

Evaluating the New Roth IRA Conversion Opportunity

Starting next year and in subsequent years, investors will have the option of converting all or part of their money from a Traditional individual retirement account (IRA) into a Roth IRA regardless of how much they earn. Currently, such conversions can be done only by those with modified adjusted gross incomes of \$100,000 or less.

This change is especially timely, given the growing number of baby boomers retiring in the near future and likely rolling over their nest eggs from their 401(k) accounts into IRAs. Whether you are years from retirement or approaching retirement, you may find it worthwhile to consider a Roth IRA conversion—either for yourself or to potentially leave tax-free assets to heirs.

The advantages include: (1) the converted assets—“the principal”—in the Roth IRA can be withdrawn tax-free at any time, (2) any future earnings in the account are also tax-free (with some limitations), and (3) the account owner will not be required to take any minimum distributions in retirement.

However, the taxable amount of a Traditional IRA (earnings plus

Keeping Assets in a Traditional IRA vs. Converting to a Roth IRA

		In Retirement						
		Pretax Value at Retirement (Age 65)		Cumulative After-Tax Value of Withdrawals (Age 65–95)		After-Tax Remaining Balance (Age 95)		
		Traditional IRA	Roth IRA	Traditional IRA	Roth IRA	Traditional IRA	Roth IRA	
Example 1								
45 year old	Taxable	\$114,366	\$114,366	\$178,235	\$217,641	\$51,046	\$120,834	
\$25,000 IRA	Side							
Taxes: \$7,188	Account*	24,755	N/A	40,674	N/A	6,281	N/A	
	Total	139,121	114,366	218,909	217,641	57,327	120,834	
		Total Roth Advantage in Retirement					\$62,238	
Example 2								
55 year old	Taxable	\$105,947	\$105,947	\$165,114	\$201,619	\$47,288	\$111,939	
\$50,000 IRA	Side							
Taxes: \$14,375	Account*	26,475	N/A	45,950	N/A	6,718	N/A	
	Total	132,422	105,947	211,064	201,619	54,006	111,939	
		Total Roth Advantage in Retirement					\$48,489	
Example 3								
65 year old	Taxable	\$100,000	\$100,000	\$155,846	\$190,302	\$44,634	\$105,655	
\$100,000 IRA	Side							
Taxes: \$28,750	Account*	28,750	N/A	59,929	N/A	8,147	N/A	
	Total	128,750	100,000	215,774	190,302	52,781	105,655	
		Total Roth Advantage in Retirement					\$27,402	

Assumptions: The examples assume no additional IRA contributions are made, an 8% annual rate of return before retirement at age 65 and a 6% rate thereafter, and an ordinary federal income tax rate of 25% before and after retirement with a state tax rate of 5% for a combined effective rate of 28.75%. The conversion pushes the 65-year-old investor into a higher tax bracket in the year of conversion only. Net income and long-term gains in the taxable side account are subject to a federal tax rate of 15% and a state rate of 5% for a combined effective rate of 19.25%. All Roth IRA withdrawals are free of taxation; all Traditional IRA withdrawals are subject to federal and state taxes. Withdrawals are made over a 30-year period with 4% withdrawn the first year and the annual withdrawal amount increased by 3% each year for inflation. Withdrawals from the Traditional IRA take into account required minimum distributions. Also, all Traditional IRA contributions are deductible, and therefore the entire conversion amount is subject to taxes.

*We assume that the taxes due on the amount converted are paid from a separate taxable account. Therefore, to do a valid comparison, the taxable side account reflects the value of keeping the “tax savings” that would have been paid in the IRA conversion invested in this separate taxable account, growing at the same rates of return and withdrawals as noted above. The advantage of a Roth IRA would be considerably greater, of course, if these “tax savings” had been spent rather than invested.

Source: T. Rowe Price.

deductible contributions) converted to a Roth IRA is subject to current taxation. So investors must examine whether it is worthwhile to go through this tax tollbooth today so they can withdraw earnings from a

sense, Ms. Fahlund says a partial conversion made today could be viewed as a hedge against possible increases in income tax rates later, or as a “tax diversification” strategy.

