HELM
INVESTMENT MANAGEMENT

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One of the more complicated decisions facing many investors today is whether to convert their IRAs into a Roth IRA (and defer the tax until 2011 and 2012). There is no "cookie cutter" answer. There never is when investments, estate planning, and income taxes get mixed up.

Big IRAs are the result of either saving and growth over time, or "rollovers" of retirement plans to an IRA. IRAs grow tax-free and are creditor protected. Withdrawals after age 59½ are taxed as ordinary income. Annual distributions are required after 70½. Roths, on the other hand, are taxed as ordinary income when an IRA is rolled to a Roth. After that, all Roth distributions are tax-free. Forever. That's a great deal, if you are willing to pay the taxes now and want to avoid future taxes. Therein lies the rub. Who wants to pay taxes now and hope for the future?

Some people will benefit from conversion to a Roth IRA. If you have other assets that you can spend, then you won't need to take distributions from your Roth . . . ever. It grows tax-deferred until you die and you give the Roth to your children. Of course, you have to pay the income taxes today. But those income taxes today will probably be less than death taxes due when you die. For that matter, the income taxes today will probably be less they might be after the income tax increase next year. Congress is expected to restore the (old) two top brackets of 39.6% and 36% beginning in 2011. Living a long time is also a good reason to convert. Roths have no annual required minimum distributions, so your investments are growing tax-deferred until you die.

Many people don't like the idea of paying the tax now, dying, and never getting anything from their Roth. But a conversion still works if the Roth owner simply wants to eliminate required minimum distributions and take whatever Roth distributions are desired on their own schedule. There is no income tax on Roth distributions of any size, and no penalty for not taking distributions. Again, the advantage goes to a Roth account growing tax-free because the account was previously taxed.

From an investment perspective, if your IRA is smaller now than it was two years ago, you will pay a smaller income tax to convert now than you will if you wait, watch your IRA grow, and then make up your mind to convert. The smaller IRA today will pay a smaller income tax and also have more growth potential. By the way, the new law lets a taxpayer converting to a Roth in 2010 defer the tax. None of the gross income from the conversion is included in taxable income in 2010; half the income resulting from the conversion is included in gross income in 2011 and the other half in 2012.

The above loophole is also a reminder to work through various scenarios with whoever does your tax return or estate planning. We are glossing over a lot of details. For example, any Roth distribution within 5 years of conversion is subject to special rules.

This is not an all-or-nothing scenario. You can convert some of your IRA to a Roth and leave the rest in the old IRA. The bottom line is, if you think you are going to live for a long time, like the idea of flexible distributions, or no distributions, are willing to pay taxes now and believe that future income taxes will be greater than current income taxes, converting all or some of your IRA to a Roth may work for you.

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