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To Roth or Not to Roth?

How do you decide which clients should take advantage of new Roth IRA rules?

By Michael Kitces

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For the past 12 years, clients could contribute to a traditional or Roth IRA. Both accounts present certain tax benefits that are attractive in some situations, but next year, the rules regarding Roth IRAs are going to change. This could be a boon for some well-to-do clients, who have been limited by their high incomes from taking advantage of Roths IRAs. And this should be an opportunity for advisors to contact clients for an IRA checkup.

Then again, whether one should choose a traditional IRA or a Roth IRA is a tricky calculation, and planners often fail to use a clear analytical framework to make that decision. In this article, I

High-income earners, either single or married, with adjusted gross incomes of over \$100,000 have been unable to convert assets from a traditional IRA to a Roth IRA. That restriction disappears next year and every year thereafter. Of course, clients who want to convert funds from a traditional IRA funds to a Roth IRA have to pay taxes on the amount to be converted, however providing they meet certain rules, they will never have to withdraw those assets or pay taxes on them if they do withdraw them.

There is also a one-time provision in 2010 that allows clients to spread their tax income from the conversion equally over the next two years, 2011 and 2012.

So should you advise your high-income earners to make the switch? Let's go over some Roth basics.

The maximum Roth contribution will still be phased out as modified AGI increases (in 2009 the limits are \$105,000 to \$120,000 for single taxpayers and \$166,000 to \$176,000 for married joint filers). So the real opportunity for wealthy clients involves converting from a traditional IRA to a Roth.

Both traditional and Roth IRAs allow the same maximum contribution (\$5,000 in 2009, plus a \$1,000 catch-up contribution for those over age 50). Note that any contribution to a traditional IRA reduces the contribution one can make to a Roth IRA. If you contribute \$3,000 to a traditional IRA, you can only contribute \$2,000 to any other IRA to avoid exceeding the \$5,000 total contribution limit (before catch-up contributions).

THE FIVE-YEAR RULE

Contributions to a Roth IRA don't create any initial tax deduction the way a traditional IRA contribution does. After-tax contributions to a Roth IRA may be withdrawn at any time, free of any income taxes or penalties. Once all original after-tax contributions have been withdrawn, subsequent distributions are treated as coming from growth in the Roth IRA (unless Roth conversions have occurred, as discussed later).

In order for withdrawals of growth from a Roth to be tax-free, clients have to wait until the first day of the fifth year after the year the Roth IRA was set up. This is the so-called five-year rule (i.e., if you opened a Roth between Jan. 1 and April 15 of 2009 as a 2008 account, the five-year clock would start on Jan. 1, 2008). In addition, the taxpayer must be either over age 59½, already deceased, suffering a permanent or total disability, or eligible for special first-time homebuyer treatment (for a limited dollar amount).

To the extent that a withdrawal of growth doesn't satisfy the five-year rule and one of the subsequent requirements, it will be subject to ordinary income taxes. Separately, a withdrawal of earnings (but not original contributions) from a Roth IRA may also be subject to the same 10% early withdrawal penalty as with the traditional IRA, unless an exception applies.

However, unlike traditional IRAs, the Roth has no requirement to begin distributions while the owner is alive. Nonetheless, traditional and Roth IRAs follow the same required minimum distributions (RMDs) for beneficiaries after the owner dies (although the post-death Roth IRA distributions may still be tax-free).

CONVERSIONS

Taxpayers can also increase their Roth IRA funds by completing a conversion of part or all of a traditional IRA to a Roth IRA. Technically, this is simply a rollover. The taxpayer has to report all pretax amounts as ordinary income.

A Roth conversion can also be reversed under the Roth recharacterization rules. A recharacterization lets you transfer back any assets that were converted from a traditional IRA to a Roth, but the recharacterization rollover must occur by the due date of the tax return for the tax year in question, including extensions. Any amounts rolled back must be adjusted for gains or losses that occurred during the intervening period. If completed in a timely manner, it's as though the conversion never occurred, and no Roth income is reported for tax purposes.

When withdrawals are taken from a Roth IRA that has a Roth conversion, a separate five-year rule also applies. This conversion five-year rule applies separately for each Roth conversion that has occurred. If the principal of the Roth conversion is withdrawn after five years, the amounts are tax-free (they are treated as principal since taxes were paid at the time of conversion), and they are penalty-free (i.e., no 10% early withdrawal penalty applies). However, if the withdrawal occurs within five years of the conversion, the 10% early withdrawal penalty may apply, unless the taxpayer is eligible for one of the other standard exceptions to the early withdrawal penalty.

