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To Roth or Not to Roth

Is a Conversion Right for You?

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What in the world is a Roth conversion, and why does my financial advisor keep calling me about it?—Susan from Santa Barbara

If the headlines are accurate, Roth conversions are one of the best things to come our way since the polio vaccine. Each day, I'm bombarded by emails, articles, and conference calls touting the miracles of the Roth IRA conversion. If you've heard the term, you may be asking yourself, what's the big deal? Is a Roth conversion right for me?

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Maybe, but probably not.

Consider Susan, who contributed the maximum to her IRA (individual retirement account) over the decades and has built up a sizable balance. Her financial advisor told her that some of the rules had changed regarding Roth conversions, and that she might want to look into it.

Susan doesn't really understand what a Roth IRA is, what it means to convert to one, and how that will affect her investments and tax status. Does it make sense for her?

Let's review IRAs and Roth IRAs briefly, then we'll figure out how the Roth conversion works.

Generally speaking, money contributed to an IRA is tax-deferred, meaning that the taxpayer gets to exclude the contribution from income. Even better, those funds grow tax deferred, and are available without penalty after age 59.5. However, when money is withdrawn from the IRA, the amount withdrawn is taxable as income.

A Roth IRA is the opposite. You receive no current tax benefit when you contribute money into a Roth IRA: You pay full income tax on it. But when you pull that money out later in life, the entire amount is tax-FREE, including both principal and earnings (if you follow IRS guidelines).

A Roth conversion happens when an investor using a traditional IRA directs the financial institution to convert her IRA funds to Roth funds. Remembering that the original contributions to the IRA were not taxed, you'll understand that the amount converted is taxed as income.

Should Susan consider converting her IRA to a Roth IRA? My first question to Susan would be, "Do you have the cash on hand elsewhere to pay the tax?" If Susan doesn't have cash on hand, it won't work for her, because she can't use IRA monies to pay the tax on a conversion. (The IRS has made some special provisions regarding the timing of paying taxes on conversions completed in 2010, buy you'll have to investigate those options and see if they work for you.)

What is Susan's income-tax bracket? Remember that when we convert Susan's IRA to a Roth, the amount converted is added to her income. We would want to be aware of this because we don't want to bump Susan into a higher bracket unknowingly.

The next thing I'd consider is her age. If she is going to pay taxes on this money, does she have time to make that back on her investments? If Susan is in her 50s, she might have time to make back the money spent on taxes. If Susan is in her 70s it might not make sense.

The benefits to Susan? In a Roth IRA, Susan's balance would grow tax-free, rather than tax-deferred. In theory, Susan's Roth IRA balance could grow to any amount, and all withdrawals would be considered tax-free income. If Susan is under 59.5, she could take money from her IRA, convert it to her Roth, and avoid the 10% penalty normally assessed when someone under 59.5 takes money out of an IRA. Susan might have some estate-tax advantages as well. And at age 70.5, she would not be obligated to take minimum withdrawals from her Roth, as she would if she left the money in her IRA.

Should you investigate the possibility of converting your IRA to a Roth? Yes, but don't expect it to work for you. I've run the numbers for dozens of clients, and find that only a very small percentage of folks benefit. Please talk to your tax advisor about your situation prior to executing any strategy.

So look into it, but don't expect it to make sense for you.

Kevin Bourke is a registered principal with and offers securities through LPL Financial Member FINRA/SIPC.