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Roth IRA Conversions—A Golden Opportunity for Advisors and Clients

By Michael C. Slemmer, CFA, and Ben Norquist

Mike Slemmer is co-founder and principal of AdvisorsTrustedAdvisor.com, a resource launched to meet the business growth needs of RIAs and financial planners. He is co-host of a weekly radio show on WNSH 1570 AM that is re-played on the site. Slemmer is also principal of The Collaborative, a business development consulting firm for the financial services industry.

Ben Norquist, CPC, CISP, is the president and CEO of Convergent Retirement Plan Solutions, LLC, a nationally recognized training and consulting firm that supports the retirement efforts of many of the country's leading financial service providers.

Imminent changes to the Roth IRA rules will open the door to more than \$1 trillion dollars in potentially convertible retirement plan assets on January 1, 2010—good news for clients and for advisors looking for new ways to grow their businesses.

The changes will offer investors, even in this dreary investment landscape, a true advantage in the quest to build and retain retirement capital. The changes create a strategy that combines advising clients to accelerate paying taxes on retirement plan assets with (believe it or not) a great marketing opportunity for wealth management firms.

While the Roth IRA conversion option has been around for as long as Roth IRAs (since 1998), access to the tax strategy has been limited to households with \$100,000 or less of modified adjusted gross income (MAGI). In other words, access to Roth IRA conversions has historically been limited to those who are the least likely to be in a financial position to take advantage of it.

Just Out of Reach

Over the past decade, Roth IRAs have enjoyed ever-increasing popularity as a tax-savvy alternative to conventional tax-deferred retirement savings such as traditional IRAs and 401(k) salary deferral contributions. Roth's popularity was underscored by the significant increase in the amount of annual Roth IRA contributions following the liberalization of the funding eligibility requirements in 2002.

But, even as the eligibility requirements for annual Roth IRA funding were liberalized, a provision in the federal tax law that allows certain qualifying individuals to "convert" traditional tax-deferred savings to Roth IRA savings has been kept just out of reach for many taxpayers, thanks to the \$100,000 MAGI restriction.

How Do Roth Conversions Work?

The Roth conversion option allows qualifying taxpayers to electively convert some or all of their traditional IRA, 401(k), 403(b), or 457(b) savings to Roth IRA savings. To do so, the taxpayer must include the taxable portion of the traditional savings in his or her taxable income in the year of conversion. Admittedly, that's no minor financial feat for anyone looking to convert a sizeable sum. But once the traditional assets are converted, taxpayers stand to enjoy a variety of future benefits, including:

- Tax-free growth (in most cases)—especially important for those who think income tax rates are likely to go up

- Tax diversification-crucial from a retirement income planning perspective
- No required distribution at age 70 ½-a key feature for individuals interested in leveraging their retirement savir as part of a financial legacy
- Peace of mind-for many retirees, simply not having to worry about whether income tax rates will increase in the future is priceless

What's Changing?

Thanks to a provision in the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005, the \$100,000 income restriction on Roth IRA conversion eligibility is set to be lifted as of January 1, 2010. This little-publicized change will open the door to a tremendous tax planning opportunity for millions of taxpayers who currently hold well over \$1 trillion in tax-deferred IRA and defined contribution plan assets.