45, 55, and 65, planning to convert \$25,000, \$50,000, and \$100,000, respectively, to a Roth IRA. In each case, the investor expects to rely on withdrawals from the accounts for income in retirement.

“Investors must carefully weigh the upfront tax costs against the long-term tax advantages.”

Roth IRA income tax-free during retirement or perhaps leave those assets to heirs who would avoid taxes on the earnings as well.

Given that the values of many IRAs are depressed by the recent financial crisis and that some investors expect tax rates to increase, a Roth conversion could pay off in the long run.

Among the general findings of a new T. Rowe Price analysis of this Roth IRA conversion opportunity:

- “As a general rule of thumb, the further you are away from drawing down from your IRAs—for income or required minimum distributions—the more advantageous prepaying taxes to convert to a Roth IRA will be because there are more years to potentially grow and compound earnings tax-free,” says Christine Fahlund, a senior financial planner for the firm.
- The investor’s potential tax bracket in retirement is also important. If the investor’s tax rate drops significantly after retirement, it may not be as beneficial to convert since the investor would be paying taxes on any earnings (and deductible contributions) at a higher rate now. But if the tax rate rises, converting now may be more attractive since taxes due as a result of the conversion would be paid at the lower current rate, while withdrawals from the Traditional IRA in retirement would be taxed at a potentially higher rate. In this

- For investors who convert Traditional IRA assets to a Roth IRA and do not intend to take retirement withdrawals from the Roth IRA unless needed for late-in-life emergencies, a conversion provides the opportunity to turn a relatively small amount of savings into a surprisingly sizable bequest to their heirs.
- In any case, for the Roth IRA conversion to be most advantageous, any taxes due on the amount converted should be paid from a separate taxable account and not from the IRA itself.

To Convert or Not to Convert

To examine the potential benefits of a Roth IRA conversion, here are some hypothetical cases of investors who are planning for or entering retirement.

The chart on page 12 summarizes the results for three investors, ages

When converted, the Traditional IRA assets are subject to taxation because they consist of deductible contributions and earnings, and the taxes due on the conversion are paid from a separate taxable account.

Assuming tax rates remain the same after retirement, all three investors would modestly benefit overall from the conversion in the long run—and the more years from retirement, the greater the benefit.

The assumptions used in this model result in a long-term after-tax advantage of about 10% for the retiree converting at age 65. However, the 55- and 45-year-old individuals could achieve long-term after-tax advantages of about 18% and 22%, respectively.

Keep in mind that the taxable amount converted into the Roth IRA is considered taxable income, so it is possible that a large conversion could push the investor into a higher tax bracket for a particular year, increasing the tax due on the converted amount.

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Building a Tax-Free Nest Egg for Yourself

Value that could be accumulated in a Traditional IRA versus a Roth IRA by a 45-year-old investor who converts \$25,000 to a Roth IRA by paying \$7,188 in taxes from a taxable account

Age of IRA Owner	Value of Traditional IRA*	Balance in Roth IRA	Roth IRA Advantage Over Traditional IRA
75	\$175,448	\$204,812	\$29,364
80	219,677	274,085	54,408
85	267,295	366,788	99,492
90	316,359	490,844	174,486

Assumptions for tax rates and rates of return are the same as those used for the exhibit on page 12.

*Value of the Traditional IRA includes the sum of cumulative after-tax required minimum distributions, the after-tax value of the account, and the after-tax value of the taxable side account.

This taxable side account was funded with the taxes that would have been paid if the investor did the Roth conversion.

Source: T. Rowe Price.

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The 65-year-old investor in this example, for instance, saw her combined marginal federal/state tax rate jump from 28.75% to 31.60% for one year as a result of the \$100,000 conversion.

“A Roth IRA is one of the most valuable assets people can leave their children or grandchildren.”

