has a 15% marginal rate. If they redeem \$100,000 from their traditional IRA, this would increase their taxable income up to \$140,000, and move them all the way up to the third bracket, which has a marginal rate of 28%. But it is not correct to consider 28% to be the effective rate for this IRA redemption. A straightforward reading of the tax table shows that \$18,000 of the redemption would be paid at the 15% rate, \$69,300 at 25%, the next rate up, and the remaining \$12,700 at 28%. The total federal taxes generated as a result of the redemption work out to \$23,581. So the effective tax rate for this redemption would be 23.6%, not the 28% marginal rate.

And actually for some people there is a third issue to keep in mind when forecasting future versus current effective personal tax rates. In retirement a larger than normal fraction of one's cash usage may not count as taxable income. This can include some or all of one's social security income. But more important for some of our clients, when one gets to the point of

⁵ If Congress does nothing, federal tax rates will automatically revert to their pre-Bush tax cut values starting in 2011. It appears likely that this will be allowed to happen for the top two brackets, which means they would rise from 33% and 35% to 36% and 39.6%, respectively. However, based on Obama's consistent policy pronouncements, it appears equally unlikely that the lower four bracket rates will be allowed to increase next year.

⁶ This would also be the prescription for a retiree owning a Roth IRA. Even though redemptions from Roth's do not generate taxable income, taking money out has a big opportunity cost because one loses the right to earn returns from those assets in the future on a tax free basis.

withdrawing money for consumption from one's taxable accounts, the portion of withdrawals that counts as principal (i.e., the cost basis) does not count as taxable income. Another portion of withdrawals may be capital gains, and although capital gains rates will almost certainly be higher in the future than they are now, they will still almost surely be lower than ordinary income tax rates. And finally, some of us may be lucky (or unlucky) enough to still have some capital loss carryovers that have the effect of wiping out taxes on current capital gains. So the bottom line is that in retirement, if cash flow is managed well, personal spending may be less correlated to taxable income than during one's working years.

From all that has been presented so far, Roth conversions would not sound like a very good idea for just about anyone still making enough income to be in the higher income tax brackets. And even for someone already retired or otherwise having low or modest taxable income, the idea sounds a bit marginal; namely you get sure thing tax costs now versus hoped for but quite uncertain tax benefits in the future. However, our discussion so far has been missing one large piece of the puzzle, and it could in some cases add a substantial benefit to the conversion option. This piece of the puzzle is what I will call the "magnitude effect".

The Magnitude Effect of Roth Conversions

When we discussed the tax equivalency principle, we compared allocating a certain amount of pre-tax income to a traditional IRA versus allocating the after tax amount of that income to a Roth IRA, and we showed if tax rates don't change, those two investment options would be identical. For example, in Table 1 we compared starting with \$100,000 in a traditional IRA with paying one's taxes on that amount first, and investing the \$60,000 left over in a Roth IRA. But here is the wrinkle. The law says we can convert the entire amount of our traditional IRA to a Roth, not just the amount left after paying the conversion related taxes. So clearly if a \$60,000 Roth IRA has benefits equal to a \$100,000 traditional IRA, then a \$100,000 Roth IRA would be more beneficial than a \$100,000 traditional IRA. This is the magnitude effect.

There is another important factor to take into account here, and that is where one gets the money to pay the taxes generated by the conversion. Clearly we are not taking it out of the IRA in this case because we are converting the entire amount from the traditional IRA into the Roth. So the conversion to a larger Roth also has the opportunity cost of using up taxable assets that we would otherwise still have, side by side with our traditional IRA, if we did not do the conversion.

Let us suppose that we have the money needed to pay the taxes available in another taxable account, and further that we can access those funds without generating any capital gains taxes or other costs or penalties. Continuing on with the algebraic example introduced earlier, the amount we would have to access from our taxable account to pay the conversion taxes would be $A * T$.

An opportunity cost of doing the conversion is that we would forfeit not only this amount, but all the future earnings we would have made on it had we not used it for today's tax bill. The earnings would probably not be compounding on a tax deferred basis in the taxable account. Some taxes would be paid year by year, due to interest, dividends and/or realized capital gains. Suppose we lose the fraction "f" to taxes each year. The effective after tax rate of return on the taxable account would then be $(1-f) * R$, where R is the pre-tax rate of return as in the earlier example. We will call this after tax rate of return "S". For example, if we were earning 6% before taxes, and losing 25% of that every year to taxes in our taxable account, then R would equal 6% and S would equal 4.5%.

