

REASONS A ROTH IRA CONVERSION MIGHT MAKE SENSE

1. The current market provides a low-cost conversion opportunity

For traditional IRA owners, they (or their beneficiaries) will eventually have to pay taxes on the value of their retirement accounts. The larger the account, the larger the tax bill. Considering that many individuals may have experienced a loss in the value of their retirement account in the past 18 months, now may be an excellent time to lock in the income tax liability. An IRA worth \$100,000 in 2007 may be worth \$70,000 today. By converting today, the owner locks in the tax bill on today's value. Should the \$70,000 account recover and grow back to \$100,000, the taxpayer will avoid paying the taxes on the \$30,000 difference.

2. Business owners may have a "tax-free conversion" opportunity

ROTH conversions can be a useful tool in harvesting certain tax losses. In particular, taxpayers that have Net Operating Loss (NOL) carry forwards, charitable contribution carry forwards, nonrefundable tax credits, and other business and ordinary losses may find it wise to generate income by converting some of their retirement accounts to a ROTH IRA. For instance, a business owner with taxable income of \$75,000 and a NOL of \$100,000 would have income of negative \$25,000. The business owner may wish to convert \$25,000 of taxable retirement assets with little or no tax cost.

3. A conversion may offer a hedge against increasing income tax rates

In past decades, the US had top marginal tax rates as high as 50%, 70%, and 90%. As a matter of fact, for the past 50 years there have only been five years (1988-1992) when the top marginal tax rate was less than the current 35%. Considering the current budget deficits, costs of stimulus packages, etc., many believe that income tax rate increases are inevitable. Taxpayers who share that belief may wish to take advantage of today's historically low tax rates.

4. A ROTH can provide “tax diversification”

Other than tax exempt municipal bonds, very few investments grow tax exempt. The ROTH IRA is an exception. Just as asset allocation and investment diversification are cornerstones of proper planning, it will become increasingly important to have tax diversification during retirement years. By being able to supplement retirement income with tax free income, retirees increase their likelihood of keeping themselves in a lower income tax bracket.

5. Social Security planning

A tax-diversified retirement portfolio also helps with Social Security planning. As you know, up to 85% of Social Security benefits are taxable depending upon the taxpayers Modified Adjusted Gross Income (MAGI). When calculating MAGI for Social Security purposes, taxpayers must include all taxable and tax exempt income, plus 50% of their Social Security benefits. Interestingly, ROTH distributions are not included in the calculation. Therefore, having a ROTH IRA to supplement retirement income may be very important in managing taxability of Social Security benefits.

6. Trust planning

Trusts are one of the preferred vehicles for transferring wealth from one generation to the next. However, for the unwary, the trust could become a tax trap. Distributions of taxable retirement accounts to a trust would be taxed at the highest marginal income tax rate of 35% as soon as the income exceeds \$11,150 for 2009. By comparison, individual taxpayers do not pay taxes at the 35% rate until their income exceeds \$372,950. If the purpose of the trust is to hold retirement assets long term and protect them against the beneficiary’s creditors and spendthrift behavior, it may make sense to convert the retirement assets to a ROTH IRA prior to death, pay the taxes at a comparatively lower rate , and allow the assets to be paid to the trust income tax free.

7. A tax free stretch opportunity

One of the more compelling reasons to convert retirement assets to a ROTH IRA is that the beneficiaries of the IRA can stretch the account tax free over their lifetime. Both traditional and ROTH IRA beneficiaries enjoy this stretch benefit, but the ROTH account will continue to build tax free, while the traditional IRA’s tax burden will increase with its future growth.

Source: Brandon Buckingham, JD, LL.M., “Getting Ready for 2010”, John Hancock, 07/2009.

Please note that First Coast Financial Advisors does not offer tax or legal advice. You should consult your tax advisor to determine whether a ROTH IRA conversion is suitable for your circumstances.