

Decision Time: Should I Convert Existing IRA Investments to a Roth?

Since 2010 due to legislation passed back several years ago (The **Tax Increase Prevention and Reconciliation Act of 2005**), anyone that holds a SEP, SIMPLE or Traditional IRA can convert to a Roth IRA, regardless of earnings. The fact is, most IRA holders have never taken the time to review their own situation and investments and make the assessment. They may be missing a golden opportunity for eliminating future taxes for their retirement plans.

Through conversion, you simply elect to be taxed at current individual tax rates for the total amount that you elect to convert to a Roth IRA. You may convert a partial amount every year, or make a lump sum conversion of your entire pre-tax IRA account. Once it is converted, any withdrawals from the Roth account after five years and achieving the age of 59 1/2 will be tax-free. (The rules are found on the IRS.Gov website under IRC Section 408A and Publication 590).

Whether the conversion is done before the investment is made or after is the accountholder's choice. Investments in private (non-publically traded) holdings that are anticipating a step up in valuation over the course of the investment would afford a significant advantage if done early in the investment lifecycle.

The critical components of the decision to Convert can be grouped into four main categories:

- 1) Your marginal tax rate for the year you want to convert to a Roth
- 2) The anticipated return of the IRA investment
- 3) The number of years until you plan on taking distributions from your Roth
- 4) Your estimate as to your marginal tax bracket when you will need to withdraw the Roth

We will look at each of these briefly.

Your current marginal tax rate: Converting to a Roth IRA may be the only time you voluntarily subject yourself to taxation – it's a difficult choice because it is so unnatural. Convert in the year that you have the lowest marginal tax rate, perhaps when you have taken losses or had a change in employment. Even if your earnings are not likely to change, factor in the likelihood of overall tax rates, especially with the Bush tax cuts set to expire this year.

The anticipated return of the IRA Investment: The more forecastable the return, the easier to make the conversion decision. No-one wants to subject their IRA to taxation and then have the Roth asset(s) lose value. Conversely, the higher the yield, the greater the tax-free growth and the more pronounced benefits of conversion.

The number of years until you plan on taking distributions from your Roth: The greater the years to distribution, the more advantaged the conversion decision will be. The fifty-year old IRA holder that doesn't need the income until seventy-five is equally as advantaged as the forty-year old that wants to draw down his IRA at sixty-five. A key variable is time available to earn back the capital used to pay the tax in advance.

Estimated marginal tax rate at withdrawal: For those that anticipate that their marginal tax rate will be equal or more than their current rate when they withdraw, a Roth may be desirable. With the Bush tax cuts scheduled to expire as of the end of the year without additional congressional action, the top rate will rise from 35% to 39.6%. At that rate, a Roth conversion will automatically provide a 15% tax benefit, without factoring in the tax free growth period. There are many Roth Calculators available on-line to work out your own scenarios – and of course you should consult with your tax professional about the approach that is right for you.

Good news - You need not liquidate your IRA investment to make the conversion. Simply notify your current IRA administrator to make the conversion for named assets in your account, or the entire account. You will need to provide an updated (last 30 days) Fair Market Value for all privately held non-cash assets in order to complete the conversion. Your tax liability will accrue and need to be paid no later than April 15th of the year following the conversion.

An interesting aspect of IRS Roth regulations permits the IRA holder to change their mind about the conversion - as late as the final filing deadline for your personal return (Oct 1) - this is the year following the elected conversion. This ability to "Re-characterize" your Roth account back to a Traditional IRA can be valuable should your investment value decline, as you can recoup the taxes paid for the conversion.

There are other benefits to converting to a Roth, among them the avoidance of minimum required distributions after the age of 70.5 years.