In real life, some of our tax liabilities taxes might stay in the form of unrealized capital gains until the time we cash in the account, but even if this fraction were 100%, we could compute an equivalent year-by-year after tax rate S that would yield the same end value. So long as our tax

rates are greater than zero, be they ordinary income or capital gains rates, the value of S will always be lower than the no tax rate R.

So now let's re-do the algebraic example assuming a 100% conversion. If we do not convert, then N years from now we will have both our IRA and our taxable account assets:

$$\text{Future Value in No Conversion Case} = A*(1 + R)^N*(1 - T) + A*T*(1 + S)^N$$

If we do convert, we will start with a Roth IRA equal to the same value A that we started with in the no conversion case, but we will not have the taxable assets anymore because we will have used them to pay the conversion taxes right at the outset.

$$\text{Future Value in Conversion Case} = A*(1 + R)^N$$

Even though we are assuming no change in tax rates over time, these two values are no longer equal. If we subtract the No Conversion Case from the Conversion Case we are left with the following value of conversion, which is the "magnitude effect":

$$\text{Magnitude Effect} = A*T*[(1 + R)^N - (1 + S)^N]$$

For those of you who did not pay attention in algebra class, this is precisely equal to the cumulative taxes that we would have been paid over the N year holding period on all of the investment earnings generated by the taxable account in the no conversion case.

We can now present numerical examples as in the tables discussed earlier. Table 4 examines the same cases as the earlier tables except that now we assume 100% of one's traditional IRA is converted to a Roth IRA. The assets used to pay the conversion taxes are assumed to come from a taxable account that would have otherwise generated the same pre-tax returns as the IRA accounts (5.65%) minus a 25% per year annual tax drain. This yields an effective after tax return of 4.24%. The effective income tax rate on conversion is assumed to be 40%, and we assume it stays at that same level at the time of future withdrawals. Again, we assume that whether there is a conversion or not, we hold the assets in the IRA accounts for the same 20 year period in either case.

Now, even though tax rates are assumed to remain constant, the future value of the Roth conversion case is shown to be \$28,307 higher than in the no conversion case. This is the magnitude effect. Recall that in Table 3 we considered a case in which one's effective tax rates were assumed to decline by 10%, but wherein we converted only so much that we could afford to pay the conversion taxes from within the traditional IRA. The benefits of not converting in that case were \$30,000. So we see that the magnitude effect in Table 4 comes within a sliver of completely making up for the effect of a 10% decline in one's effective tax rate.

To me, this is the most complicated and crucial issue of the Roth conversion decision: How large a future tax rate decrease does one have to assume in order to make up for the magnitude effect of being able to convert one's entire traditional IRA to a Roth rather than just the amount in a tax equivalency case? Although it may not be immediately obvious this question does depend upon the assumed length of time one holds his IRA's (20 years in the table cases), on the investment rates of return in the various accounts, and on the assumed tax drain in one's taxable account. In addition, though not considered in the examples above, we must also consider additional costs of accessing the assets needed to pay conversion taxes. For example, if we have to sell assets with unrealized gains in our taxable account, there is the cost of accelerating those taxes. Even if we have a tax loss carryforward so that no taxes would be due in the conversion year, we would be using up that carryforward reserve sooner, and thereby advancing the day at which additional capital gains taxes would be due.

Table 4 - Magnitude Effect With Tax Rates Constant

Panel 1 - Conventional IRA Without Conversion

	Conventional IRA	Taxable Account
Initial Account Balance	100,000	40,000
Growth of Accounts (20 years, 5.65% pre-tax rate, 4.24% effective after tax rate in taxable account)	300,000	91,693
Tax on Withdrawal (40%)	(120,000)	-----
Final Account Balance	180,000	91,693
Sum Total Both Accounts	271,693	

Panel 2 - Convert 100% to Roth IRA

	Roth IRA	Taxable Account
Initial Account Balance	100,000	40,000
Conversion Tax (40% rate)	-----	(40,000)
Account Balance	100,000	0
Growth of Accounts (20 years at 5.6% annually triples the balance)	300,000	
Sum Total Both Accounts	300,000	

Benefits of Conversion (Panel 2 - Panel 1)	28,307
Percent Benefits	10.4%

Scenario Analysis

To do a thorough analysis of one's conversion decision, we need a calculator tool of some sort. There are numerous such tools available, some for free and some (the more complete types) for a fee. For the illustrative examples in this article, I have built my own spreadsheet based calculator. Just to take a brief look at some of the possibilities, Table 5 shows how one's assumed future tax rate changes and IRA holding periods would affect the benefits of a 100% conversion of a traditional IRA to a Roth. The numbers in the table show the percentage change in wealth upon the date you cash in your IRA if you do a conversion now versus not doing one. A positive number shows a net benefit for conversion and a negative number means there is a net loss of wealth due to a conversion.