If there are contributions in a Roth IRA attributable to both regular contributions and a Roth conversion, the amounts are treated as first coming from the Roth contributions (tax- and penalty-free), then from Roth conversions (tax-free but requiring a separate five-year rule to be penalty-free), and then from any Roth earnings/growth (tax-free only if the separate requirements are met for withdrawing growth from a tax-free Roth IRA). If there are several Roth conversion contributions, withdrawals are deemed to come from the earliest one first.

MAKING THE DECISION

The starting point for deciding whether to contribute to a Roth or traditional IRA is what I call "the tax-equivalency principle," combined with the idea that it's best to pay taxes when the tax rate is lower. That is, you should make Roth contributions or conversions when your tax rate is low now and higher later, and use traditional retirement accounts when the reverse is true.

First, to witness the tax-equivalency principle in action, let's compare contributions to each kind of IRA, making sure that we start with the same pretax income. Assume an individual earns \$5,000 in income and contributes it to a traditional IRA. There are no immediate tax consequences for the \$5,000 of income earned, because the deduction for the \$5,000 contribution offsets the \$5,000 earned income. With a Roth IRA, a person could contribute only \$3,750 after taxes, assuming a 25% tax rate (the other \$1,250 goes to pay taxes on the \$5,000 of income earned).

It may seem that the \$5,000 traditional IRA is better, but to compare the two accurately, you have to look at how much a taxpayer would have available to spend after liquidating the IRAs (since you can't directly spend money from an IRA without paying taxes).

Assume the IRA accounts are invested identically and, over time, growth doubles the value of each account. The traditional IRA grows to \$10,000, and the Roth IRA, to \$7,500. If the Roth meets the appropriate requirements, it contains \$7,500 of tax-free and therefore spendable dollars. However, the \$10,000 in the traditional IRA will be reduced by 25% for taxes, resulting in $\$10,000 - \$2,500 \text{ (taxes)} = \$7,500$ of spendable dollars.

Both accounts yield the same \$7,500. This holds true whether the dollars are taken out in a lump sum or over time, and regardless of the growth rate or period. Thus Rule No. 1 of Roths vs. traditional IRAs: When tax rates remain the same, directing pretax income toward either a traditional IRA or Roth will result in the same spendable after-tax dollars. This is the tax-equivalency principle.

TAX RATE CHANGES

However, the tax-equivalency principle only applies when tax rates don't change. When tax rates do change between the time of contribution and the time of withdrawal, Rule No. 2 kicks in: Pay your tax liability whenever the tax rate is lower. It is beneficial to contribute to a Roth IRA if tax rates are lower now (and higher later). Conversely, it's better to contribute to a traditional IRA if tax rates are higher now and will be lower later. This holds true regardless of the current account balance, rate of growth or time period.

The growth rate and the deferral period will magnify but not reverse the results of a change in tax rates. If the tax rate change is favorable, a longer time period and/or higher growth rate create even more wealth, and vice versa. Therefore a lower current tax rate favors the Roth, and a higher current tax rate favors the traditional IRA.

EXCEPTIONS

There are three exceptions to these two basic rules.

- 1) The opportunity to avoid RMDs from a traditional IRA by using a Roth IRA can benefit the client, even if the tax rates don't change, because more of the client's savings remain in a tax-preferenced account for a longer period of time. However, the benefit is relatively modest unless the client lives significantly beyond age 70½ and avoids many compounded years of RMDs.
- 2) A greater exception to the tax-equivalency principle applies when an individual can contribute or convert the maximum amount to a Roth IRA and use money from an outside taxable account to pay the tax liability. This lets a client take a traditional IRA—essentially a tax-deferred investment combined with a deferred-tax liability inside the account—and turn it into an entirely tax-preferenced savings account by using up tax-inefficient outside dollars. The magnitude of this benefit depends on the time period over which the taxable account is no longer growing in a tax-inefficient manner. Since the benefit begins to accrue immediately when the Roth is created/contributed/converted, it allows for a far longer accumulation period and a potentially greater benefit than simply avoiding RMDs.
- 3) Occasionally, an individual can enjoy an estate-tax benefit from a Roth conversion, although the benefits tend to be at the state, rather than Federal level, unless the pretax retirement accounts are the majority of the estate.

FORECASTING TAX RATES

In deciding whether to use a Roth or traditional IRA, one must still make a forecast about future tax rates in order to compare current to future tax rates so the client can aim to pay the tax liability when the rate will be lower.

