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Should you convert your Traditional IRA to a Roth IRA in 2010?

By Scott P. Noyes, CFA® CFP®

In 2010, tax laws have changed to permit taxpayers with income over \$100,000 to convert all or part of their IRA's to Roth IRA's. This is good news because income earned in Roth IRA's is not taxed by federal or state governments. The downside is that you have to "buy out" the government's share of your current IRA by adding the converted amount to your taxable income. This could very likely push you into a higher tax bracket and may result in supplemental AMT taxes. ***This strategy only makes sense if your current combined tax rate is equal to or lower than your future tax rate.***

What is the difference between a Traditional IRA and a Roth IRA?

Traditional IRA's are usually formed by depositing pre-tax dollars that are deducted from your salary into an IRA, 401k or Profit Sharing account. Taxes are paid many years later when taking distributions in your retirement years or by your descendants. All three types of accounts enable you to compound your investments tax free while in the IRA. The key purpose is to shift income from your high tax years to low tax rate years. This strategy works as long as your future tax rates are lower than your current tax rate.

Your Traditional IRA should be considered a joint investment between you and the government. Their share is equivalent to your marginal tax rate during the years when the income is distributed and taxed to you or your descendants. For example, if you have a \$100,000 IRA and are in a 35% tax bracket, the government theoretically owns \$35,000 of your IRA. They will have to get paid at some point in time.

Roth IRA's and Roth 401k's are formed by contributing after-tax dollars. The good news is that the income earned in Roth accounts is never to be taxed by the government and it does not require distributions during your lifetime. They compound tax free during their life and are a great inherited asset.

Should you convert all or part of your Traditional IRA to a Roth IRA?

Our overall conversion recommendation is to buy out the government's share when your tax rate is as low as possible. This may be 2010, 2011 or never, as there are many variables in the decision process. Here are some key concerns:

- Is your combined current tax rate lower than your expected future combined tax rate?

- If you have very low income this year versus future earnings prospects, then consider converting.
- If your descendants' tax rates will be meaningfully higher than your tax rate, then consider converting.
- If you plan to retire in a lower tax state, conversion may **not** be for you.
- Do you have sufficient liquidity in non-IRA accounts to pay the tax? If not, conversion is probably not for you.
- Will you need to spend the IRA during your lifetime? If yes, then conversion is probably not for you.
- If you receive federal, state or local aid based on your level of income, there may be a higher cost to convert.

Three steps for a successful Roth conversion

- 1) Have your financial planner run a conversion projection to compute your potential Roth conversion savings using multiple assumed tax rates.
- 2) During this tax season, have your accountant compute a 2010 tax projection scenario using multiple Roth conversion amounts.
- 3) Consider meeting with your estate attorney to discuss the impact of Roth conversion on your estate plan.

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