Table 5 - Benefits of 100% Conversion

		Future Effective Tax Rate Compared to Now				
		20% Higher	10% Higher	No Change	10% Lower	20% Lower
Holding Period	10	29.1%	16.0%	5.3%	-4.7%	-13.0%
	20	32.8%	20.6%	10.4%	-0.6%	-9.6%
	30	36.3%	24.9%	15.3%	3.4%	-6.3%

Reading down the columns, Table 5 shows that for any given future tax rate assumption, the longer the holding period, the greater the benefits of conversion. For example, if tax rates are assumed not to change, as in column 3, the benefits of conversion increase from 5% up to 15% as we increase the holding period from 10 years up to 30 years. This is because the magnitude effect gets larger the longer we hold assets in a tax free Roth IRA instead of a regular taxable account. (Also remember that it is only because of the magnitude effect that there are any benefits at all in column 3. If we converted just enough to pay taxes out of our traditional IRA, all of the cells in column 3 would have zeroes.)

Reading across the rows, we see that the larger one's assumed decrease in future effective tax rates, the greater the benefits of not converting out of one's traditional IRA. For example, with a 20 year holding period, as in row 2, we shift from a 10% benefit of conversion if tax rates stay the same up to a 10% benefit of not converting if tax rates decrease by 20%.

Of course, these examples are based on the same simplified assumptions mentioned above. One's IRA is assumed to be cashed in all at once and at the same time in either case. And the conversion (if there is one) is done all at once on day one. Of course, in reality most people will cash in their IRA's in fractional amounts over many years, and those doing conversions may do partial conversions over several years so as to keep themselves in lower tax brackets. For these and other reasons, real world cases are more complex than the examples herein. Still, these examples do a fine job of illustrating the important factors that affect the decision.

Tax Equivalency Cases Revisited - When first discussing the tax equivalency principle, we explained why higher future tax rates pushed our decision towards doing a conversion now, while lower future tax rates pushed our decision towards not converting. Having introduced our calculator, we can show more about the quantitative effects of tax rate changes. Table 6 goes back to the earlier assumption where we convert only just enough assets so we can pay the conversion taxes out of our traditional IRA⁷. Here, because of the tax equivalency principle, the holding period has no effect whatsoever. But changes in future tax rates make significant differences. For example, by reading across the columns of the table within any row, we see that we shift from a 33% benefit due to conversion if future tax rates turn out to be 20% higher than today's (first column), to a 25% benefit in favor of not converting if future tax rates turn out to be 20% lower (last column).

⁷ I.e., we are taking the magnitude effect out of consideration for now.

Table 6 - Benefits of Converting Just Enough to Pay Taxes from Conventional IRA

		Future Effective Tax Rate Compared to Now				
		20% Higher	10% Higher	No Change	10% Lower	20% Lower
Holding Period	10	33.3%	16.7%	0.0%	-14.3%	-25.0%
	20	33.3%	16.7%	0.0%	-14.3%	-25.0%
	30	33.3%	16.7%	0.0%	-14.3%	-25.0%

Comparing Tables 5 and 6 is also interesting because it illustrates how substantial the magnitude effect can be. The differences between the Table 5 values and those in Table 6 are precisely equal to the magnitude effects for each scenario. For example, if we presume a 10% lower future tax rate and 20 year holding period, and we are only converting enough so as to pay taxes out of the IRA, Table 6 shows a 14.3% benefit due to not converting (see the circled value in the middle row, second to last column). However if we convert 100% of the traditional IRA as in Table 5, the magnitude effect brings the benefit of not converting down to near zero (-0.6%, also circled in Table 5). The magnitude effect is just large enough in this case to change the decision from a clear “no conversion” recommendation to a wash.

Investment Rates of Return - As we’ve seen, in a tax equivalency case investment rates of return make no difference to the conversion decision. But in a 100% conversion case (or indeed in any case where we pay our taxes out of a taxable account), the investment rate does have some effect. Table 7 shows some examples. Higher rates of return favor conversion. Lower rates of return favor staying with one’s traditional IRA.

