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Roth IRA Conversion Isn't All Or Nothing Proposition

With all of the recent buzz about Roth IRA conversions, it's easy to get the wrong impression. While for many people establishing a Roth IRA is a great way to get tax-free retirement income, moving assets from a traditional IRA to a Roth doesn't make sense in every case. And even if the positives outweigh the negatives, it may be best to convert only a portion of your IRA assets.

The Roth IRA, created in 1997, can be a remarkable retirement planning vehicle. Qualified distributions from a Roth that has existed for at least five years are completely exempt from income tax. You're eligible to receive this income once you reach age 59½, and qualified distributions are also possible in case of death or disability or to pay up to $10,000 of first-time homebuyer expenses. And with a Roth IRA, you never have to make withdrawals during your lifetime. That contrasts with a traditional IRA, which requires mandatory distributions after age 70½. With a Roth, if you don't need the money, investment gains can continue to compound throughout your lifetime, and your heirs can enjoy the tax-free income (though they'll have to take required minimum distribution).

Before 2010, you could convert a traditional IRA to a Roth only in a year in which your modified adjusted gross income didn't exceed $100,000. Thanks to the Tax Increase Prevention and Reconciliation Act of 2005, this dollar cap has been removed, and now all retirement savers, even those with stratospheric incomes, are eligible to switch.

The primary reason not to convert is the price tag. Income tax is inescapable, and if you didn't pay tax on contributions to your traditional IRA, you'll have to pay up later—either when you move the money to a tax-free Roth IRA, or when mandatory distributions begin. In both cases, you'll be taxed at ordinary income rates, and if you convert a large account, that flood of income may push you into the highest tax bracket (if you're not already there). The only consolation is you can spread out the tax on 2010 conversions over 2011 and 2012. Tax on conversions in later years will have to be paid right away.

Deciding whether to convert your traditional IRA, and how much to move to a Roth, means analyzing many interconnected variables. One of the most important involves tax rates—how much you'll pay on a conversion versus what you would pay if you left the assets in a traditional IRA and withdrew the money during retirement. You might ordinarily expect taxes to be lower during retirement (because you'll likely earn less then), and that could reduce the value of a Roth's tax-free income. But higher tax rates may be coming, particularly for top earners. You'll also need to factor in these other variables.

- Your age and the ages of your spouse and the potential heirs of your IRAs

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Fed Policies Make TIPS Popular But They're No Panacea

If you think conditions are ripe for higher inflation, you might invest in Treasury Inflation Protected Securities, or TIPS. But keep in mind that these investments can be more complicated than they seem.

TIPS are popular now in part because of the steps the Federal Reserve has taken to pull the economy out of its deep recession. By increasing the money supply and pushing down interest rates, the Fed has helped banks and the rest of corporate America begin to recover. But those policies could have the unintended effect of spurring rapid price increases.

If inflation spikes during the next few years, TIPS could minimize the impact on your portfolio. Like other Treasury bonds, TIPS pay interest at a fixed rate until the bond matures. But there's a bonus: a TIPS' principal adjusts up or down each month to keep pace with changes in the Consumer Price Index. When TIPS mature, the government returns either your original principal or the adjusted amount, whichever is greater.

However, like other bonds, TIPS sold before maturity may gain or lose value based on changes in bond yields and inflation. And TIPS' yields tend to be lower than those of comparable Treasuries without inflation protection. Recently, a 10-year TIPS was yielding less than half of what a 10-year Treasury note provided. So, if inflation rises less than the breakeven level reflected in TIP yields, this investment may not pay off.

Caution On Muni Bonds And Funds

Even if Congress doesn't pass new legislation, 2011 will bring higher income tax rates for people in the top brackets. That, in turn, could continue to fuel a recent surge in demand for municipal bonds. The interest they pay normally isn't taxable on federal returns and may avoid state taxes as well. Munis have also been relatively safe investments. Yet now may not be the time to load up on municipal bonds. The fiscal woes of state and local governments may force some to default on their obligations. Meanwhile, an improving economy would bring more tax revenue to state and local governments but could lead to a spike in interest rates that would hurt muni prices.