That is one reason investors might prefer to convert portions of their Traditional IRA over several years, rather than doing it all in one year. This approach may enable investors to avoid a big jump in tax liability in a single year. (See article on page 15 for special 2010 tax rules.)

Building a Tax-Free Nest Egg

While a Roth IRA conversion may not provide substantial additional benefits for investors who consider their IRAs a source of steady income in retirement, it could prove

extremely worthwhile for those who can afford to accumulate a fund for possible emergency expenses later in retirement or possibly leave tax-free assets to their beneficiaries.

For example, what if the 45 year

old making a \$25,000 Roth IRA conversion (as detailed in the chart on page 12) made no withdrawals from the account? (A Roth IRA is exempt from required minimum distributions (RMDs), which the owner of a Traditional IRA must take upon reaching age 70½ and for each year thereafter.)

By age 85, the balance in the Roth IRA would have grown to more than \$366,000 (See chart on page 13), or about \$100,000 more than the balance in the Traditional IRA if the conversion had not been made.

This money could provide a comfortable cushion for unexpected expenses late in retirement.

A Bonanza for Beneficiaries?

The Roth IRA could provide a significant advantage over a Traditional IRA if it turns out the owner did not need the money and leaves it to beneficiaries.

Non-spouse beneficiaries of an inherited Roth IRA are required to take RMDs from the account over their own remaining actuarial life expectancy (certain conditions apply). But such distributions over this extended period may be income tax-free, whereas all earnings and deductible contributions withdrawn from an inherited Traditional IRA are taxable to the beneficiary. Beneficiaries can take more than the minimum amount at any time.

If the 45-year-old investor used in previous examples died at 85 and bequeathed the \$366,000 accumulated in the Roth IRA to a 55-year-old child beneficiary, the total Roth IRA benefit could be more than \$1 million by the time this beneficiary reached 75 (assuming only RMDs were taken from the account and using the same return assumptions noted in the chart on page 12). This would be almost double the amount left in the Traditional IRA.

If the money were left to a 25-year-old grandchild instead of the 55-year-old child, it could grow to as much as \$4.6 million by the time the grandchild reached 65 compared with \$2.3 million from a Traditional IRA, applying the same assumptions.

This strategy could also prove extremely worthwhile even for older investors entering retirement who may be much more certain

Passing on a Roth IRA to Heirs Could Reap Huge Benefits

In this example, the owner of a Roth IRA who converted \$100,000 from a Traditional IRA at age 65 by spending \$28,750 in income taxes passes away at age 85.

Since she took no distributions, the balance in the account grew to \$320,714, which she leaves to her son, age 55, in the year following the year of the owner's death.

The table shows the total benefits to the beneficiary at various ages from the inherited Roth IRA.

The analysis assumes the beneficiary only withdraws required amounts each year, though he may always withdraw more than the required minimum distributions (RMDs) at any time. The other assumptions are the same as in the exhibit on page 12.

Age of Roth IRA Beneficiary	Cumulative Tax-Free Distributions	Remaining Roth IRA Balance	Total Roth IRA Benefit	Advantage Over After-Tax Traditional IRA*
65	\$183,446	\$477,225	\$660,672	\$296,619
70	329,132	475,564	804,696	360,776
75	528,318	413,498	941,816	426,990
80	804,481	244,452	1,048,932	482,105
85	1,086,191	0	1,086,191	510,964

Dollar amounts have not been adjusted for inflation to reflect current purchasing power.

Note: While RMDs are required from inherited Roth IRAs, the amounts distributed are not taxable.

*Reflects sum of cumulative after-tax withdrawals and balances.

The value of the Traditional IRA includes the earnings in a separate taxable account funded by the tax savings, or the amount that would have been paid in taxes if the conversion was not made. This taxable account is not subject to RMD rules but such withdrawals were made for this comparison.

The assumed tax rates and rates of return are the same as in the exhibit on page 12.

they want to carve out a tax-free bequest for heirs.

