The 2010 Question

No I'm not referring to, "should you plan to die in 2010 to avoid the death tax"? The answer to that one by the way is, I don't recommend it.

The question that many are discussing is whether you should convert your traditional IRA (or rollover a lump sum distribution to a traditional IRA and then convert it) to a Roth IRA, when the $100,000 income limit for eligibility is eliminated, beginning January 1, 2010. There is not a single right answer by the way. As with most financial planning decisions, it deepens on what happens in the future and we don't have a perfect crystal ball. There are however a few key considerations that can help you make a more informed decision and even if you decide not to convert, it will be an informed decision, rather than letting inertia decide.

Financial Services Industry Perspective:

Roth conversions are one of those occasional bonuses (or burdens, depending on your perspective) thrown to the industry by the Congress, creating an opportunity for public confusion and the need for advice from the industry. Just the possibility of finding a way to save taxes gets an enormous amount of attention. Many firms will view it as an opportunity to provide education and advice to clients and prospects, creating an opportunity to strengthen or acquire relationships. Firms that do it poorly are likely to lose clients or have declining client satisfaction.

Much of the financial services industry is anticipating a flood of Roth conversions in 2010 based on some pretty sound thinking:

- Many assume income taxes may be higher in the future and it's a good opportunity to convert now;
- There's pent up demand among affluent investors who have been ineligible to convert in the past due to the $100,000 income cap ;
- This is a good time to convert while IRA values are low and pay less in tax and still benefit from tax-free growth when the markets recover. (This may be a bit of a red herring, as I'll explain later.)

Financial firms and advisors should have these discussions with their clients and help them navigate the pros and cons. My concern, however, is that many clients will not get sound personal advice in the midst of generalizations and the firm's or advisor's zeal to capture more assets. Conversely, some advisors may be reluctant to encourage clients to convert, since it will likely mean withdrawal of some assets under management and therefore reduction in revenue. Either way, your best protection is to be an informed consumer.

As to the predicted wave of conversions, I'm personally very skeptical that it will be as big as some think. I was IRA product manager for the IRA industry leader when the Roth was first introduced. Few people

converted and relatively few contributed to a Roth. Many have attributed it to the income limits. However, if you think about it, the Roth stands to most benefit those in the lowest tax brackets currently, but who are likely to be in higher tax brackets later. Benefits to those currently in higher tax brackets are less certain.

Plus, the government and the industry have done a pretty good job drilling into us the benefits of tax-deferral, with one of the key assumptions being, that you'll likely be in a lower tax bracket when you take distributions, based on reduced income in retirement. For many, this may not have been a true assumption, but in the absence of a Roth IRA or Roth 401(k), the power of tax-deferred compounding likely would benefit one, even if in the same or slightly higher tax rate in retirement. If rates turn out to be substantially higher, of course, saving in a taxable account with a long-term buy and hold strategy may actually have been better, unless of course you gave up an employer match.

Thankfully, I've never been eligible to contribute or convert to a Roth IRA. However, the no-brainer decision for me when my daughter was in college and had some part-time and summer income, was to fund a Roth IRA for her. Hopefully, those few years of contributions will grow substantially by the time she retires and presumably she'll be in a higher tax bracket than when she was in school.

Four key considerations:

You don't really need a complex calculator or to complete a lengthy questionnaire to make a good decision. (Of course a good calculator can help quantify the magnitude of the advantage or disadvantage based, of course, on future assumptions.) However, many of these calculators leave out a couple of the more important considerations, and produce projections that are based on assumptions that you can't really predict anyway. But the results can still be interesting, as long as you don't let them obscure the key decision criteria.

1. Will the effective tax rate you pay on the conversion, be higher or lower than the effective tax rate on distributions you would take in the future from your traditional IRA if you do not convert? You (or your accountant) can determine the effective tax rate you will pay on the conversion, although if your income is variable, this will be more accurate toward the end of the tax year than it will be if you do it on January 1. The rate you will pay in the future can only be estimated, but will be affected by a wide range of factors, including:
    a. What will be your taxable earnings (and deductions) when you take distributions? Note: If you take distributions over several years, it will not only spread out your income but make it harder to predict what your income will be in each of those years on average.
    b. What will future tax rates, as well as allowed exemptions, deductions, AMT, etc. be during the time you take these distributions.
    c. To what extent will you be able to control the timing of income and therefore reduce your overall taxes?
    d. If you leave some or all of your IRA in your estate, what will be the applicable tax rates for your beneficiaries?

