

A Personal Note

It seems that nearly every day some sort of advertisement, article or promotion regarding the 2010 changes for Roth IRA conversions comes across my desk. I admit that this is a potentially great option for some individuals. However, most of what I see looks more like a sales pitch than real financial advice. As with most all financial issues, there are pros and cons that rarely lead to a simple yes or no decision. In today's Financially Speaking, we'll take a deeper look from an advisor's point of view.

Have a question or topic idea? Send us an email at financial.questions@barronfinancialgroup.com – We'd love to hear from you.

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The Roth IRA, Conversions & Rule Changes

Let's start by assuming our readers have a basic understanding of the Traditional IRA and its tax-deferred characteristics. The overriding logic behind saving in a Traditional IRAs is to put money away during your working years and (ideally) receive a tax deduction. The theory goes that while working you are in a higher income tax bracket than when you take withdrawals from the IRA during retirement. It all seems relatively simple. Now let us introduce the Roth IRA. The Roth IRA was developed after the Traditional IRA as an alternate option, particularly for those who are outside the income limits for deductible IRA contributions (though there are also income limits for eligibility to make Roth contributions). Roth IRA contributions are always non-deductible, but there is no tax due upon withdrawal of principal or interest and gains. Unlike traditional IRAs, withdrawals are not required at any age. Government policy allows an IRA owner, within qualifying income limits, to convert a traditional IRA to a Roth IRA. The conversion requires the owner to pay tax on all principal, interest and gains, but results in the future tax free distributions associated with the Roth IRA. Again, seems simple enough.

Here's where things get interesting. For 2010, the Government has changed the rules and removed the income limit for converting a traditional IRA to a Roth IRA. Now, many more people have this option available...but is it a good idea to make the conversion? Answering that question requires future assumptions to be made. First, what is your current effective income tax rate? Then, looking ahead to your retirement, what do you expect your income and income tax rate to be? While history suggests taxes usually go up, if your retirement income is lower than pre-retirement income, couldn't your taxes be lower as well?

Be Wary of Broad Advice

There is no way to offer good financial advice via an article or newsletter. They are too broad to accommodate individual situations and circumstances. But, the mass of articles and examples surrounding Roth IRA conversions seem to suggest they can. From my view, I feel too much of the discussion has focused on why to convert your IRA to a Roth, with very little effort on why not to convert. I believe good

Conversion Logic and General Rules

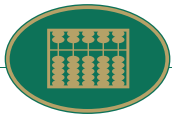
The dominant IRA conversion logic is to pay tax now, convert to a Roth IRA and avoid tax on future IRA distributions. The avoidance of tax on interest and gains alone could make the conversion worthwhile. The counter-logic of the conversion is that you may be paying conversion tax at a higher rate while working than you would during retirement. To complicate the discussion further, consider the source of the funds needed to pay the conversion tax. Once paid to the Government, that money is no longer available to generate interest or investment gains. That is the opportunity cost of prematurely paying taxes.

Which brings us to Roth conversion Rule #1 - Never pay the conversion tax from your IRA. Put simply, if you don't have the funds available outside of your IRA, don't convert. Shrinking a tax-deferred account to pay tax and avoid future taxes is math that does not work well. This rule is followed closely by Roth conversion Rule #2 – The tax payment is certain. In other words, your future income and taxes are uncertain, as are your future investment returns. But the tax payment to make the IRA conversion is certain, so you should have a strong case and convictions about your future situation. This brings us to our next Roth conversion Rule #3 – Don't convert near the start of distributions. The primary Roth advantage is that all interest and earnings are tax free at withdrawal. Thus, it is important to give those assets time to accrue gains and the tax advantages. I generally consider seven to ten years to be sufficient. A final Rule, actually more like a Corollary, is to create a balance of tax-deferred and tax-free retirement income - traditional IRAs providing the tax-deferred income and Roth IRAs providing tax-free income.

financial advising seeks to illustrate pros and cons and enable individuals to make informed decisions. Use this broad advice as a starting point when considering your retirement.

Best Regards,

Jim Thibault



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