

When To Convert a Traditional IRA to a Roth IRA

When Roth IRAs were established by Congress in the late 1990s, many people took advantage of a provision to convert monies in their traditional IRA to a Roth IRA. A Roth IRA allows for tax-free growth of assets as long as you have owned the account for 5 years and are past the age of 59 ½. Since then, it seems there has been less discussion about this great planning technique.

If your modified adjusted gross income is below \$100,000 you may wish to consider a conversion. (Married folks filing separately are not eligible for this conversion.) When you convert monies to a Roth IRA you will be taxed at ordinary income tax rates on the amount of the conversion. It is a good idea to have funds outside of the IRA to pay this additional tax.

Here are a few situations in which a person might wish to consider this planning option:

- 1) If you expect to be in a higher tax bracket later on and you will not need the funds for at least 5 years. This could be especially useful for someone who is relatively young and will not retire for many years. Let's say your top marginal tax rate is 15% and you have at least 15 years before you would need to tap any of the funds in the IRA. Paying the tax now and allowing this account to grow tax-free is likely to be a winner even if you are in the same 15% tax bracket in retirement. (If you are in the 25% tax bracket and it is highly unlikely you would ever be lower than the 25% tax bracket then conversion might make sense as well.)
- 2) If you are in retirement and do not need the money to live on, a Roth conversion will help you to lower (or even avoid) required minimum distributions at age 70 ½. There is no requirement to withdraw Roth IRA funds at any age. The primary advantage to this is to provide your heirs with a tax-free asset. (Your beneficiaries will be required to make minimum distributions based on their life expectancy though.)
- 3) If you are interested in lowering your overall estate in an effort to avoid estate taxation. By paying the tax now on the IRA funds, you lower the amount of your estate.

A Roth IRA conversion is generally not a good idea when:

- 1) You do not have funds outside the IRA to pay the tax on the conversion.
- 2) You expect to be in a lower tax bracket in retirement.
- 3) If the conversion increases your adjusted gross income (AGI) to the point where it may reduce other tax deductions based on AGI, thereby increasing the tax you pay on the conversion.
- 4) You think Congress will change the rules and begin taxing the earnings inside of Roth IRAs. I consider this highly unlikely as the uproar from so many people would be deafening in the halls of Congress.

Another interesting consideration is to diversify your 'tax buckets' prior to retirement to provide maximum flexibility. If all of your retirement savings are in 401(k)'s and traditional IRAs that will be subject to ordinary income tax upon withdrawal, you will be in a position where distributions could force you into a higher tax bracket during retirement. By having a 'tax-free' bucket of retirement savings you may be able to stay in a lower marginal tax bracket in retirement with proper distribution planning.

Every situation is unique so the general rules discussed above are just that: generalizations. If you would like to discuss whether a Roth IRA conversion makes sense for you, please call us at 609-620-1770.

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