Roth IRA Conversion: Should I or Shouldn't I?
Stembrook Special Commentary – November, 2009

As I mentioned in my last commentary , next year the Roth IRA will be accessible to individuals in higher income brackets. This option represents an opportunity to grow your portfolio in a more tax-efficient way and can provide more income for your own retirement or more assets for your heirs.

As is the case with most tax issues, the concepts are somewhat simple, but the details can be a bit confusing. Deciding on what to do in your specific situation based on analysis and not hunches is even more challenging. In such a situation, I asked an expert to weigh in and we are fortunate to have Martin Silfen write on these pages. Marty is a tax attorney, the former head of Wealth Planning at Brown Brothers Harriman & Co. where he and I worked together for almost ten years, a member of Stembrook's Investment Committee, a published author, a former professor and a good friend. Most relevant to this letter is the fact that he is one of the best and most knowledgeable retirement planning specialists in the business.

Marty lays out the ground rules for conversion to a Roth IRA, outlines the potential benefits of converting and provides a few rules of thumb for our reference.

Ultimately, the decision to convert all or part of your traditional IRA to a Roth IRA, is highly dependent on factors specific to each individual. We can help you, in conjunction with your tax advisor, to evaluate the options in a logical and well-researched way.

I hope you find this Special Commentary helpful, and please do not hesitate to contact me with any questions or comments.

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by Martin Silfen

No doubt you're starting to read a lot about converting your so-called "traditional" (i.e., pre-tax) Individual Retirement Account to a Roth IRA. There's a reason for that. Until now, traditional IRA owners with above-average income (i.e., Adjusted Gross Income of more than $100,000) have simply not been allowed to take advantage of this opportunity. Starting in 2010, however, anyone with a traditional IRA, regardless of income, may convert all or part of it to a Roth IRA.
Should you or shouldn't you? First, the ground rules.

The Ground Rules

You are no doubt familiar with the traditional IRA. Generally contributions are made with pre-tax dollars; earnings inside the IRA grow tax-free until distributed; distributions must begin the year you reach age 70-1/2; and distributions are generally taxable when made. Traditional IRAs can be built up gradually with modest annual contributions. Or, more significantly, you might have rolled over a large lump sum distribution from your employer's retirement plan into a traditional IRA.
In contrast, a Roth IRA is funded with after-tax dollars. Like a traditional IRA, earnings grow tax-free. But no distributions are required during your lifetime—neither at 70-1/2 nor at any age. And if two requirements are met, your distributions are totally tax-free: you must be at least age 59-1/2, and you must have had your Roth IRA for at least five years.

When you convert all or part of a traditional IRA to a Roth IRA, you pay an income tax at that time for the privilege. Simply add the amount converted to the rest of your taxable income, and pay whatever the tax table tells you. (More accurately, if you have made non-deductible contributions to your traditional IRA, you get to reduce the amount you're adding to your taxable income; but I won't go into the complexities of that here.) In 2010, the IRS is having a special sale on Roth IRA conversions. For that year only, you have the option of not including the amount converted in your 2010 income, and instead adding half the amount to your 2011 income and half to your 2012 income.
So should you or shouldn't you? Not so fast. It's complicated. Let me next set the stage with some basic principles.

Basic Attributes of Traditional and Roth IRAs

	Traditional IRA	Roth IRA
Contributions	Pre-Tax Dollars	After-Tax Dollars
Withdrawals	Taxed as Income	Not Taxed
Required Minimum Distribution at age 70-1/2	Yes	No
Investment Earnings	Not Taxed When Earned	Not Taxed When Earned

Some Basic Principles

To determine which approach is better—to Rothify or not to Rothify—you first have to understand and accept a few basic principles.

> "The best way to think about the tax cost of converting a traditional IRA to a Roth, is to think of those tax dollars you pay as if it were a hidden contribution to your traditional IRA"