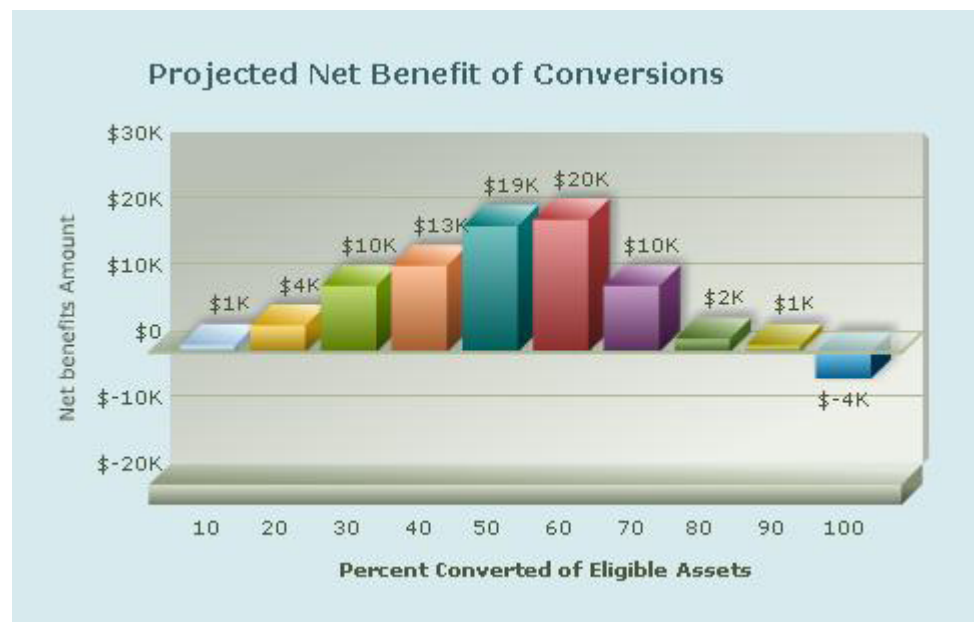
In addition, there is a special tax incentive for those who choose to convert during 2010. For conversions that are mad during the 2010 calendar year, federal law allows taxpayers to delay taxes by electing to include the taxable portion of the 2010 conversion ratably in taxable income for 2011 and 2012.

While advising clients to "defer the taxes at all costs" may be good advice in most situations, when it comes to Roth conversions that's not necessarily the case, especially in 2010.

Careful Analysis Required

With millions of additional households on the verge of gaining access to this potentially invaluable planning strategy, n is a good time to revisit the key variables that must be considered when assessing the pros and cons of a full or partial Roth IRA conversion.

Unfortunately, the Roth conversion question has historically been looked at as an "all-or-nothing" proposition. As sophisticated advisors have learned, however, the key question clients need to be asking is not "should I convert?" but rather, "what is the *optimal* percentage-if any-of my overall retirement savings that I should consider converting?" (See Projected Net Benefit of Conversions below.)



To be effective, an analysis of the potential pros and cons of Roth IRA conversion analysis must account for a variety of factors in addition to the client's current and future tax liability. There are several interrelated variables that have a profound effect on the projected advantages or disadvantages of a Roth conversion. (See Results below.) These key variables are:

1. Projected Income Needs

Since one of the potentially significant advantages of a Roth IRA conversion is the opportunity it offers to avoid taking required minimum distributions (RMDs) at age 70 ½, the client's projected income needs during retirement relative to overall retirement savings is a crucial variable in a proper Roth IRA conversion analysis. If, after taking into account all

needs from his or her retirement savings is projected to be *less* than his or her projected RMDs, this is a strong indicator that a partial Roth IRA conversion may yield significant benefits.

2. Legacy Objectives

Converted Roth savings leverage the federal tax laws in favor of a client's heirs. Given current uncertainty regarding the future of estate tax laws, the ability to reduce the future value of a client's estate by paying income taxes now can potentially yield significant future benefits in the form of lower estate tax liability at death. What's more, with converted Roth IRA assets, the client's beneficiaries will enjoy the benefits of a tax-free income stream. By considering the potential impact for a client's heirs, advisors are able to better quantify the potential advantages of a full or partial Roth IRA conversion.

