

Converting a Traditional IRA to a Roth: A Quick Analysis of the Math

Converting a traditional IRA to a Roth IRA can be advantageous because qualified distributions from a Roth IRA are income tax free, and a Roth IRA owner is not required to take lifetime distributions. Under current law, many IRA owners are “saved” from considering conversion because, to be eligible to convert, the owner must have adjusted gross income (AGI) of \$100,000 or less (not including the conversion amount).¹ Under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), beginning in 2010, anyone can convert their traditional IRA to a Roth IRA regardless of income.

Removing the AGI limit will allow many more people the option of converting their traditional IRA to a Roth IRA. But just because the option will be available doesn’t mean all IRA owners should take advantage of it. All things being equal, it seems that having a Roth IRA is better than having a traditional IRA.

But, of course, all things aren’t equal: there is a tax cost to converting. When a traditional IRA is converted to a Roth IRA, the entire IRA balance (other than nondeductible contributions) is included in income, often generating substantial state and federal income tax.²

Here are a few rules of thumb to keep in mind: Typically, the conversion will only “make sense” if the owner has other resources to pay the income tax. If the owner’s tax rate at the time of conversion is lower than or equal to what it is expected to be when amounts are to be withdrawn from the account, the owner will either be in the same position or better off converting, no matter what the rate of return and time horizon. Bottom line: Conversion makes sense if you think your tax rate will be higher in the future. Generally speaking, the longer between conversion and withdrawal from the account, the more likely conversion yields a better outcome.

Assuming the IRA owner has cash to pay the income tax upon conversion, he then must consider his tax brackets both now and when funds are to be withdrawn from the IRA, the rate of return, inflation and time until withdrawals will be or must be made to determine whether to convert.

¹ In addition, the IRA owner must have an income tax filing status other than married filing separately. This requirement is also eliminated beginning in 2010.

² TIPRA adds an incentive to convert in 2010: for conversions in that year (and that year only) the taxpayer may elect to have the income taxed equally over two years – 2011 and 2012. An IRA owner could also convert the account in parts over several years to spread out the tax hit.

Advanced Planning Ideas

The following table shows the number of years needed between conversion and when funds are withdrawn from the account for an IRA owner to be better off converting to a Roth IRA rather than retaining a traditional IRA. The table shows the effect of various tax rates “now” – the owner’s marginal tax rate at the time of conversion, and “later” – the owner’s projected marginal tax rate when amounts are withdrawn from the account.³

The calculations assume that the IRA owner has a “side fund” available equal to the income tax due upon conversion which is used to pay the income tax if the account is converted. If the IRA is not converted, the account is allowed to grow at the assumed rate of return, subject to a tax rate of 20% (combined capital gains and ordinary income). A higher tax rate makes conversion more appealing, while a lower tax rate reduces the benefit of conversion.

Number of Years for Conversion to “Make Sense”

Income Tax Rate Now	Projected Income Tax Rate Later	Rate of Return				
		4%	6%	8%	10%	12%
35%	33%	9	7	5	5	< 5
35%	28%	30	21	16	14	12
35%	25%	45	31	24	20	17
35%	15%	> 60	> 60	58	48	41
33%	28%	23	16	13	10	9
33%	25%	37	26	20	17	14
33%	15%	> 60	> 60	54	44	38
28%	25%	16	11	9	8	7
28%	15%	> 60	56	43	36	30
25%	15%	> 60	46	36	29	25

To use the chart, determine the IRA owner’s effective income tax rate upon conversion “now” (including the converted funds) and upon withdrawal of the funds from the account “later”.⁴ Choose an assumed investment rate of return for both the IRA (whether traditional or Roth) and the tax “side fund” assuming the IRA is not converted.⁵ Follow the assumptions to a number of years. If the owner will not withdraw funds from the IRA for at least that period of years, he is better off converting.

³ The analysis assumes the converted account balance is taxed in one year. Neither state income tax nor inflation is included in this analysis.

⁴ Projecting an owner’s future tax rate is no easy task; it requires estimating income, deductions and tax brackets. Recognize that a guess at the owner’s situation in the future is just that – a guess.

⁵ The number of years is based on constant investment rates of return that are compounded annually.

Advanced Planning Ideas

Those planning to convert may want to plan now to minimize their other income in the year of conversion (or 2011 and 2012, if conversion is in 2010). IRA owners should look for ways to shift income to an earlier or later year or to shift deductions to the year of conversion.

Source: [Advanced Planning Bulletin, October, 2009](#)

This publication is not intended as legal or tax advice; nonetheless, Treasury Regulations might require the following statements. This information was compiled by the Advanced Planning Division of The Northwestern Mutual Life Insurance Company. It is intended solely for the information and education and/or promotional purposes of Northwestern Mutual Financial Network. It must not be used as a basis for legal or tax advice, and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Financial Representatives do not give legal or tax advice. Taxpayers should seek advice based on their particular circumstances from an independent tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.

- To comply with Circular 230