- What should you be measuring? If you would prefer to increase your spending during retirement, then you should focus on which approach is projected to yield greater after-tax retirement spending. On the other hand, if you anticipate having more than enough to meet your retirement spending desires, then you should focus on which approach leaves the greater amount of after-tax wealth to your beneficiaries.
- Regardless of which quantity you're measuring—spending or wealth—it's important to focus on which approach is projected to yield the higher after-tax result; which is most definitely not the same as paying the least amount in taxes.
- You can glean no guidance just by looking at your personal balance sheet. When you Rothify an IRA, the tax cost of doing so nominally disappears from your net worth. But you've just made your IRA worth more. The trick is to try to measure how much more valuable it is, to see if that increase is worth the tax investment.
- You can only compare results over the long run—your (and your spouse's) life expectancy if you're shooting for increased spending; your beneficiary's life expectancy (presumably your children or grandchildren) if you're shooting for wealth accumulation. That's because you can't compare dollars in a traditional IRA to dollars in a Roth IRA or to dollars in a garden variety taxable investment account—dollars in a Roth IRA are worth more. How much more? You never really know until they have all been distributed out, which only happens after you or your beneficiaries have reached the end of your life expectancies—a very long time indeed.
- Given the significant upfront tax investment of converting a traditional IRA to a Roth IRA, and the long-term nature of the benefits, you want to be sure the potential reward is worth the cost. So it would be good to have a sense of whether you're projecting a 1%, 10% or 35% improvement in your retirement spending or wealth.
- But it could be misleading to just measure your entire spending or your entire wealth when assessing the magnitude of the projected improvement. For example, for someone with significant wealth but only a modest IRA, nothing he does to that IRA will significantly move the needle. The percentage improvement in his overall wealth may be tiny, but the percentage improvement in the power of his (modest) IRA might be significant. I find it helps, therefore, to look at two different percentages: the percentage effect on your entire spending or wealth, and the percentage effect on the power of the IRA.
- The true risks of Rothifying your IRA are the hardest to predict, project or measure. Will Congress renege and tax distributions from Roth IRAs? Or will Congress scrap the income tax altogether, and impose a consumption tax, perhaps double-taxing those who paid the tax cost of Rothification?
- Diversification is always an option. You can convert part of your traditional IRA to a Roth IRA, and have two very different buckets from which to take potential distributions.

- The best way to think about the tax cost of converting a traditional IRA to a Roth, is to think of those tax dollars you pay as if it were a hidden contribution to your traditional IRA—one that you might not be allowed to make directly due to legal limits on IRA and other tax-advantaged retirement contributions. It's hard to think of taxes paid as an addition to saving, but that is indeed the effect of converting potentially taxable distributions to tax-free distributions.

So should you or shouldn't you? The only way to answer that question with any degree of confidence is to do a long-term projection, taking into account your unique circumstances. And indeed, given the large tax investment of Rothifying your IRA, that's an analysis well worth doing. Nonetheless, we all crave easy answers, so here are a few rules of thumb:

A Few Rules of Thumb

- If your wealth is such that you don't expect to need the assets in your IRA to meet your (or your spouse's) living expenses, then converting it to a Roth IRA is probably a good idea; maybe a very good idea.
- If you are taking maximum advantage of traditional pre-tax saving (e.g., electing maximum $15,500 elective deferrals to your 401(k) plan), and wish you were allowed to defer more, then Rothifying your IRA is likely a favorable option.
- If you are limited in your pre-tax saving by the amount you can afford to save, rather than the legal maximum, then:
    - Rothifying is a good idea if your projected future (post-retirement) tax rate is greater than your current tax rate.
    - If your projected future tax rate is only modestly lower than your current tax rate, then Rothification may still be a good idea. Further analysis is needed.
    - If your projected future tax rate is significantly lower than your current tax rate, then Rothifying is probably a bad idea.
- The further you are from retirement, the more likely Rothification is a good idea.
- Whether or not to do a Roth conversion is a strategic decision. Timing that conversion is a tactical decision.
    - It is most cost-effective to convert when the IRA's value is lowest, but when is that? Now or next month or next year?
    - If after conversion, the Roth IRA drops significantly in value, you can undo it by "recharacterizing" the Roth IRA back to a traditional IRA. The deadline is the extended due date for filing your tax return for the year (e.g., October 15, 2011 for a 2010 Roth conversion). You may not then do a Roth conversion again in the same calendar year of the original Roth conversion, or for 30 days after the recharacterization. If the Roth IRA has increased in value, the recharacterized amount must be accompanied by income attributable to the recharacterized amount.
    - If you Rothify in 2010, you have another decision to make: whether to pay the tax with your 2010 tax return or delay until 2011 and 2012. If you elect to delay and tax rates are increased, the increase might more than offset any tax deferral benefit.
- All rules of thumb are wrong.

Summary

A Roth IRA conversion holds a unique set of opportunities for investors. While making such a conversion requires out of pocket spending today, there are a number of compelling reasons why it might make sense to convert all or a portion of your traditional IRA to a Roth. While rules of thumb are helpful in giving you a better sense for the mechanics of the conversion, each decision requires consideration of your specific situation.

If you would like to learn more about converting your Traditional IRA to a Roth IRA, please contact Peter D'Agati at 201-484.063, or e-mail him at peter.dagati@stembrook.com.