Consider the hypothetical 65-year-old investor who converts \$100,000 to a Roth IRA and pays the \$28,750 in taxes from a separate account. If she takes no distributions, she will have an account balance of more than \$320,000 by age 85 (using the same return assumptions as in the chart on page 12).

If she dies at that age and leaves the money to a 55-year-old child, for example, it could provide more than \$1 million in cumulative tax-free distributions and the remaining account balance after 25 years. That would be more than twice as much as if the money had remained in the original Traditional IRA. The potential benefit, at various ages of the beneficiary, is reflected in the chart on page 14.


“A Roth IRA is one of the most valuable assets people can leave their children or grandchildren,” Ms. Fahlund says. “The investments are tax-sheltered, the income can be tax-free, and, after the death of the Roth IRA account owner, those who inherit the assets can make withdrawals based on their life expectancies, generally to age 80 or older.”

Online With Niall Ferguson

T. Rowe Price will sponsor a free, interactive online lecture and live Q&A with renowned financial historian and award-winning author Niall Ferguson on November 24 at 6:00 p.m. ET at www.thirteen.org/troweprice. The program, open to anyone, will feature a discussion on the U.S. economy in a global context.

Dr. Ferguson, a professor at Harvard Business School, is the author of several widely acclaimed books, including “The Ascent of Money,” which was adapted for a series that aired on the Public Broadcasting System and was sponsored by T. Rowe Price.

While the benefits of a Roth IRA conversion could be considerable, investors must carefully weigh the upfront tax costs against the long-term tax advantages. Those considering a conversion should consult their tax advisors for the best strategy.

For more information about Roth IRAs and Roth IRA conversions, please see troweprice.com/rothira. The Morningstar IRA calculator tool available at troweprice.com/IRA also can help investors gain perspective as to whether a Roth IRA conversion may be worthwhile. 

Roth IRA Conversion Basics

If you are considering converting assets from a Traditional IRA to a Roth IRA, here are some nuts and bolts to keep in mind:

- A key advantage is that the amount converted from a Traditional IRA and any future earnings in the Roth IRA can be withdrawn tax-free in retirement (after age 59½) if the account has been established for at least five years. Beneficiaries inheriting a Roth IRA also may be able to take distributions tax-free.
- The investor must pay income taxes on the taxable amount of the Traditional IRA (earnings plus any deductible contributions) converted to a Roth IRA. In 2010 only, investors who complete a Roth IRA conversion will have the option of paying taxes due on the conversion for that tax year or spreading these taxes equally between the 2011 and 2012 tax years. If tax rates remain the same or decline after 2010, it would most likely be advantageous to delay the tax payment for a Roth IRA conversion completed in calendar year 2010. If tax rates rise modestly after 2010—as they are set to do unless Congress passes a new tax law next year—it may be better to pay the tax for a 2010 conversion for the 2010 tax year, assuming the conversion itself does not push the investor into a higher tax bracket in 2010. Because taxes due on a Roth IRA conversion completed in 2010 would not be payable until April 15, 2011, the investor should know by then what new tax rates, if any, are in effect and make the decision about when to pay the tax at that time. (The actual conversion must take place on or before December 31, 2010.)
- The taxable portion of the amount converted from a Traditional IRA is calculated based on all the investor’s Traditional IRAs—not just the one that may be tapped for conversion. So if the investor had made any nondeductible contributions to a Traditional IRA, the portion of any conversion that is not subject to tax would be the total of after-tax contributions to all her Traditional IRAs divided by the total value of all the Traditional IRAs at the time the conversion is made. The same rule applies to any additional Roth IRA conversions made in subsequent years.
- To minimize the tax impact in any one year, the investor can do several partial conversions spread out over different tax years, but only conversions in 2010 are eligible for a delay in paying taxes due on conversion.
- Those who make a Roth IRA conversion can later nullify it and “recharacterize” the amount converted to a Traditional IRA (certain restrictions apply).
- No required minimum distributions (RMDs) must be made from a Roth IRA during the account owner’s lifetime. In a Traditional IRA, RMDs must be taken beginning the year the investor reaches age 70½ and each year thereafter.