

WealthCounsel®



Roth Conversions 2.0 (The Roth Revolution!)

By: John Bledsoe, CFP, CLU, ChFC, MSFS



From the very beginning of Roth IRAs there has been an income limitation on Roth conversions. Only people who had modified adjusted gross incomes of \$100,000 or less could convert to a Roth whether married or single. This substantial limitation prevented the majority of people who could benefit from this conversion to a Roth from being able to convert. Rumor has it that some people even quit their jobs and a few even got divorced just so they could qualify for the Roth conversion. Well happy days are ahead because beginning January 1, 2010 the income limit is lifted for Roth conversions. This opens the conversion field to everyone with an IRA and a pulse; so I wanted to give a few general tips on the new (2.0) age of Roth conversions.

1. Roth IRAs are better than regular IRAs!

There I said it, and now many are thinking me an IRA bigot; but in truth Roth IRAs are better. Roth IRAs are tax free where regular IRAs are merely tax deferred. So if you have \$100,000 in a Roth IRA you have the spending ability of \$100,000. With the regular IRA you only have the purchasing power of the net after tax result or around \$80,000. Plus Roth IRAs have no mandatory lifetime distributions. This is a big deal when you realize regular IRAs start unwinding after age 70 ½ due to mandatory taxable distributions that get bigger (by percentage) every year. Roth IRAs have no lifetime distributions required for the original owner and spouse beneficiary. I say you have enough to remember after you turn age 70, much less 70 ½, to have to keep up with complex mandatory taxable distributions that change every year.

2. There is no “crossover” on Roth IRA conversions.

Many people have asked me over the years how long before the converted Roth catches up with the regular IRA to make up for the huge income tax that had to be paid on the conversion. The reality is the converted is worth more money (or at worst the same) from the day it is converted. The reason for this is that regular IRAs

have a tax burden that is owed and must be paid. Regular IRAs are like a partnership with the IRS that must some day be settled by paying the tax. Converting to a Roth is just like having a home mortgage and deciding to pay off the lender. You are not poorer by paying the income tax even though you may feel poorer.

3. Use outside funds to pay the tax.

When people are contributing to their retirement plans every year they often put in as much as allowed each year. The Roth conversion gives you a chance to make your allowable retirement plan contributions all the bigger by paying the income tax triggered by the conversion from other (non IRA) funds. Please consider any and all ways possible to pay the income tax from a non-IRA source. Even considering borrowing money is advised depending on your situation. So how does this make your retirement contributions bigger, you ask? Consider that you had \$1,000,000 in a regular IRA that you just converted to a Roth. By you paying the tax with “outside” funds your Roth IRA has become effectively bigger because it is now all net spendable money! It has become bigger by your tax bracket percentage and can now grow tax free! It is as if the \$300,000 of outside funds that you used to pay the taxes on this conversion has been morphed in to your Roth IRA.

4. Convert to a Roth January 1, 2010.

Everybody. Everything. This appears to be a no brainer as there are wonderful new special rules and conditions that apply. Income taxes do not have to be paid until 2011 and 2012 (divided equally) on this conversion. You may also undo or recharacterize the conversion anytime until October 15, 2011 if you extend your tax return. So you have one year and ten and a half months to determine that you have made the right conversion decision. That is 652 days to decide! A lot can happen in 652 days and if the conversion makes sense you keep it or you may recharacterize. And this effort costs

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you nothing. Yet if you do nothing about converting you may not later convert in retrospect. In 652 days your account could go up by a significant amount and you may have the satisfaction of knowing you paid taxes on a much smaller amount. Plus you did not finalize your decision until after you actually saw the Roth conversion become an even better deal due to asset growth.

5. Separate asset classes before conversion.

There are no limits to the actual number of IRA accounts that you have. Therefore if you are going to convert you should consider separating your IRA in different assets or asset classes for maximum control. Let's say you had three major assets in your IRA of bonds, small cap stocks and large cap stocks. You would be advised to convert three separate IRAs into Roth IRAs. That way if one of your accounts goes down in value you can decide to unconvert or recharacterize it up to 652 days later as shown above (number 4). If you converted three separate IRAs instead of one you can pick and choose and let the two that increased in value remain as Roth conversion and get a "do over" on the one that went down.

2010 will be a great year for Roth knowledgeable financial professionals!

John Bledsoe can be reached at john@johnbledsoe.com.