Table 7 - Benefits of 100% Conversion

**Alternate Investment Returns & Holding Periods
(Tax Rates Constant in All Cases)**

		Pre-Tax Rate of Return		
		2.82%	5.65%	8.47%
Holding Period	10 yrs	2.7%	5.3%	7.7%
	20 yrs	5.4%	10.4%	15.0%
	30 yrs	8.1%	15.3%	21.7%

Other Factors to Consider

I believe the tax equivalency principle and the magnitude effect are the most important factors to understand. These factors show us why changes in personal tax rates, the source of conversion tax payments and the amount of assets converted have major effects on the decision to convert or not to convert. We showed that other aspects of financial markets and of one's personal situation also enter and make this a multi-faceted decision. But we are not finished, as there are some other factors to consider as well. I will introduce them here for completeness, but will forgo detailed analyses (which could be quite lengthy).

Recharacterization – Suppose you convert your traditional IRA to a Roth IRA and pay income taxes based on the account value at the time of conversion. But subsequently the markets tank and the value of your new Roth account declines. Amazingly enough, the IRS allows you to take a mulligan. At some time, potentially as late as October 15 of the year following the year of conversion, you are allowed to “recharacterize” your new Roth IRA back into a traditional IRA. Then, so long as you wait at least 30 days and are beyond the tax year in which the original conversion was elected, you may re-convert again if you so choose. Presumably at this point you would still have a lower account value than when you did your original conversion, so your conversion taxes would be lower (assuming of course that your marginal tax rate did not increase enough to make up for the lesser amount of assets⁸). Furthermore, you can do this over and over again. (Hopefully, you will not need to!)

Avoidance of RMD's – In the discussion above, we generally assumed that the amount of time that assets would be held in one's IRA would be up to the individual, and would likely be the same whether one held a traditional or Roth IRA. Generally, we should leave assets in tax advantaged accounts as long as possible and use other assets for cash flow first. But the assumption is not strictly true for traditional IRA's due to Required Minimum Distributions (RMD's). The owner of a traditional IRA is required to start taking distributions from his IRA starting at age 70½. The amounts that must be distributed are specified in IRS tables, but they generally amount to 4% to 5% of the account balance in one's 70's, and over 6% per year starting in one's 80's (and increasing a bit each year). RMD's do not, however, apply to Roth IRA's⁹. So this is another benefit of Roth IRA's: the owner is allowed to hold his assets in a tax advantaged account for a longer time period.

Estate Taxes – The U.S. has no federal estate tax this year, but this is a one year anomaly. No one is sure what form the estate tax will take in future years, but there appears to be remarkable agreement that it will be something like what it was last year. The first \$3.5 million for an individual, or \$7 million for a couple with proper trust documents, would be free of estate taxes¹⁰. (This exempts approximately 99.75% of all estates from any and all estate taxes.) The amount in excess of this would be taxed at something like 45%. Some

⁸ For conversions in 2010, keep in mind that the top two tax brackets are very likely to increase starting in 2011. So if you are in the top federal bracket this year, you are paying a marginal rate of 35%, but this will likely rise to 39.6% next year. So it would take a notable drop in account value for such a taxpayer to elect a recharacterization.

⁹ This benefit does not, unfortunately, apply to non-spousal beneficiaries of an inherited Roth IRA. They do have to take regular annual distributions, although the distributions are not taxable to them seeing as the original owner has already paid the conversions taxes. Distributions of Roth assets are still costly, however, since this terminates the feature of tax free investment earnings.

¹⁰ Remember, your estate includes all of your assets – your home, other real estate, business and personal possessions, as well as your financial assets.

MAM clients have a legitimate interest in the estate tax, some don't. For those who do, Roth IRA's might provide some relief to your beneficiaries.

The estate tax can be especially brutal on traditional IRA's. If your estate aside from your IRA holds more than the exemption amount, the full value of your IRA would be subject to the estate tax. But the estate tax payment does not come out of your IRA, so when your beneficiaries do take distributions from it, those amounts would also be subject to ordinary income taxes. For example, if you have a \$1 million IRA, the estate tax would be \$450,000. Then when your beneficiaries redeem the assets, if their combined federal and state tax rate is 40%, they would pay another \$400,000 in taxes. The effect would be to leave them with only \$150,000 after both taxes!

Suppose instead you had converted the IRA to a Roth before you died, but only converted enough to pay your taxes out of the IRA. In that case, your heirs would not only have no further income taxes to pay on the Roth IRA assets, but the total amount in the Roth would be smaller so that the estate tax bite would be smaller as well.

