

# Gresham Partners, LLC Tax Planning Brief

## Roth IRA Conversion: Is it worth it?

Beginning in 2010, a planning opportunity is available for individuals owning traditional IRAs. A new law eliminates the income limitations on Roth IRA conversions, enabling anyone, regardless of income level, to convert a traditional IRA to a Roth IRA.

Roth IRAs have existed for over ten years, but due to income limitations for contributions and conversions, they have not been available to high income taxpayers. While both traditional IRAs and Roth IRAs provide tax benefits, they have important differences. For example, traditional IRAs allow for tax-deferred growth with generally tax deductible contributions, but withdrawals (called Required Minimum Distributions, or RMDs) are mandatory once the owner reaches age 70-½, and these withdrawals are subject to income tax at ordinary rates.

By comparison, Roth IRAs offer tax-free growth, with post-tax contributions, but no federal income taxes on withdrawals and no required RMDs for the owner during the life of the account holder or their spouse (although there may be RMDs for heirs). While the income limitations on Roth IRA contributions remain, eliminating the income limitation on conversions of a traditional IRA to a Roth IRA makes the Roth IRA more widely available and worthy of consideration.

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### **Benefits of a Roth IRA**

Given that assets in a Roth IRA grow tax-free and distributions are not subject to income tax, a Roth IRA can provide numerous planning benefits. Depending upon the designated beneficiaries named under the Roth IRA, it may be possible to create a pool of assets that continues to grow income tax-free for decades.

### **Conversion Costs**

As you would expect, converting a traditional IRA to a Roth IRA comes with a cost: current income taxation on the taxable portion of the traditional IRA in the year of conversion into a Roth IRA. By paying this tax on the conversion, you in effect prepay the income tax for your beneficiaries and reduce the size of your estate. Paying income taxes on the conversion with pre-estate tax dollars is one of the estate planning advantages of converting a traditional IRA to a Roth IRA; it generally produces a lower combined tax than if estate tax is paid first on the traditional IRA, and income taxes are paid after death with after-estate tax dollars.

There is a special provision for 2010 only allowing investors who convert to a Roth IRA to split the taxable income between their 2011 and 2012 tax returns. However, if income tax rates increase over the next few years – as many expect – this could result in a higher overall tax liability.

### **Conversion Considerations**

For larger retirement accounts, the tax due on conversion can be significant. Paying a substantial amount in tax today for a future benefit that may be difficult to quantify is not likely to appeal to most investors. There is also the possibility that the federal government may change the rules at some point in the future and subject all or part of Roth IRA withdrawals to some level of tax or required distribution rules. Although there is no indication that such a change is currently being considered, if it were to occur it would likely undo much, if not all, of the benefit otherwise gained by the conversion.

From an estate planning perspective, it is important to keep in mind that taxable retirement accounts (such as traditional IRAs) are not the best assets to leave to beneficiaries because they are potentially subject to both estate tax and income tax when distributions are made. Thus, a Roth IRA conversion offers the greatest potential future benefits for investors who are likely to remain in the highest income bracket, do not intend to draw on their retirement assets during their lifetimes and who plan to leave their retirement assets to their heirs. Other factors to consider prior to making a decision to convert to a Roth IRA include:

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- Your age, your life expectancy, and that of your spouse and/or potential IRA beneficiaries. Once you perform the conversion, ideally you want your assets to have a substantial amount of time to grow tax-free before beneficiaries begin taking distributions.
- Whether you have sufficient assets outside the IRA to pay the tax due on conversion. To maximize the benefit of allowing the Roth IRA to continue growing tax-free, it is best to pay the tax using funds outside the IRA.
- Whether you plan to leave your IRA to charity. Charitable bequests are exempt from income and estate taxation, so a Roth conversion would not be appropriate to the extent this is your intent.
- Performance expectations. How you invest the Roth IRA assets, and your views on future market performance, plays a role in the decision as to whether you should convert. Good performance helps you reach a breakeven point – the point at which the benefits of the conversion outweigh the cost of the tax paid – more quickly.
- Income tax rate assumptions. If you believe that income tax rates will rise in the future, then this view may be an additional factor in wanting to make a Roth IRA conversion today.

### Summary

Deciding whether to convert a traditional IRA to a Roth IRA requires analyzing a number of factors and is highly dependent on your particular facts and circumstances. By making certain assumptions about rates of return and future income and estate tax rates, we can run financial models that may provide some insight on the costs vs. benefits of making a Roth IRA conversion in your particular situation. We will be happy to analyze your situation in light of the many variables and discuss with you whether making a conversion makes sense.

## GRESHAM

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