Delaying your decision to late in 1998 is probably prudent. But preliminary planning now could increase your options next year.

Should You Convert to a Roth IRA? It Depends on Your Circumstances

By Peter James Lingane

This summer's tax legislation introduced several spin-offs on the conventional individual retirement account (IRA). Clark Blackman and Christine Romsdahl discussed these new options in the October issue of the *AAII Journal* (Retirement Plans column). One new option, the Roth IRA, follows most of the rules governing conventional IRAs and other deductible pension plans with the twist that you pay the tax up front, but future appreciation is exempt from federal income tax.

Withdrawals are also free of California income tax; residents of other states should determine whether their state has conformed to the federal legislation.

There are the usual restrictions on withdrawing money before retirement. In addition, money withdrawn from a Roth account within five years is subject to a 10% penalty.

If the marginal tax rate when making a contribution is higher than the rate that will be applied to the distributions—the typical scenario for most individuals—then conventional IRAs and other deductible pensions offer a more tax-advantaged investment environment than does a Roth IRA. That is, deductible pensions generally provide more aftertax benefit per dollar invested.

Tax efficiency is not the whole story. An investment return of 10% may provide more benefit per dollar than does an 8% return, but you may end up with more dollars on a larger investment earning 8% than on a smaller one earning 10%!

The Roth IRA allows a larger tax-advantaged investment than does a conventional IRA: $2,000 aftertax to a Roth account is larger than $2,000 pretax to a conventional IRA. This extra savings may make contributing to a Roth IRA attractive for some taxpayers.

Converting a deductible pension to a Roth IRA has the potential of substantially increasing tax-advantaged investment. This can increase wealth and save estate tax.

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Converting can be attractive because you end up sheltering more money in a Roth account. How? Conversion requires that you take a distribution from the conventional IRA and pay income tax on this distribution. You then make a Roth contribution equal to the pretax value of the distribution from your conventional IRA. And $500,000 in a Roth account—an aftertax amount—is worth more than $500,000 in a deductible pension—a pretax amount.

On the other hand, converting usually means paying more tax than if you were to withdraw the money during retirement. Thus, converting is more attractive if done when other taxable income is low and if done gradually rather than all at once. This strategy minimizes the adverse effects of graduated tax rates at the time of conversion.

The dilemma is that the possibility of extra tax favors conventional IRAs and deductible pensions while the potential for extra savings in a tax-advantaged environment favors conversion. Because of this trade-off, the benefits of conversion are case-specific.

This article focuses on the kind of analyses necessary to determine which factor dominates in your specific circumstance. These analyses are multifaceted and involve a number of assumptions too lengthy to reproduce here. However, they will be attached to this article as it appears on the *AAII Journal*'s Web site (www.aaii.com).

Assuming benefits are attractive in your circumstance, you should assess several additional issues before deciding to convert. First, you should determine whether your state will adopt the federal legislation.

Second, and more problematic, are future changes that could affect the benefits of a Roth conversion. Because the Roth IRA is new and regulations have not been issued, the rules are unclear and vulnerable to change. While the tax-exempt status of Roth IRAs probably won't be repealed, the appreciation of a Roth account, for instance, may become subject to the alternate minimum tax or it might be considered when determining the taxability of Social Security benefits.

Third, 1998 is a special opportunity because the conversion income can be spread over four years. This lowers the tax bill. But your adjusted gross income must be less than $100,000 in the year of conversion. (The pension distribution is not included in this ceiling.) Thus, if you want to have the option to convert in 1998, you may need to take steps now to bring next year's income below this conversion limit.

Why Roth Provides Different Benefits

There is no difference between a deductible retirement plan and a Roth IRA if you start with the same *pretax* amount and if the marginal tax rate when making contributions is the same as the tax rate on the distributions. However, a deductible retirement plan is favored if tax rates are lower in retirement.

Figure 1 illustrates how income and pension tax rates typically change upon and during retirement for a married couple. Data after the first death have been omitted for clarity.