Historically, IRAs were created so that individuals could save money during their high-tax years when they earn employment income and then withdraw money when they transition to more modest income and means in retirement. Wealth would be created both through tax-deferred growth and because taxable income is deferred to a lower tax-rate environment.

However, the size of the savings necessary to replace employment income in retirement and the taxable income those savings produce may still result in a similar, or higher, tax rate. Thus, an estimate of future tax rates based on a client's anticipated wealth savings is critical. In fact, the entire conversion might be undesirable, especially given how portfolio income does (and does not) affect the taxation of other ordinary income.

Future tax rates can in part be estimated by identifying an individual's future retirement income needs and the assets necessary to sustain them. For example, if a client's spending goal is \$4,000/month (or \$48,000/year), that would require some \$1,070,000 in investment assets (assuming a 4.5% withdrawal rate). If the investments were in a 60/40 equity/fixed portfolio, this would imply a \$642,000 equity investment and a \$428,000 fixed investment. If equities generate an average of 3% dividends and 7% capital gains, and bonds produce a 5% yield, the taxable income of the entire portfolio can be derived for an average year. Using these numbers, the portfolio would generate \$19,260 in dividends, \$44,940 in capital gains, and \$21,400 in bond interest, for a total of \$85,600 in investment income. These amounts could then be referenced against the tax tables to determine the individual's likely tax bracket.

If the individual also held a \$400,000 IRA, the current tax rate could be compared against this anticipated future tax rate to determine whether a Roth conversion would be beneficial. If the IRA was part of the \$1,070,000 in future assets, the accounts could be further apportioned to determine the income from IRA withdrawals and the taxable portfolio.

Planners often assume that a significant amount of retirement wealth will inevitably lead to the highest tax rates, but the reality is often far more nuanced.

For instance, assume a client retiring soon has \$5 million in assets, including a taxable \$3 million and a \$2 million IRA. These will be added to \$2,000/month in Social Security to provide for a \$200,000+/year standard of living. Given that the client will face an RMD of nearly \$75,000 at age 70 1/2 (thus, if income wasn't already high, it will be driven higher at this point), and even more in subsequent years, and significant income from a \$3 million taxable portfolio, is a Roth conversion appropriate?

Many would automatically assume the answer would be "yes," given the significant wealth involved. But let's see what happens when we delve further into the math in "A Tax Story," at right. You will see that the client's total tax liability in the end is only \$52,773 on a gross income of \$336,993. This represents an effective tax rate of only 15.7%! Moreover, the client's ordinary income never even crossed above the 25% bracket. Thus, converting this client's traditional IRA to a Roth would only have avoided 25% of future tax rates, nowhere near the 33% or 35% top tax brackets. In fact, the entire conversion might be undesirable.

If the client were invested in municipal bonds for the fixed-income portion of the taxable account, the total ordinary income after deductions would have been only \$73,593, and virtually all of the client's IRA distribution would have been taxed at the bottom two tax brackets of 10% and 15%! Obviously, for most clients with less wealth, it's even more likely that their actual future tax rates will be modest if they are derived primarily from portfolio income.

Thus, it's not a foregone conclusion that clients, even those who may accumulate many millions in future wealth, will be subject to the top tax rates-though at some point (e.g., above \$10 million), that is inevitably going to happen. Nonetheless, the wealth threshold necessary to truly force all of a client's marginal IRA withdrawals into a top tax bracket is far, far higher than most planners realize.

POSSIBLE TRAPS

This analysis uses today's tax brackets. But the tax law is clearly subject to change, and many would argue that higher tax rates are on the way, given current budget deficits and Social Security and Medicare/Medicaid shortfalls. However, that doesn't necessarily mean higher future tax rates will affect IRA distributions. There are many other ways to fill the Treasury's coffers, including a national sales tax, a value-added tax or a payroll tax increase, none of which affect the tax rate on IRA withdrawals.

There's also the possibility that retirees will receive some form of tax relief, especially given the large baby boomer voting block. So be cautious about seeking significant Roth conversions in anticipation of higher tax rates if a client's situation doesn't already justify it. A higher aggregate tax burden relative to the size of the U.S. economy may be in our future, but it doesn't have to be accomplished via income tax rates applicable to IRA withdrawals!

While the repeal of income limits for Roth conversions will create new first-time conversion opportunities, they are best suited for those who now face lower tax rates and anticipate higher tax rates in the future. Thus, ironically, removing the income limits opens up the opportunity for Roth conversions to those who have higher income, and who already face above-average income tax rates, and thus are less likely to find Roth conversions favorable.

