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Planning for Unlimited Roth IRA Conversions

By Gil Hanoach, October, 2009

If you have high income, you may know that a Roth IRA is off limits for you. You cannot contribute to it or convert a Traditional IRA to it. Starting in 2010, Roth IRAs will be accessible to everyone. This article can help you decide whether and when to convert your Traditional IRA to a Roth IRA.

Before continuing, note that this article is not intended to provide a full review of IRA tax laws. You are encouraged to consult your CPA before making tax related decisions.

How can you contribute to a Roth IRA? The new law does not remove the income cap on contributing to a Roth IRA, but it does remove the income cap on converting a Traditional IRA to a Roth IRA. This means that every year you can contribute to a Traditional IRA and the next day convert the contribution to a Roth IRA, essentially resulting in a contribution to your Roth IRA.

Here are a few characteristics of IRAs (referenced later as #1 to #5):

Characteristic	Traditional IRA	Roth IRA	Taxable
1 Are investment taxes ¹ imposed?	No, investments are tax free while the money is in the account		Yes
2 When is income tax paid?	When money is taken out	When income is earned	
3 Can income tax be paid from outside the account?	No	Yes	N/A
4 How long can money stay in the account?	Up to age 70½, then withdraw throughout life	For life, then withdraw throughout life of heirs	Forever
5 How soon can money be withdrawn from the account?	Age 59½; disability; death; up to \$10,000 for first home for you, your parents, children or grandchildren; unreimbursed medical expenses above 7.5% of AGI; higher education; medical insurance after getting 12 weeks of unemployment payments due to losing your job; as a result of an IRS levy; or equal payments at least till age 59½ and at least for 5 years, but: Roth Contributions: Can be withdrawn any time. Roth Earnings & Rollovers: Cannot be withdrawn for 5 years after the first ever contribution to a Roth IRA.		Anytime

Maximize IRA Balances: Both IRA types are free of investment taxes for as long as the money is in the account (#1). Therefore, you should maximize contributions of money designated for retirement into IRAs, and minimize withdrawals. Given #5 above, you can maximize Roth IRA contributions regardless of when you may need the money (with limitations on withdrawal of earnings).

¹ Investment taxes = Interest, dividends and capital gains

Maximize Roth IRA Balances, with several exceptions. The Roth IRA provides the following benefits:

- 1. Reduced Taxable Portfolio:** When paying income taxes from outside the account, you have more money grow free of investment taxes (#3). If you are at the 33% tax bracket and you convert today using taxable money, you save investment taxes on 33% of the IRA balance. If you are taxed on 4% of your portfolio per year on average, at about 30% combined federal & state tax rate, it equals 1.2% in taxes on 33% of the IRA balance = 0.4% saved per year.

Put differently, if you take money out of the IRA with your income tax rate at 33%, you are left with \$67 on every \$100 withdrawn. By paying the tax from outside the IRA earlier on, you increase your balance by 49% ($100/67-1$), and substantially increase the amount that is free of investment taxes.
- 2. Money Growing Longer with the Tax Benefits:** You can keep your money in your Roth IRA for your life expectancy beyond age $70\frac{1}{2}$ + the age difference between you and your heirs (#4), typically providing 20-50 extra years free from investment taxes.
- 3. Reduce Taxes During Stock Declines:** When your IRA balance shrinks during stock market declines, any dollar amount you choose to convert will represent a larger percentage of your IRA balance, allowing you to convert a greater portion of your money at the same tax rate. If your IRA has a diversified long-term stock investment, this is an opportunity to save on taxes.
- 4. Convert Less Money at High Tax Rates:** As your IRA balance grows, more of the amount that you later withdraw or convert to a Roth IRA gets pushed into higher income tax brackets. Given that IRAs tend to grow much faster than the expansion of tax brackets, converting earlier on can keep more of the converted amount at lower tax brackets. This can be huge. If your portfolio tends to double every 5 years compared to the expansion of tax brackets (~14% long-term difference), any IRA that is likely to stay invested for more than a few years, is likely to cost a lot more to convert in the future (even when income tax cost is correctly calculated as a percentage of the account balance).
- 5. Shield from Uncertain Future Tax Rates:** Given that current tax rates are known while the future is unknown, it is more conservative to pay the taxes in today's known rates, as opposed to risking being subject to higher future rates. Any risk you can remove may help you better plan for your retirement.
- 6. An extra incentive in 2010:** Only in 2010, the payment of taxes on converted amounts can be deferred by an average of an additional 1.5 years ($\frac{1}{2}$ the tax is paid in tax year 2011, and $\frac{1}{2}$ in 2012). If your portfolio grows on average by 15% per year, the money used to pay the income tax on the conversion can grow by an average of 23.3% over 1.5 years, reducing your effective tax rate by 18.9% ($= (1-1/(1+23.3/100))*100$). For example, converting in 2010 at the 28% tax bracket, would be equivalent to converting any other year at 22.7% ($28*(1-18.9/100)$).

