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Why It May Pay To Convert to a Roth IRA

By KELLY GREENE

Investors and financial advisers are preparing to take advantage of a new tax law that makes it easier to gain access to Roth IRAs—even if it means breaking a sacrosanct rule about Roth conversions.

Starting, Jan. 1, the $100,000 income limit disappears for converting traditional individual retirement accounts and employer-sponsored retirement plans to Roth IRAs, one of the biggest changes on the IRA landscape in years.

Roths, of course, have long been viewed as one of the best deals in retirement planning; after investors meet holding requirements, virtually all withdrawals are tax-free.

Just how many investors will make the leap is unclear. Converting to a Roth can be expensive; it requires paying income tax on all pretax contributions and earnings included in the amount converted.

What's more, financial advisers have long argued that converting makes sense only if an investor can pay the tax from funds outside the IRA itself—an admonition that seemingly limits the strategy to the very wealthy.

That said, some financial advisers say growing numbers of their clients are leaning toward a Roth conversion, even if they have to tap their traditional IRAs to pay the taxes. The primary reasons: new, contrarian analyses of taxes and conversions—and a desire to gain more control over nest eggs in the years ahead. With a traditional IRA, investors must begin tapping their accounts after reaching age 70½ , which increases taxable income.

With a Roth, there are no required distributions, giving retirees more flexibility in managing their investments and cash flow.

For many investors, "the required minimum distribution makes them sick," says John Neyland, president of JCN Financial Group in Baton Rouge, La. "They don't want the government to tell them when to take the money out."

Although only 5% of the country's $3.7 trillion IRA assets currently are held in Roths, about 13 million households holding more than $1.4 trillion in retirement assets will become newly eligible next month for conversions, says Ben Norquist, president of Convergent Retirement Plan Solutions LLC, a Brainerd, Minn., consulting firm. Vanguard Group predicts that 5% of its customers will do Roth conversions in 2010, up from a typical 1.5% rate.

Charles Schwab & Co. found that 13% of 400 households with adjusted $100,000-plus incomes are

considering converting at least part of their IRAs.

Conventional wisdom about Roth conversions states that paying conversion taxes with funds outside an IRA gives investors the biggest bang for their buck: The more IRA dollars you can transfer to a Roth, the bigger the Roth—and the bigger the chance for long-term, tax-free growth. But that argument is a nonstarter for many people. That's because few—including those with incomes of $100,000 or more— have enough assets outside their tax-deferred accounts to pay the IRS. Others, who do have the money, are reluctant to part with it; such funds, often, are set aside for emergencies.

But some financial planners, after running projections involving retirement savings, withdrawals and taxes in coming decades, have concluded that it is worthwhile for many in this group to convert at least some of their IRA assets to a Roth—and pay the tax with funds inside the IRA.

"I have a case where my client is 60, and I was surprised to find that she comes out ahead whether she pays the tax with cash [outside the IRA] or the assets inside the IRA," says Deborah Linscott, a financial adviser in Dublin, Ohio.

Here's why: Even though individuals who convert and who decide to pay the tax bill with funds inside their IRA are lowering their overall IRA balance, their new Roth account eliminates the requirement to make taxable withdrawals after age 70½ . For some people, that means they can stay below the threshold at which much of their Social Security checks would be taxed. Others can avoid higher Medicare premiums (which are tied to income levels). And a few could wind up leaving larger legacies down the road, since inherited Roth IRAs aren't subject to income tax, either.

Bob Phillips, a 64-year-old retired engineer in suburban Cleveland, plans to covert his traditional IRA valued at $552,000 to a Roth. He has only about $8,000 in cash, so he plans to pay the tax from his IRA assets, which will reduce his retirement savings. But when Mr. Phillips turns 70½ , he won't have to make any taxable withdrawals, meaning the $35,000 in Social Security benefits that he and his wife receive annually shouldn't become taxable.

If the Phillipses can avoid losing about 20% of their Social Security to taxes, their Roth withdrawals—should they need them—will be smaller, as well. That, in turn, gives the Roth a better chance to increase with time, says Mark Tepper, the couple's investment adviser.

Mr. Tepper used 10,000 "Monte Carlo" simulations (designed to estimate the odds of reaching financial goals) and found that, without doing a Roth conversion, they have only a 50-50 chance of making their funds last across their life expectancies. With a Roth conversion, even using assets from the account itself to pay the tax, they have an 88% chance of not outliving their savings.

Some additional points to consider:

• Investors weighing Roth conversions may want to run their plans by a local accountant: At least one state, Wisconsin, didn't drop the $100,000 income limit, meaning unwitting residents over that limit face a penalty for Roth conversions.

• IRA owners with Medicare Part B who convert to a Roth may subject themselves for a year or two to higher premiums (which, again, are tied to income).

• Investors under age 59½ who convert to a Roth would pay an early-withdrawal penalty on IRA assets used to pay tax.

• Using IRA assets to pay the tax man reduces the amount you could later "recharacterize": If the converted Roth assets fall in value, you are allowed to recharacterize the account as a traditional IRA and no longer owe the tax. "But if you take $100,000 out of your IRA and you only roll $80,000 into a Roth, you only have $80,000 to recharacterize, not the whole thing," says Ed Slott, an IRA

consultant in Rockville Centre, N.Y.

—Anne Tergesen
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