

Should You Convert Your IRA to a Roth?

By Glenn G. Kautt, CFP, EA

I'm 45 and have about \$360,000 in a tax-deferred IRA. How do I decide whether to keep it in the regular IRA or convert to a Roth? What are the key differences between the two?

Answer

A Roth IRA allows you to make tax-free withdrawals and does not require you to take minimum distributions. With a traditional IRA you have to pay taxes on your withdrawals and start taking minimum distributions when you reach age 70 1/2. The ability to defer withdrawals is a big reason the Roth IRA became so popular.

But before trying to decide whether you want to switch, make sure you qualify for a Roth. That means your modified adjusted gross income (see IRS Publication 590 at www.irs.gov for details) must be \$100,000 or less.

Another consideration is how much you will have to pay in taxes on the IRA money if you convert. If you are in the 34 percent marginal tax bracket, say, your tax liability on the \$360,000 in your traditional IRA will be about \$122,000. Assuming you have money available outside of your IRA (in an after-tax account) to pay those taxes, the conversion may be worthwhile. If not, the conversion is not attractive, because you will decrease the principal from the IRA in order to pay the taxes.

For example, if your portfolio is comprised of a modest IRA total and high net worth, you are a favorable candidate for converting to a Roth IRA based on the following characteristics:

Total IRAs: \$54,335

Other Accounts: \$726,273

You have sufficient non-IRA funds to cover the taxes due upon conversion. You are less likely to use the IRA during your lifetime.

The most popular way to make the decision is to figure the potential income stream from a Roth IRA, then compare that with what you would get from the traditional IRA and earn on the after-tax money you would have used to pay taxes on a Roth conversion. You will have to estimate what annualized growth rate you'll get on your investments and the tax rate that will apply when you retire.

Let us assume a pre-tax investment return of eight percent annually for 20 years. Both the Roth and the regular IRA would be worth \$1,677,945 at that time, because both compound tax-free. If you are in a 32 percent tax bracket when you retire (28 percent federal tax bracket and using four percent as an average state tax rate), you will get \$158,243 a year for 20 years from a Roth account, vs \$145,400 after taxes from your regular IRA and your after-tax account. Based on this calculation, converting to a Roth IRA would give you an extra \$12,843 annually.

But wait! How likely is it you will get an eight percent investment return and be in the marginal tax bracket you anticipate when you withdraw money? More likely, you will not earn exactly eight percent each year and tax rates will change by the time you retire. So basing your decision only on those assumptions is not the best way to analyze the problem.

I suggest using a more realistic, albeit more complex, calculation: a computer method known popularly as a "Monte Carlo simulation," which most financial advisers can run for you. This factors in the odds of a particular future event happening—such as getting an eight percent rate of return, or your tax bracket being 28 percent when you retire—and requires special software. Typically, only financial advisers have this software.

When I ran the simulation for your situation, I found converting to a Roth IRA *is not* necessarily wise. There is only a 54 percent chance you will do better with a Roth IRA—meaning there is a 46 percent chance you will lose value by converting. Given those odds, I would recommend you stick with your traditional IRA.

Investors who would likely benefit the most from converting to a Roth IRA fit the following profiles:

- *Have sufficient funds (non-IRA funds) to pay the taxes due from conversion.*
- *Not likely to use the IRA money - would pass it on to their heirs.*
- *Not eligible to access IRA money for many years (younger clients).*
- *Likely to be in high tax brackets during their retirement.*
- *Very large IRAs that would incur minimum distributions in excess of needs.*

These are just general guidelines - a more in-depth analysis is required for determining the benefits of conversion.