3. Future Tax Rates

Clearly, if one is going to consider paying taxes on retirement savings now in order to avoid paying taxes on those assets (and their earnings) in the future, some assumptions must be made regarding future income tax rates. While no one can say with absolute certainty where personal income tax rates will be in the future, a good case can be made that top marginal tax rates are likely to go up given the state of the federal budget deficit and the fact that top marginal tax rates are currently at an (almost) all-time low. While it is certainly important to consider the impact of future tax rates when considering a Roth IRA conversion, it is also crucial for advisors to recognize that there are numerous ways to benefit from a Roth conversion, even if personal income tax rates do not rise thanks to the tax diversification benefits and legal planning advantages of Roth IRA savings.

4. Available "Outside" Assets

While many taxpayers and advisors mistakenly presume that a full or partial Roth IRA conversion only makes sense if outside assets are available to pay the resulting conversion taxes, the truth is actually far more nuanced than this. Depending on a client's situation, paying some or all of the income taxes related to a Roth IRA conversion out of existing retirement savings—when other sources are not readily available—can make perfect sense. Accordingly, to be both accurate and reliable, Roth IRA conversion analysis should not simply "assume" that conversion taxes will either be paid 100 percent out of pocket or 100 percent out of IRA assets, but rather look at what amount of "out-of-pocket" assets is available for paying conversion taxes and then ask the question, "Is additional conversion likely to yield additional net benefits (e.g. more projected income in retirement, or a greater financial legacy for heirs)?"

While paying conversion taxes with out-of-pocket assets is almost always the preferred approach whenever possible, many advisors are surprised to find that the advantages of a Roth IRA conversion are often sufficient to outweigh the negative consequences of having to dip into retirement savings to pay for some or all of the conversion taxes. (Note: Individuals who are under age 59 ½ will generally be subject to a 10 percent early withdrawal penalty on IRA distribution amounts that are not converted—e.g., taken out to pay the taxes related to a conversion. In such cases, the likelihood of such a strategy being advantageous is significantly diminished.)

Your Inputs | **Results**

Results

Please adjust the sliders below to model various assumptions.

First Generation

Future Rate of Return 8%	Consumption Start Year 2020
Future Tax Rate 31%	Outside Assets Available to Pay Conversion Tax 60% (= \$60,000)
First Generation Payout Period 27 years	Monthly Consumption Withdrawals \$1,200

Next Generation

Future Tax Rate 28%	Monthly Consumption Withdrawals \$1,800
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[Additional Inputs](#)

Roth 2.0

Historically speaking, Roth analysis and decision making by taxpayers has been haphazard at best. While simplistic, Web-based "Roth calculators" have become the de facto standard on many financial Web sites, most professional planners agree that the various conventional tools and analysis fall short of meeting the needs of the evolving and increasingly sophisticated retirement income planning field. As the Roth 2.0 landscape begins to unfold during 2009, advisors can anticipate access to an entirely new generation of educational content, analysis, decision support tools and business development strategies as an increasing number of product providers jockey for the lead position in this rapidly expanding market space.

How Can This Grow My Business?

In times like these, when *good* news is scarce, these changes offer a great opportunity to reaffirm your value to your clients and open doors with prospects. For business building, advisors who seize this opportunity to be "out in front" will have a compelling reason for prospects (and the press) to listen to them. Likewise, educating centers of influence about this change will build credibility and open more doors for business development.

From a *defensive* perspective, advisors that aren't knowledgeable about Roth changes and who don't proactively educate their clients will likely get client calls also-to ask "why didn't you tell me about this?" Another important reason to communicate with clients in 2009 is that among those clients for whom a full or partial conversion is appropriate, many will need planning time to be able to pay the conversion taxes.

Properly conducted, a thorough Roth IRA conversion analysis sets the stage for a comprehensive retirement income planning discussion-and opens the door for a much broader relationship.

Advisors Trusted Advisor and Convergent Retirement Plan Solutions will host a workshop called The Roth Factor: A Conversion Opportunity on April 28 in Boston to help advisors and retirement plan providers understand the technical aspects of the Roth conversion and to be able to act on the unique marketing opportunity offered by Roth in 2010.