This sounds like a bigger deal than it necessarily has to be however, because of an obscure deduction called "income in respect of decedents" or IRD. This deduction (for those who know about it!) allows your heirs to deduct some portion of the estate taxes paid on your IRA from your IRA balance prior to calculating the income taxes that are due on it. The portion that is deductible depends on your estate particulars in ways I don't pretend to understand, but from what I've read and heard, it can range from 0% to 100%. If it is 100%, then it would entirely eliminate the supposed benefit of holding a Roth IRA instead of a traditional IRA at death. I have already written more about this than I want to, so for anyone who thinks their conversion decision may get down to understanding this factor, I recommend meeting with your tax accountant and/or estate attorney to analyze your own estate particulars.

Charities – If you plan to donate all, or even a significant portion, of your estate to charity, a traditional IRA is an especially efficient way to do so. It is an asset that if used by you or your heirs, or even if converted to a Roth IRA, would be 100% subject to ordinary income taxes. But if you leave it to a tax exempt charity, the taxes are entirely forgiven. To see the benefit in a stark example, suppose you converted a \$1 million IRA to a Roth IRA and died the next day. If you had decided to pay the conversion taxes out of your IRA, say \$300,000, and only converted what was left, then your favorite charity would receive only \$700,000 instead of the full \$1 million. True, if you had done a full \$1 million conversion the charity would be made whole and still receive its \$1 million. But meanwhile your other heirs would be out the amount of taxes you paid for the conversion from other sources. So traditional IRA's do have benefits for those interested in leaving parts of their estates to charities.

Other States– I talked a good deal here about the importance of changes in your personal tax rates at the time of conversion versus the time when you would be using your retirement assets. One aspect of this that I think is worthy of special mention is state income taxes. The tax rates that matter are the combined effective federal plus state tax rates. Most MAM clients live in California, which of course has very high personal income tax rates. The near top rate of 9.55%¹¹ kicks in for a married couple this year when taxable income reaches only \$93,000, and for a single person at only \$46,000 (and remember, taxable income includes the amount

¹¹ I say "near top" tax rate because there is also a "millionaire tax bracket" in California that adds another percentage point on all taxable income over \$1 million, this the result of Proposition 63 passed by the state's voters in 2004.

of IRA assets converted). For a taxpayer also in the current top federal tax bracket of 35%, this makes her combined rate 41.2%¹².

Getting to the point, if someone who now lives in California thinks they might retire in another state that has lower or even no state income taxes, this would take a large bite out of their expected future combined tax rate. This would push such a person in the direction of not converting now. Nevada, Washington, Texas and Florida are examples of states that currently have no state income tax at all. On the other hand there are some MAM clients who now live in zero or lower tax states. If they are thinking about retiring in California, they might well want to convert their IRA's to Roth's before they move here!

Other People – In a similar vein, if you think there is a good chance you will not have to use up most of your tax advantaged accounts in your lifetime, then it is your beneficiaries' future tax rates that you should be comparing to your current rates. If you think they will be in much lower tax brackets than you currently are, this gravitates towards leaving your traditional IRA as is. But if they are big corporate executives or venture capitalists or the like and you are a poor wage slave, this would gravitate towards doing a conversion so as to pay taxes at your lower rate.

Tax Diversification – We cannot be sure what our tax rates will be years down the road when we will be redeeming assets from our tax advantaged accounts. In fact, they may even vary quite a bit from year to year due to spikes in income or large non-repeating deductions. When we design an investment portfolio, rather than base our whole portfolio on our best guess about whether stocks or bonds or commodities will do better, or large or small stocks, or value or growth, we diversify by allocating some assets each. Some commentators have suggested a similar strategy for setting the structure of one's retirement accounts; i.e., that one should purposely hold a variety of tax related accounts, including taxable, traditional IRA's and Roth IRA's.

This approach would not only hedge against one's best estimate of future tax rates being way off the mark. It would also provide the retiree with added flexibility year by year as his or her income and tax situation change. For example, in years when deductible medical expenses or charitable contributions are large, taxable income may be negligible. In such years, the retiree could access funds from her traditional IRA and/or choose to convert more traditional IRA funds to a Roth IRA at an unusually low tax rate. Alternatively, if the retiree has an unusually high tax rate one year—perhaps due to consulting income or a large realized capital gain—she could withdraw any additional funds needed that year from a tax-exempt Roth account.