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These questions will be much more difficult for some to answer than others and at the end of the day, you'll probably just go with your gut. I.e. If you expect your taxes to be higher in the future, conversion makes sense. If you think your personal taxes will be less (even if you think taxes in general will go up), then it may not make sense to convert. On the other hand, you may simply want to wait and revisit the decision in the future when perhaps you'll have a clearer sense of the key assumptions. Of course you can also hedge your bets and convert some, but not all. (More on partial conversions in a little bit.)

This rule about current and future tax rates holds true, even if you have to use part of your traditional IRA to pay the taxes. Also, the length of the investment period and the rate of return do not change whether or not there's an advantage. It only affects the extent of the advantage. (Please see mathematical explanation and examples in the Appendix.)

If you need your money sooner than 5 years, beware that there is a 5 year waiting period before you are able to take distributions from a Roth IRA and preserve the tax status. Also, beware that if you are using IRA money to pay the tax and you're not yet 59 ½ years old, you'll likely incur the 10% early distribution penalty and offset much or all of the advantage of converting.

2. What money will you use to pay the tax? We demonstrated above that even if you need to use some of the IRA money to pay the tax on the conversion, you will still benefit from conversion if you are in a higher tax rate when you need the money. Conventional wisdom, however urges investors to use other "taxable" investments to pay the tax, and by doing so, you can actually increase the benefit of the conversion. My only caveat to this rule is to note that it's not quite as simple as just using money from a taxable account to pay the tax. You may have some savings or securities to liquidate that are at full basis, i.e. there is no tax due upon sale or withdrawal. However, you may need to sell some appreciated securities and will therefore both incur tax and perhaps move you into a higher income tax bracket. Even if you have money you can use to pay the tax that will not create a taxable even, you may want to subsequently rebalance your portfolio and in doing that may create some gains. In the end, any gains realized are likely to only be a portion of the funds liquidated and the overall effective tax rate will likely be substantially less than the ordinary income tax rate. Of course if this taxable money was the money you planned to live on for the 5 years until you can take "tax-free" distributions from your Roth IRA, the conversion may not work out very well.
3. How are your investments split between taxable (likely some with unrealized gains and some at full or nearly full basis), tax-deferred (401(k)s, traditional IRAs, etc.) and Roth, if any? As a 30 year plus veteran of the retirement industry, I've seen retirement plans, rules and regulations change significantly. However, even more significant has been the change in tax policy. In my working life time, the top marginal rate has been as high as 70% (with a lot of deductions and loop holds) and as low as 28%. Capital gains and dividends have been taxed as ordinary income and currently long-term gains and qualified dividends are taxed at a top rate of 15%. I'm a strong proponent of tax diversification. Whatever you believe will happen to taxes next, it's reasonable to assume that over the next 20 to 30 years, taxes are likely to change multiple times. Having long-term investments in a taxable account, plus a traditional and a Roth IRA

provides a great deal of flexibility as to which pools to tap for retirement income and to control your level of taxable income in any given year. One strategy could be as simple as convert ½ of your tax-deferred assets to a Roth and leave the remaining in the traditional IRA or 401(k). You could also, convert a smaller or larger portion, or even break up the conversion over a period of years, provided the rules don't change again. Simply reducing your reliance on the tax-deferred accounts for retirement income will likely help you lower your marginal tax bracket and taxes, even on the amount that remains in the tax-deferred account(s).

4. Will you need your tax-deferred assets in your lifetime? This really isn't a primary consideration, but since so many talk about it, I feel I should include it. If you don't anticipate that you'll need to tap your tax-deferred assets in your lifetime, you can avoid Required Minimum Distributions (RMD's) by converting to a Roth. This, however, is another of those red herrings. You essentially are taking all of your RMD's and then some up front. The government is very happy to take your money now rather than waiting. It really comes back to #1 above, how does your tax rate now compare to your expected tax rate at the time you would take your RMD's? Of course if you don't need the money and you want to leave it to charity, simply donate the RMD's or more and avoid paying the tax. If you want to leave it to your beneficiaries, then simply consider their expected tax rates relative to your current tax rate.

Oh! And back to that death tax thing. If you have an estate that's likely subject to estate taxes, under current or future estate tax rules, are you better off converting to a Roth? Tax-deferred accounts are what are referred to by estate planners as "expensive" assets to have in your estate, since your estate must pay income tax and potentially estate taxes on the assets. I've seen a lot of complex projections on both sides of this argument, but none of these have convinced me that it should be a decision driver. By paying tax now, you reduce the size of the estate and potential estate tax. However, if you leave the money in the traditional IRA the estate gets an income tax deduction for the estate tax paid in computing the income tax due to the estate with respect to the decendent. Which way the math works out depends on the effective income tax rate compared to the effective estate tax rate, which we really can't reasonably predict past 2009. Plus you have the flexibility to leave IRAs to charities or to beneficiaries who may be in lower tax brackets that you are.

