



The Life Financial Group, Inc.

978 Ben Franklin Hwy. (Route 422 east) Douglassville, PA 19518
(610) 385-4500 FAX (610) 385-6868 (800) 688-5800

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Roy L. Russell, Certified Financial Planner
J. Jeremy Ebst, Timothy Russell and Mark Magruder, Advisors



Does a Roth IRA Conversion Make Sense for You?

Recent changes in the IRS tax law have brought the issue of Roth IRA conversions into focus again here in 2010. The Tax Income Prevention and Reconciliation Act of 2005 eliminates the \$100,000 income limit for conversions this year. In addition, a person who converts in 2010 can opt to defer the taxes generated by the conversion until the following two years. Converting to a Roth makes the funds converted, taxable as income. However, for 2010 conversions, half of the income can be reported and taxed in 2011, and the balance in 2012. In light of these changes and other potential benefits, should you consider converting some or all of your traditional IRA to a Roth? To better answer that question, let's begin by considering a few of the fundamental characteristics of a Roth.



- Contributions are made with after-tax dollars. You cannot deduct Roth IRA contributions on your tax return.
- However, withdrawals can be completely federal tax-free and penalty-free provided the account has been held for at least 5 years, and the account owner is over 59 ½. Your invested principal can be withdrawn at any time without paying federal tax or a penalty.
- There is no Required Minimum Distribution from a Roth IRA while the account owner is alive. Traditional IRA owners are generally required to take annual distributions when they reach age 70 ½.

Now consider the following list of potential benefits and drawbacks of a conversion.

Reasons Why a Conversion May Make Sense:

- 1) **Tax Rates are at Historical Lows.** The growing, record-breaking national debt which now exceeds \$13.5 trillion, has many people speculating that these current historically low tax rates are unsustainable.¹ Converting to a Roth would cause you to pay tax on the converted amount at current rates, as opposed to potentially higher rates in the future. If at all possible, taxes on the conversion should be paid from non-qualified money. That eliminates the potential for additional taxes and a penalty if the conversion happens before 59 1/2.
- 2) **The Market is Still Relatively Low.** On October 12th of 2007 the S&P 500 Index reached its high of 1,561.80. Even with the increased strength in the stock market

over the past year and a half, the S&P 500 finished the month of September at 1,141.20, still well below its previous high.² Consequently, many peoples' IRA account values still remain lower than what they were in 2007. Assuming that this is the case, investors who convert today will pay less in taxes than they would have had their they'd converted in 2007.

- 3) **Potential Tax-Free Growth.** Investors who convert now, have the potential to see gains during the next bull market grow income-tax free! This may be of special significance for those investing for the longer term, as the timeline for potential growth is greater.
- 4) **A Full Conversion is Not Required.** Investors have the option of converting only a portion of their IRA to a Roth. Current taxation (discussed below) needs to be evaluated before converting to a Roth. For those concerned about a heavy tax burden resulting from the conversion of their IRA to a Roth, a partial conversion may be a beneficial option.

Potential Concerns to Consider Before Converting:

- 1) **Current Taxation.** Funds converted from a traditional IRA to a Roth generally become taxable in the year in which they are converted. (Note however the exception mentioned above, where for conversions done in 2010, you have the option of counting half of the conversion as income in 2011 and the remainder in 2012). Consequently, persons should carefully consider the following before converting:
 - o **Change in tax bracket.** Will converting to a Roth bump you into a higher tax bracket for the current year (or in 2011 or 2012)?
 - o **Social Security taxation.** For those collecting Social Security, the increase in taxable income resulting from the conversion, could make a greater portion of your Social Security income taxable.
- 2) **Account Holding Period.** As discussed above, one of the requirements for tax-free withdrawals of growth from a Roth, is that the account has been held for at least 5 years. This may make a conversion less attractive for seniors or those planning to take withdrawals from the account within the next 5 years.



If you'd like to discuss further whether converting your IRA to a Roth may be beneficial for you, we invite you contact our office to speak with your advisor.

J. Jeremy Ehst,
Financial Advisor

¹ See treasurydirect.gov, which as of 10/7/10 calculates the total national debt to be in excess of 13.5 trillion.

² Market statistics are taken from <http://www.google.com/finance>.