Rule of Thumb: You should not convert your Traditional IRAs to Roth IRAs (or contribute to a Roth IRA), if you expect your tax rate to be:

1. Much lower (typically 10% less or more),
2. In very few years (typically 5 or less).

Otherwise, you probably should convert, since the growth of the IRA balance can push you into higher tax brackets², negating the benefit of waiting. In addition, if you have money outside your IRA for paying the income tax, by paying it now, you shield the tax amount from future investment taxes, making the case for conversion soon even stronger.

² When estimating your future tax rate, take into account the investment taxes on your taxable portfolio + IRA amounts you convert or withdraw in that year. For example, a portfolio like Long-Term Component may generate 3%-4% taxable income each year. If you expect to have over \$10M in such portfolio in a taxable account you are likely to stay at the highest tax bracket for life.

When in the Year should you Convert to a Roth IRA? It is most beneficial to convert your Traditional IRA to a Roth IRA right in the beginning of the tax year (January 2nd), for two reasons:

1. Your converted money can grow an additional 1.3 years until you pay the taxes on the conversion (4/15 of the following year).
2. You can undo the conversion (officially named: "recharacterizing") until your tax filing deadline 4/15 (or 10/15 with an extension). During these 1.3 years, you can choose to undo the conversion if the account declined, and redo it next year at a lower cost.

Convert More than Planned. If you have any doubts regarding the amount to convert, a beneficial strategy could be to convert the full IRA (or at least the most you could possibly expect wanting to convert). Up to 4/15 of the following year, you can undo any part of it, providing you maximum freedom to leave converted as much or as little as makes sense, with the benefit of hindsight. This is especially useful in 2010, given the benefit of extra tax deferral, and while the stock market is so low.

Advanced Planning (not typical). There is one reason to not convert the full account. If you are almost certain you want to convert a lot less than the full account, even if its value jumps substantially, you could convert, say, half of it. In case the account drops in value during the year, you can undo the full conversion, and reconvert the second half right away. Without this tactic, you would have to wait until next year, and at least 30 days from the previous conversion (the latter not being a problem if you convert early in the year), because only one convert-undo cycle is allowed per year.

Disclaimers about the Advice Above.

1. It is usually smart to use retirement money last, and keep in it investments that grow fast (stocks). If you hold in your IRA slow growing assets, such as bonds or cash, some of the considerations in favor of a conversion are moderated. This case is not addressed in this article, since it is typically not recommended.
2. If the government decides to abolish the income taxes, replace them with a consumption tax, and leave the Traditional IRAs free and clear of taxes, a Roth IRA would be a much worse choice. It is doubtful that the government will give such a big gift to Traditional IRA owners, but it is a possibility.

Summary

Starting in 2010, all Americans have an opportunity to convert their entire IRA balances to Roth IRA. This article analyzed some of the considerations. While it may be difficult to make the best decision, in most cases it is well worth the effort. If you do not have a professional that can help you with this decision, in most cases a Roth IRA will be your better deal.

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