TO ROTH OR NOT TO ROTH?

That Is The Question! BY GARY ALTMAN, ESQ.

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One of the biggest questions that will pop into the minds of baby boomers this summer as they catch some rays at the beach is whether or not to convert their IRA to a Roth IRA.

Simply put, a Roth IRA is different from a regular IRA in two ways: No distributions are required to be made during the participant's lifetime and any distributions, after 5 years of the conversion, are income tax free – but remember the income taxes are paid in the year converting to a Roth. In other words, you would be paying the income tax up front in order for future appreciation and income to never be subject to income taxes again.

Note: There is special rule for any conversion to a Roth IRA made in 2010 - a taxpayer can elect to have one-half of the income taxed on the 2011 income tax return and the other one-half of the income taxed on the 2012 income tax return.

So, what should a person do? Well, it depends!

It depends on whether or not you will need the money in the IRA to live on and whether you can pay the income tax with assets that are held outside of the IRA. It depends on who you want to leave your IRA to when you die and your age and life expectancy. It depends on your current income tax rate vs. your future income tax rate and whether you believe that income tax rates will be increasing in the future. It depends on your state tax laws and how they tax distributions from IRAs. Finally, it depends on whether you want to pay the income tax on your IRA in 2011 and 2012 in order to escape income taxation on future earnings. It depends on whether you have a taxable estate for estate tax purposes. It depends on the future earnings and tax rates of the beneficiaries of your IRA.

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Generally, in order for a Roth IRA to be beneficial for the person doing the conversion, that person must pay the income tax from assets outside of the IRA and must outlive the conversion by 20 or so years in order for the income tax free future earnings to compensate for the payment of the income taxes when the IRA was converted to a Roth. Exactly how long depends on what investment return is assumed for the newly converted Roth IRA and what assumption is being made for future income tax rates. However, if you assume you will never need to use the Roth IRA, then a conversion will generally make sense and is dependent on the value of your estate and what your estate plan says.

Simple rules that are applicable to most people:

Here are some simple rules that are applicable to most people. However, you should not follow these rules without first getting advice from your accountant, tax lawyer and/or financial planner.

1. If you will need the money in your IRA in the near future, converting to a Roth IRA does not make sense.

2. If you will not need the money in your IRA ever, or at least for 20 plus years, then converting to a Roth IRA may make sense, especially if you are going to leave your IRA (now a Roth IRA) to your grandchildren.

3. If you want to leave your IRA to a charity at your death, then converting a Roth IRA may not make sense.

4. If you want to leave your IRA to your grandchildren, then converting to a Roth IRA may make sense.

5. If you are under 40, converting your IRA to a Roth IRA or contributing to a Roth IRA should make sense.

6. If are over 40, then all of the factors above must be taken into account when determining whether conversion to a Roth IRA makes sense.

The Bottom Line

Financial and estate planning are most effective when considered together and re-evaluated regularly as your needs or circumstances change. Once again, you should not follow the aforementioned rules without first getting advice from your accountant, tax lawyer and/or financial planner who can assess your individual needs.

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