Income, the solid line, falls upon retirement but continuously increases after mandatory pension distributions begin at age 70½. Part of the increase is inflation (the chart shows future dollars) but the larger effect is the operation of the minimum distribution rules.

The first two dots (upper left corner) identify the 37% marginal tax rate before retirement. This is the rate that determines the tax savings from pension contributions.

The dots thereafter are the rates of tax on the annual pension distributions. These are incremental rates and are determined from two tax calculations, one with and the other without the pension distributions.

The average tax on the pension distributions, 25% in this example, is calculated by adding the tax on all the pension distributions and dividing by the value of the distributions.

Since the average tax rate on the pension distributions is lower than the pre-retirement marginal tax rate, pre-retirement contributions would be more tax-efficient if made to a deductible pension.

These same principles apply to conversions. If the couple in this illustration converts before retirement, the tax rate effect of and by itself would generate a *tax loss*. If they convert between retirement and age 70½ when their income is lower, the tax would be less and their tax loss would decrease. The tax loss would become a *tax gain* if the incremental tax on the conversion income were less than the tax on the pension without conversion, 25% in this example.

Most people find that their tax rate goes down in retirement, but there are exceptions. Small business owners who plan to sell upon retirement, investors with substantially appreciated portfolios, and someone with a multi-million dollar pension plan or an inheritance could see their tax rate go up in retirement if their current income corresponds to a 28% or lower federal tax bracket.

Someone just starting out whose income will grow should consider a Roth IRA contribution or conversion. A grandparent hoping to encourage a teenager by matching part-time earnings should insist on the money going into a Roth account.

The Roth Advantages

So far, we have been considering differences in tax efficiency between a Roth IRA and a conventional IRA or deductible pension. But we must also consider that paying the tax at the time of conversion from non-pension assets allows you to substantially increase your tax-advantaged investment.

Roth accounts are free of the minimum distribution rules that apply to deductible pensions. Since tax-free compounding continues until you need the money or die, a Roth IRA offers more tax-advantaged compounding than does a deductible pension if living expenses can be met from non-Roth assets.

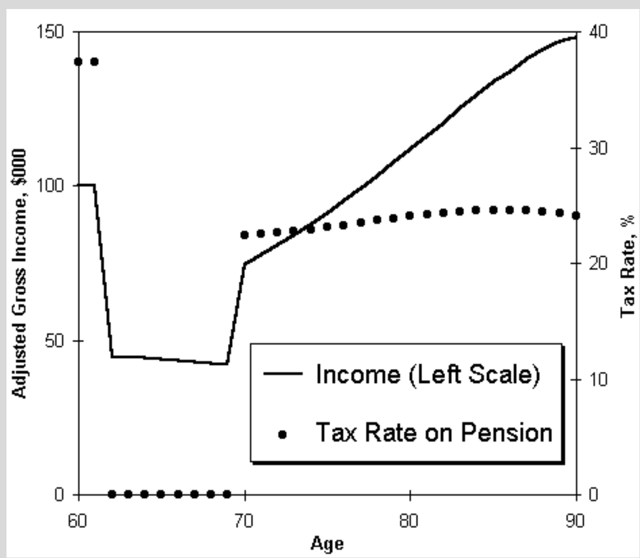
Conversion produces positive benefits when the value of the extra tax-advantaged investment and longer compounding outweighs the cost of any extra tax.

Planning Ahead

Careful planning is essential to optimize conversion benefits. The important variables include:

• The amount of the IRA to be converted,
• The value of the taxable portfolio, investment return, and amounts of other income in relation to expenses,
• When the conversion is carried out, and

Figure 1.
Income and Pension Tax Rates:
A Typical Example



- The IRA withdrawal schedule without conversion.

