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“Does conversion to a Roth IRA always make sense?”

By Mark S. Germain

The new Roth IRA rules have lifted the previous income cap of \$100,000, thereby making everyone eligible for conversion from traditional IRAs into Roth IRAs. As one might expect, the number one marketing initiative of most financial firms this year is to convert investors to take advantage of this new legislation. But before you jump on the bandwagon, do your research. Our analysis does not support a blanket recommendation for our clients; rather each situation needs to be considered independently and carefully.

BACKGROUND

The Roth IRA, named after the late Senator William V. Roth Jr., was created on January 1, 1998, as a result of the Taxpayer Relief Act of 1997. It is an after-tax investment retirement account that builds income tax free and allows for tax-free withdrawals, providing it is held for at least five years. Until 2010, significant income limits on the Roth prevented many wealthy investors from reaping its benefits. Today, every product company and every brokerage is hyping the conversion opportunities and potential.

WHY CONVERT?

With the obvious tax-free advantages associated with retirement distributions, it is easy to conclude that everyone would want a Roth. But what you see is not always what you get. Two simple questions get to the heart of our analysis:

Do you have the money to pay the taxes on the conversion?

Is your income tax rate going to be higher after retirement, when you withdraw funds from the IRA?

If you answered yes in both cases, then conversion makes some sense. First off, you will need enough money upfront to pay taxes on earnings and pretax contributions (only in 2010 can you spread out payments over two years). And secondly, you will have to pay income tax on the conversion at your current rate as opposed to your rate at retirement. It may be hard to predict the future, but there is a big difference in payments (say from 15 percent to 35 percent). Therefore, conversion makes sense only if you expect to be in a higher income tax bracket at retirement.

THE BIG IRS CATCH

So what is the catch? To convert you

must either pay all the tax on the conversion in 2010 or pay it over two years in 2011 and 2012 (subsequent years are included in income during the tax year in which the conversion is completed). Let us look at an example: Our investor, age 55 with a \$1 million IRA, is currently subjected to a 35 percent federal tax bracket and a 5 percent state tax rate. Immediately on conversion, a \$400,000 tax payment is due and is to be paid by funds not in his IRA. That means he just reduced his total investment dollars by \$400,000, from \$1.4 million to \$1 million in his Roth. Assuming a modest 6 percent growth rate, it would take six years to get back to the \$1.4 million of value held prior to the conversion.

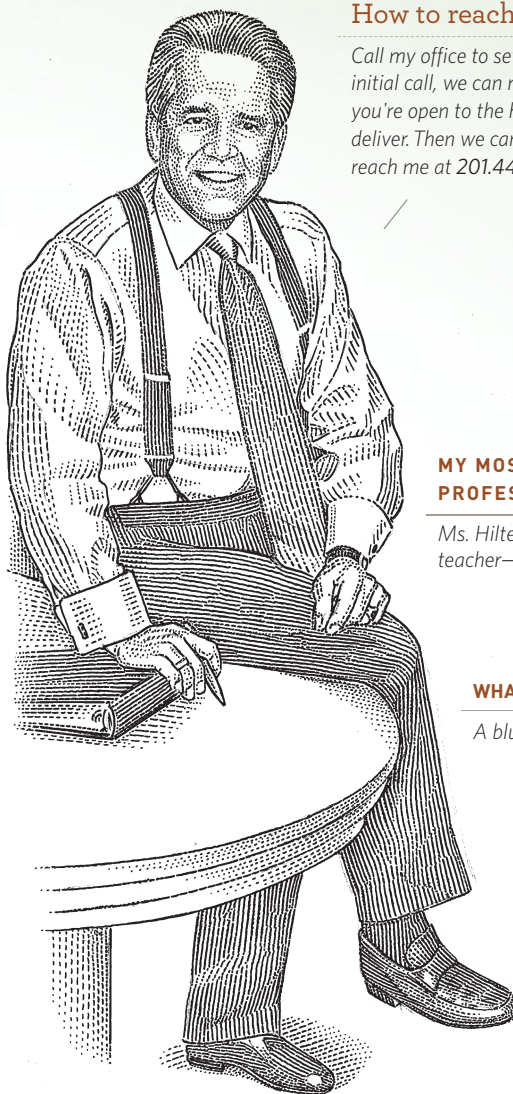
Now compare the same scenario without the Roth conversion. If he lets the \$1.4 million grow at 6 percent, he will have \$1.9 million in six years, which equates to a significant gain—\$512,000 more than the Roth conversion! **Most of the Roth hype fails to recognize and compare the future values of not converting.** The lesson here is to do the math and get help from a registered investment advisor who can walk you through each step of the calculation. ☺

“Conversion makes sense only if you expect to be in a higher income tax bracket at retirement.”

– Mark S. Germain

WHAT MAKES A GOOD WEALTH ADVISOR...

A blunt, honest and client-focused listener



How to reach Mark S. Germain

Call my office to set up a phone consultation. In an initial call, we can make sure our values align and that you're open to the high level of customer service we deliver. Then we can determine next steps. You can reach me at 201.447.9500.

MY MOST INFLUENTIAL PROFESSOR/TEACHER...

Ms. Hilterhouse, my eighth-grade art teacher—she saved me from quitting

WHAT MAKES A GOOD CLIENT...

A blunt, honest and inquisitive mind

About Mark S. Germain

Mark S. Germain is the founder of Beacon Wealth Management. A relentless tactician, Mr. Germain has managed his clients' financial lives with passion and precision for more than 25 years. In addition to his work building wealth management strategies for professionals, Mr. Germain educates professionals on all facets of asset protection, investment growth, tax reduction and financial planning. After completing his BS in economics and accounting, Mr. Germain earned his MBA in finance and taught accounting at Northeastern University. He is currently an adjunct professor at Fairleigh Dickinson University where he teaches CFP® candidates the financial planning process.

Assets Under Management
\$300 million

Minimum Fee for Initial Meeting
None required

Minimum Net Worth Requirement
\$2 million

Largest Client Net Worth
\$28 million

Financial Services Experience
26 years

Compensation Method
Asset-based, fixed and hourly fees

Primary Custodian for Investor Assets
TD Ameritrade

Professional Services Provided
Planning, investment advisory and money management services

Association Memberships
FPA, IMCA, CFP®

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