Special Tax Situations – If someone has exceptionally large one time deductible expenses in a given year (capital losses excluded), this could be a great time to do a Roth conversion while getting your tax deferred assets out at a very low tax rate. On the other hand, if it is a year in which the taxpayer has both good income and substantial itemized deductions, then a Roth conversion could push taxable income so high as to phase out those itemized deductions. For people who are already retired, a similar concern might be that the extra income from a

¹² The effective combined rate is not the simple sum of the federal plus state tax rates, because state taxes are mostly deductible from federal income taxes. So the effective state rate is one minus the federal rate times the state rate. State taxes are not deductible for people paying alternative minimum taxes (AMT), so for them the rates are directly additive. But the top AMT marginal rate is only 28%, so for such people, the current combined rate would be only 37.55%. AMT is a complicated subject, but it is worth pointing out that doing a large conversion may actually have the effect of knocking a person out of the AMT system who would otherwise have been in it.

conversion could increase their Medicare Part B premiums and the taxable portion of their Social Security benefits.

Summary and Wrap-Up

Review - Clearly the decision on whether to convert your traditional IRA to a Roth IRA is complex, multi-faceted and based on some highly uncertain variables. Having spent considerable time on the matter, I’m convinced that the most important factors are your projections of future versus present day tax rates – your own, not the statutory tax brackets – and your ability to access assets to pay the conversion taxes from outside of your IRA while avoiding large opportunity costs (like capital gains taxes or liquidity problems). We saw with the tax equivalency principle discussion that if we had to pay our conversion taxes out of our IRA account, then present versus future tax rates is clearly the dominant factor. If tax rates are expected to be greater in the future, conversion is beneficial; if tax rates will be lower, conversion is not a good option; if tax rates stay the same, the decision is a wash. But when we consider the option of paying our conversion taxes from assets outside of our IRA, we explained how a magnitude effect would enhance the benefits of conversion in most scenarios. The breakeven point on tax rates in this case is pushed out to somewhere in which future tax rates are a little lower than present rates.

What to do? - All things considered, should you do a conversion? For some people, given their financial situations and expectations about tax rates, this will pretty clearly be a “no go” decision. For a few others, the numbers may look compelling, in which case we should sit down and determine a plan for doing the conversions. Finally, I suspect for many people the numbers will look pretty good, but less than compelling (e.g., a potential 10% to 15% benefit). I think the burden of proof in this decision is on the conversion option. As mentioned in the opening section, the cost of conversion, which is the tax bill it generates, is certain and will occur now. The benefits, whether they outweigh the costs or not, will accrue years in the future and are uncertain in magnitude. So if it looks like a close call, I would likely recommend against doing a conversion right now. I have compiled a simple decision matrix in Table 8 to make it easier to keep the main factors in mind.

Table 8 – Simplified Decision Matrix for Roth Conversion

If you expect your future tax rates will be ...	Don’t Do It	Consider It	Do It
→ Much lower	X		
→ <u>Same or a little lower</u> , but <u>do not</u> have outside assets to pay taxes	X		
→ <u>Same or a little lower</u> , and <u>do</u> have outside assets to pay taxes		X	
→ Higher			X

Partial Conversions - So far we have only considered full conversions of one's traditional IRA, "full" in the sense that either 100% of the assets are converted to a Roth IRA, or that only a portion of the IRA is actually converted but all of the remaining traditional IRA assets are withdrawn to pay the conversion taxes. For people with large IRA's, we might also consider partial conversions. Partial conversions could have taxes paid out of the IRA or from outside sources, but the latter is the recommended way for reasons discussed herein. With a partial conversion, one may be able to manage his tax situation more beneficially, by, for example, converting only so much as to keep his taxable income in a lower tax bracket¹³. This is a strategy that could be applied over and over again in future years, depending on one's own tax situation. With a partial conversion the exact same benefits or costs apply as discussed herein, only at a smaller magnitude. If such strategies look interesting, clients surely should work with both MAM and their tax accountants to analyze the specific details.

I hope this article provides you with an appreciation of the factors that affect the decision about whether to convert your traditional IRA to a Roth IRA, and how they apply to your own situation. But the decision is complex enough that I doubt it will look open and shut to very many people. So please let me know if you would like to discuss your situation in more detail.

Sincerely,

Bob Marshalla
Your Financial Advisor

¹³ Suppose a married couple had \$110,000 of taxable income absent a conversion. This would put them in the 25% tax bracket in 2010, and they would have a buffer of \$27,000 more before being pushed into the next higher tax bracket. Thus, they may choose to convert no more than \$27,000 this year.