More confused now than before reading this?

Behavioral Finance has shown that we're pretty much wired to place a high value on money today and discount future benefits, particularly if those future benefits are uncertain. Very few, if any of us, like paying more tax than we have to. Plus there's the psychological factor of not wanting to see your "net worth" shrink, particularly after the market crash we've experienced already. Of course the true net worth might not shrink or might actually go up, if you take into account the liability for future income taxes on tax-deferred accounts. But almost no one actually includes a liability for future taxes in their personal net worth calculations. For these reasons, I don't expect the flood of conversions that some do. However, there are many who are convinced that income taxes will go up in the future and stay up for our lifetimes. Many are determined not to pay those higher taxes and are likely candidates to convert to a Roth.

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My suggestion if you expect your tax rate to be higher in the future and you have other funds you can use to pay the taxes, consider converting some but not necessarily all of your tax-deferred assets to a Roth. Don't feel you have to do it in January. You may want to wait until closer to the end of the year to be able to have a very clear idea as to how it will impact your taxes. As for the "convert while the market is down" argument to rush to do it, that's only a primary consideration if you don't expect the assets you would use to pay the tax to go up with the market as well. It's that commutative property of multiplication and division rule again, with one exception: if converting the while the market value is lower means you'll be in a lower marginal rate than you would be in if values rise again, there may be some added advantage. Of course if you have a year with lower taxable income than typically, that may be a good year to do a conversion.

What about unrealized appreciation?

If converting tax-deferred assets to a Roth IRA is a good idea, certainly harvesting unrealized long-term capital gains while you can pay 15% seems like a no brainer, as well. Be sure to avoid the wash sale rules and you can stay invested in the sectors and industries you like by trading one high quality stock for another, e.g. sell Wells Fargo and buy J P Morgan Chase or vice versa. If you have stocks that have unrealized long-term gains that you think may be ready for a pause, it's an ideal time to harvest those gains.

About the author:

A recognized expert in retirement income planning, Stephen Mitchell has spent more than 30 years in the retirement and financial services industry. His impressive experience includes serving as a marketing executive at Fidelity Investments and at Merrill Lynch, where he lead the development of *The Merrill Lynch New Retirement Studies – A Perspective From The Baby Boomer Generation(in 2005) and A Perspective from Individuals and Employers (in 2006)*. Today, Mitchell is Chief Operating Officer for the Retirement Income Industry Association, and a consultant to the retirement industry. Additional retirement income resources: www.riia-usa.com; www.stephenwmitchell.com . The opinions expressed in this article are those of Mr. Mitchell as an individual, not as an officer or director of RIIA. RIIA in no way endorses the content nor do either Mr. Mitchell or RIIA intend for the information provided to constitute financial, investment, tax or legal advice of any kind.

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Appendix

The equality of a traditional tax-deferred IRA and a “tax-free” IRA when the current and future tax rates are the same is demonstrated by the basic commutative property of multiplication and division. i.e.

$$\$ \times (1+i)^n \times (1-t) = \$ \times (1-t) \times (1+i)^n$$

Where $ = your IRA balance; i = the rate of return; n = the number of years; t = the effective tax rate, i.e. the two sides are equal if these values, including the tax rates, are equal.

For example:

$ = $100,000; i = 7%; n = 10; t = 28%

$$\$100{,}000 \times 1.07^{10} \times (1 - 28\%) = \$100{,}000 \times (1 - 28\%) \times 1.07^{10} =$$

$$\$100{,}000 \times 1.97 \times 72\% = \$100{,}000 \times 72\% \times 1.97 = \$141{,}840$$

However, if the current tax rate is 28%, but the expected future tax rate is 35%,

$$\$100{,}000 \times 1.97 \times 65\% \text{ or } \$128{,}050 < \$100{,}000 \times 72\% \times 1.97 \text{ or } \$141{,}840$$

This suggests a significant advantage to converting to the Roth.

However, if the tax rates are reversed, i.e. 35% now but the expected rate when the distributions would be taken is only 28%, then the advantage is to leave the money in the traditional account.

Of course, distributions are typically taken over time and rates of return fluctuate. Return and affects the significance of the advantage or disadvantage, but not whether or not converting is better. That is driven by the relationship of the current and future tax rates. Of course if some of the funds are expected to be used in your life time and some will be passed on to beneficiaries, there will be multiple potential tax rates to consider.