Unfortunately, several factors prevent taxpayers from achieving the full potential of conversion benefits:

- Lower income tax rates in retirement reduce the benefit of conversion.
- Marginal tax rates increase in the years of conversion due to the conversion income. This further reduces the benefit of conversion.
- You could be assessed state income tax on both the conversion income and appreciation in the Roth account.
- If you sell appreciated assets to pay the tax, the conversion benefit is decreased by the future value of the accelerated tax on the assets sold. (Even though there is more tax on the conversion, an investor with unrealized capital gains achieves a higher effective return than an investor with the same nominal return who pays tax currently. The net effect can be to increase conversion benefits.)

The Trade-Offs: Sample Cases

Our first couple has $1.2 million equally distributed among their home, retirement plans, and investment portfolio. They spend $4,000 a month after taxes and plan to retire in 1998 at age 62 with Social Security benefits of $1,600 a month. Both are in good health; the husband will live to age 90 and his wife to age 94. Their retirement resources are comfortably in excess of their needs and net worth at the second death will be $1.8 million. As shown in Figure 1, they will pay a 25% average tax on pension withdrawals.

If they convert their entire retirement plans in 1998, when the conversion is eligible for income averaging, the tax on their pension increases to 34% and they end up with slightly less money at the second death. Converting in 1999, without the benefit of income averaging, increases the tax to 43% and decreases net worth at the second death by a whopping $425,000.

If they were to convert half their pension in 1998, the tax on their pension drops to 20% and net worth at the second death *increases* by $225,000. This benefit is equivalent to an extra two years living expenses late in life.

Converting your entire pension may not be optimum. Your plan should investigate converting less and converting slowly.

This couple could convert a quarter of their pension in 1998, wait a few years before converting some more, and still achieve a $250,000 increase in net worth at the second death. You may lose nothing by approaching conversion cautiously.

Benefits are smaller if the deductible pension is the primary retirement asset. Suppose our couple had retired with $100,000 in their portfolio and $750,000 in pensions. (These valuations were chosen so that the net worth at the second death would be the same as in the original case.)

Conversion benefits and the optimum conversion plan have changed. The couple would be marginally less well off if they converted $200,000 in 1998. This corresponds to converting half in the original example.

Converting less than $200,000 is worthwhile, but the benefit is always less than what they would have gained if their assets had not been pension-dominated.

Calculated benefits are sensitive to assumptions about how you would draw upon your pension if you did not convert. In these simulations, annual withdrawals are the smaller of an emergency distribution to balance income and expenses—which is frequently zero—or the minimum distribution over the joint lives of husband and wife refigured annually. Any remaining balance is withdrawn in the year of the second death. This strategy delays pension withdrawals and gains benefit from tax-deferred compounding.

If you assume your pension will be withdrawn uniformly over 20 years beginning from age 65, your pension will be drawn down more rapidly than in these simulations. An accelerated drawdown increases the tax paid on the distributions and limits the time for tax-deferred compounding. These effects make the non-conversion case less attractive and this, in turn, biases the analysis in favor of conversion. These effects can be so important as to change a negative result into an apparent benefit.

Make sure that you use a realistic distribution strategy when analyzing your own situation.

Benefits When Resources Exceed Expenses

The next couple has a $200,000 IRA, a $300,000 home and $200,000 in their investment portfolio and spend $3,000 per month. Without conversion, they will have $750,000 at the second death, pensions and other investments will be exhausted and there will be a small home-equity loan outstanding. They will pay 15% income tax on their pension distributions.

It would be a mistake to convert all their pension in 1998. This would increase tax on their pension to 27% and decrease net worth at the second death by $150,000. Converting one fourth of their pension in 1998 does not increase tax and provides a small benefit.

Suppose that this couple are avid readers of the *AAII Journal* and use the information therein to increase their investment return from 7% to 8% annually. Converting one fourth of their pension in 1998 now produces a $75,000 benefit at the second death, about one year's extra living expenses late in life. Starting with $100,000 more in their investment portfolio produces a similar increase in benefit.

If expenses were less, $2,500 a month for example, net worth would be $1.6 million at the second death without conversion. Converting half in 1998 increases net worth at the second death by $100,000.

