NOYES CAPITAL MANAGEMENT, LLC
Personal Financial Planning & Prudent Investment Management
www.noyescapital.com
973-267-8120

February 1, 2010

Roth IRA Conversions have Become a Sales Gimmick
By Scott P. Noyes, CFA® CFP®

The Wall Street selling machine has a new gimmick – Roth IRA conversions. Commission brokers, insurance agents, media pundits and yes, financial advisors, are creating all sorts of fantastic reports and models that tell you why you should convert your IRA to a Roth IRA. There are even strategies on how to game the system using multiple accounts, picking winners and undoing the losers. You should consider if there is a hidden agenda from the firm or advisor making the recommendation – typically to gather your assets. While Roth conversions make sense for some investors, they are certainly not right for everyone.

BE CAREFUL!! – Roth conversions are complicated and can be very expensive. Be prepared to carefully do your homework, think through the key assumptions, and write a big check to the IRS.

Overview
In 2010, tax laws changed to permit taxpayers with incomes 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. Our overall conversion recommendation is to buy out the government's share when your tax rate is as low as possible.

The decision to convert depends upon how you respond to several key assumptions:

First Key Assumption - What will your future tax rates be when you, or your decedents, actually use the money? While many of us believe tax rates are going higher for the next five years, trying to predict 20, years, 30 years and 40 years in the future can be a difficult decision. If you assume higher future tax rates, the benefits of converting to a Roth IRA increase.

Second key Assumption – Roth conversions make more sense for aggressive investors. The higher your future rates of return, the better off you are converting to a Roth IRA. The benefit of a Roth IRA is that future gains are untaxed. If you invest your Roth IRA cautiously, you are not likely to maximize the benefits. For example, if you keep your money in CD's or bonds, converting to a Roth IRA does not make as much sense. Roth IRA conversions are more successful if high future returns are likely.

Third Key Assumption – Conversions make the most sense if you pay the tax out of a taxable account not the IRA. Paying extra tax on an IRA withdrawal to pay the conversion tax just does not make much sense to me. Do you have the cash to pay the tax?

Fourth Key Assumption - If you plan to soon move from a high tax state to a low tax state, wait until after you move to convert to a Roth IRA. Paying an extra 10% in state taxes, can adversely affect the breakeven for converting to a Roth.

Fifth Key Assumption - Will you need to spend the IRA during your lifetime? If yes, then conversion is probably not for you. Your tax rate in the future is likely to be relatively low.

Three steps for a Successful Roth IRA Conversion

If you think that a Roth IRA conversion could be for you, consider doing the following:

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. Decide if you can and want to pay the additional tax of your taxable accounts.

3) Consider meeting with your estate attorney to discuss the impact of Roth conversion on your estate plan.

Scott P. Noyes, CFA®, CFP® is the President of Noyes Capital Management, LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey. www.noyescapital.com. He is a frequent presenter on Roth Conversions to advisor groups.