At a minimum, a thorough analysis of the client's individual situation is merited as the current tax rate on the Roth conversion increases, to be certain that a tax-adverse event doesn't occur.

Advisors may also need to be especially cautious about the two-year income-averaging provision that applies in 2010. It may actually be less favorable under current law to spread income out over two years because current income tax rates are scheduled to sunset at the end of 2010 and the new income tax rates (actually, the reinstatement of the old early-2001 tax rates) will actually be higher in 2011 and 2012 by a few percentage points. Thus, for some clients, especially those with modest conversion amounts, such as \$50,000, electing the 2011/2012 income-averaging provision will only push conversion income into higher income tax rates. For them it would be better to opt out of the income averaging.

On the other hand, a \$300,000 Roth conversion will likely push income into the very top tax bracket, and thus income averaging may still be desirable, even though each tax bracket will increase slightly.

Either way, planners should monitor income-tax law changes through 2009 and early 2010 to see if the tax brackets are changed further. Congress is considering proposals to make at least the bottom four tax brackets permanent so that they won't increase after 2010. There is still the possibility that legislators will tinker with the top tax brackets, but they may not. In any case, the decision to use Roth IRAs for income should be client-specific.

TAX DIVERSIFICATION

The decision to Roth or not is inherently risky, since we don't know what tax rates will be in the future. We risk either converting when we shouldn't have, or not converting when we should have. Some advisors manage this risk with tax diversification—using some Roth and some traditional IRA contributions (or conversions), so the client holds a portion of each.

However, this approach should be used cautiously, since completing a Roth conversion for a high-income client already in the top tax bracket is probably an unnecessarily risky transaction. To convert an already-high tax rate sets a very high tax threshold to clear.

An alternative approach is "opportunistic tax diversification," which allows the client to make Roth contributions on a year-by-year basis. For instance the planner might have a client contribute to a Roth IRA only in years when the individual's tax bracket will be 25% or less (anticipating tax rates at least that high in the future for that client). On the other hand, if the focus is conversions and not new contributions, this type of approach might lead to a systematic process of doing partial Roth conversions opportunistically to fill the lower tax brackets year after year, while cutting off the Roth conversion amount before it reaches higher tax brackets. This strategy may be especially effective for retirees, whose taxable income often varies annually. A client may even be able to do a partial Roth conversion to offset negative taxable income in years with excess deductions, creating a zero-tax liability Roth conversion for a portion of the account.

BRINGING IT ALL TOGETHER

If the current tax rate is lower than the future tax rate, a Roth IRA will clearly be more favorable. If the current tax rate is equal to the future tax rate, or future rates are anticipated to be lower, then the analysis needs to consider how much lower future tax rates can be and still favor a Roth account. This will depend on how long the client lives (the value of avoiding RMDs), and how long the account is likely to grow and remain intact. (That in turn depends on the client's age, future withdrawal and spending goals, and possibly the period over which beneficiaries may stretch the account after the owner dies.) This assumes that the client has other outside taxable dollars available to cover the tax liability for the contribution or conversion. In any event, if the future tax rate is anticipated to decline more than 10%, it is unlikely that the Roth will be favorable except for unusual circumstances.

By following this process, planners can take advantage of Roth IRA contribution or conversion opportunities for clients, without "over-converting" and creating unnecessarily large current tax liabilities that could result in less future wealth.

Overall, the Roth versus traditional IRA presents a favorable opportunity to time tax events, so the client can pay taxes when rates are anticipated to be lowest. Timing the taxation of retirement savings alone can present a significant opportunity to enhance client wealth. The longer the time period and greater the savings growth rate, the more added wealth can be accrued.

Beyond that, the tables tilt slightly toward a Roth IRA simply because of the opportunity to avoid RMDs, enjoy occasional state or Federal estate-tax savings, and especially by using outside taxable accounts to maximize Roth amounts. These advantages of the Roth IRA allow taxpayers to enjoy a benefit for the Roth account, even if future tax rates are actually slightly lower.

Nonetheless, the Roth is no panacea. Converting at a tax rate that's currently too high can cause a significant loss of wealth over time if tax rates are much lower in the future for that particular client.

Michael E. Kitces is the director of financial planning for Pinnacle Advisory Group, and the publisher of the e-newsletter, The Kitces Report, and the blog, Nerd's Eye View through his website, kitces.com. For additional information, go to kitces.com/BICRothSpecial.php.

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