MANAGING YOUR FINANCES

Weigh Pros and Cons of a Roth IRA Switch

ROBERT MILLER of Pittsburgh is looking forward to doing something that most Americans would consider, well, un-American: He's awaiting a 2010 change in the law that will let him pay extra income tax.

No, the 79-year-old isn't crazy. Miller is making a calculated gamble that converting part of his traditional IRA to a Roth IRA—and paying taxes on each dollar converted—will pay off for his heirs, who will inherit the Roth tax-free. "I look at it as the best kind of gift I can give to my children and grandchildren," he says.

Does converting to a Roth make sense, or is it nonsense? That question will become increasingly important in 2010 when those with income of more than $100,000 will be allowed to convert. Until then, only IRA owners with income of $100,000 or less can convert.

One of the most important factors is also the most unknowable: what tax rates will be in the future. If rates rise over time, paying taxes sooner rather than later could prove a brilliant move. However, if rates fall, or if you slip into a lower bracket, then "the conversion could backfire," says Earl McMahan, a certified financial planner in suburban Detroit.

If your tax rate stays steady, it makes no difference, says Michael Kitces, director of financial planning for Pinnacle Advisory Group, in Columbia, Md. Say you have a $100,000 IRA and you're subject to the 25% tax rate. If you convert to a Roth, you'll owe $25,000 in tax, leaving $75,000 in the account. Assuming it doubles in value before you tap the Roth, you'd have $150,000 of tax-free money. If you left the IRA alone, the $100,000 would double to $200,000, and when you pay tax on the full amount in the 25% bracket, you have, voilà, $150,000.

Actually, even if tax rates stay the same, the conversion can pay off as long as you pay the tax bill with money from a taxable account rather than raiding the IRA to pay the IRS. Money left in an IRA will grow faster than in the taxable account because compounding won't be diminished by the taxation of interest, dividends and capital gains.

Also, remember that money you convert is reported as taxable income, and that could bump you into a higher bracket. Take a couple whose taxable income is $45,000 and falls in the 15% tax bracket. "A $100,000 conversion would throw them into the 28% bracket," says James Lange, author of *Retire Secure! Pay Taxes Later* (Wiley, $25). Instead, he says, you can do a series of conversions over several years, being careful not to let the converted amount push you into a higher bracket.

This tax-bracket roulette means people at the peak of their earning power should probably postpone the Roth conversion until they leave the workforce. At that point, they will likely be in a lower bracket.

Unlike the traditional IRA, the Roth does not require minimum distributions at age 70½, nor does a surviving spouse who inherits a Roth ever have to take distributions. If you don't need to tap your IRA, you or your spouse could let the account grow for years. This is one of the factors motivating Miller, the Pittsburgh resident, to convert to a Roth. "While my intent is not to use it, it's there if I need it," he says.

Beneficiaries who inherit a Roth will enjoy tax-free withdrawals, while those who inherit a traditional IRA owe tax on every dime. "What you're handing them is a lifetime of tax-free income," says Michael Jones, a certified public accountant with Thompson Jones, in Monterey, Cal.

For example, a 9-year-old who inherits a $100,000 Roth IRA, assuming an 8% return, would get nearly $6 million tax-free over her lifetime, says McMahan. But Kitces counters that there's less to inherit because the estate is reduced by the amount of income tax paid on the conversion.

Those who convert won't have to report any of the income on their 2010 returns. Instead, the converted amount can be reported evenly on 2011 and 2012 returns, so you can pay the bill in installments.

But there's a twist. Tax rates are set to rise after 2010. If that happens, Kitces says, "for some people, it will be better to not spread the income, but instead elect to report it all in 2010." K —KATHRYN A. WALSON

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