Conversion benefits increase when resources exceed expenses, probably because there is less need to draw upon the Roth account with the result that the account compounds tax-exempt for a longer time.

Because the excess of resources over living expenses affects conversion benefits, living expenses in the subsequent illustrations were adjusted so as to exhaust pensions and other assets by the second death.

Special Considerations for the Wealthy Couple

This couple has $2 million in retirement plans, a $1 million home and $2 million in their investment portfolio. They enjoy a $14,500 per month lifestyle and will pay 38% of their pension as California and federal tax. The gross estate at the second death will be $3 million.

It will take some doing to get their income below the $100,000 conversion ceiling. But they are willing to try because they gain $725,000 at the second death if they convert their deductible pensions in 1998.

As in the other examples, there is an incentive for the wealthy couple to convert gradually. Since it is not practical for them to limit their income over several years, their only option is to convert less. If they were to convert half their pension in 1998, they would have $1.0 million more at the second death. This is equivalent to 27 months living expenses late in life.

If conversion were delayed to 1999, income averaging would not be available. Converting half their pensions in 1999 would provide a $475,000 benefit. This is substantial but it is sharply reduced from the benefit of converting in 1998.

Income averaging provides an incentive to decide now whether to position yourself so that your 1998 income is less than the $100,000 conversion ceiling.

Individuals who cannot name a spouse as their IRA beneficiary should consider taking a full pension distribution before death, as is done in these simulations. Otherwise, the unpaid income tax is included in the taxable estate.

Since the Roth IRA grows tax-exempt, there is never any unpaid income tax and Roth owners need not be concerned about holding a tax-advantaged portfolio late in life.

If the wealthy couple were to convert half their pensions in 1998, they would reduce estate tax at the second death by $675,000 if they died unexpectedly at age 80. This estimate assumes a by-pass trust at the first death and a conventional estate plan.

In addition to reducing estate taxes at the second death, a Roth IRA can provide planning flexibility for those couples with insufficient non-IRA assets to take full advantage of the "exclusion amount" when funding a by-pass trust at the first death. A Roth IRA can be used to fund the trust without accelerating income taxes.

Converting Before Retirement

Should you convert if you are 45 years old with a $25,000 IRA? The benefit would be that you could shelter $8,750 from future tax, assuming you are in a 35% marginal tax bracket. Or would you be better off investing the $8,750 in a taxable account and waiting to convert the IRA until you are retired?

From what has already been discussed, the answer depends on the living expenses and asset accumulations at retirement and on the rate and extent of conversion. Let us assume that this couple will accumulate $900,000 in retirement assets by age 65, split about equally between pension and tax-paid accounts, and that living expenses will be $42,000 in current dollars.

Converting after age 65 provides a $50,000 benefit. The *incremental* benefit from converting in 1998 is marginally *smaller*. The recommendation is not to convert.

The situation is different if retirement resources are larger or expenses are less. For example, if expenses were lower in retirement, say $34,000 in current dollars, the benefit from converting after age 65 would be $200,000, or four times larger. There is a $50,000 *incremental* benefit from converting in 1998. The recommendation is to convert.

Do you think that you can forecast your retirement situation precisely well enough to chose between these alternatives? Given the strong influence of the financial situation at retirement and the unknown effects of future tax changes, I think that it's tough to make a convincing case in this instance for converting before retirement.

On the other hand, if you are pretty sure that your tax rate will increase later in life and you have the additional funds with which to pay the tax, it makes sense to convert.

Start Planning—But Don't Rush to Convert

Converting in 1998 offers special benefits because of income averaging. If you think you might benefit from converting, decide whether you should take some steps now to bring your 1998 income under the conversion ceiling.

But don't convert until toward the end of next year. Give the tax authorities a chance to figure out the details and your state legislature a chance to act. Delay also provides you an opportunity to perform a thorough analysis or to seek competent advice.