The recent history of municipal bonds has been turbulent. As the financial crisis unfolded in late 2008, investors flocked to the very safest investments—U.S. Treasury bonds—and sold other assets en masse. Although munis also have a strong safety record, they suffered a sharp drop in demand and prices. That pushed up municipal bond yields, so that in many cases they rivaled those of Treasuries (normally, muni yields are lower, though after-tax yields tend to be roughly comparable, depending on your tax bracket). But then, as bond markets calmed down, investors rushed back to munis, making 2009 a banner year for tax-free bonds.

Muni bond ETFs, meanwhile, have served as an attractive vehicle for investing in these assets. Holding baskets of munis, ETFs are easy to buy and sell—on public exchanges, just like stocks—and they provide diversification and low fees. Returns have been strong, and with tax rate increases approaching, muni bond ETFs have much to recommend them.

Yet they come with two significant risks. The first is credit risk—the possibility of default. The state and local government entities that issue municipal bonds—and that must pay interest and return investors' principal when the bonds mature—have seldom been in a more precarious position. With unemployment high and businesses faltering, tax revenues have fallen sharply, and governors and mayors across the country are struggling to close large budget gaps. Though widespread defaults are unlikely, scattered problems are possible.

And if the economy gets back on track? An accelerating recovery could eventually lead to higher inflation and a hike in interest rates. Inflation reduces the value of bond interest, while rising interest rates hurt bond prices, as investors sell existing holdings to finance the purchase of higher-yielding replacements.

The credit and interest rate risks of municipal bonds—and of the mutual funds and ETFs that hold them—may undercut their value as tax-favored investments. We can help you weigh your investment goals, tax situation, and other considerations in determining whether these bond funds should be part of your investment mix. ●

[1]The term "municipal bonds" is typically used to describe all tax-exempt bonds. Although such bonds are commonly referred to as "tax-exempt," there are numerous federal and state tax consequences associated with the acquisition, ownership, and disposition of such bonds. The tax-exempt status of municipal bonds does not extend in all instances to the Alternative Minimum Tax. Please contact your tax advisor for more information.

[2]You should consider an Exchange Traded Fund's investment objectives, risks, charges and expenses carefully before you invest. The fund's prospectus contains this and other information about the fund, and should be read carefully before investing. A prospectus may be obtained from your advisor or from the fund company directly.

Do A Direct 401(k) To Roth Rollover

In the not-so-distant past, it wasn't particularly easy to roll over funds from a 401(k) plan to a Roth IRA, which can provide tax-free income during retirement or for your heirs. Now, it's a relative snap. What's more, the IRS has provided new guidance on how to complete this maneuver.

Prior to the Pension Protection Act of 2006 (PPA), it took two steps to complete a 401(k) to Roth rollover, and it was possible only if your income didn't exceed a specified limit. First, you transferred funds from your 401(k) to a traditional IRA. Next, you converted the traditional IRA to a Roth, paying income taxes on the amount of the conversion. But you could do this only in a year in which your modified adjusted gross income (MAGI) didn't exceed $100,000.

The PPA fixed part of the problem. Beginning in 2007, you were allowed to roll over funds directly from a 401(k) plan to a Roth, bypassing the traditional IRA. But you still might have been blocked by the $100,000 limit.

That impediment no longer exists. Based on a tax law change that took effect in 2010, you may now convert to a Roth regardless of your annual MAGI. And, for conversions completed in 2010, you can split taxable conversion income between 2011 and 2012. That lets you postpone the tax hit of converting to a Roth, and you may pay less overall if the smaller taxable amount keeps you out of a higher tax bracket.

The IRS recently issued rulings clarifying aspects of a direct rollover. The guidance included these points:

• You can convert to a Roth IRA from retirement plans including 401(k)s, 403(b)s, and 457(b)s.

• A direct rollover to a Roth isn't subject to automatic 20% withholding. But you can agree to voluntary withholding.

• Beneficiaries may make rollover

A Good Time To Reassess Your Risk Profile

The recent past has given investors an invaluable lesson in risk, which makes now an ideal time to reconsider your “risk profile,” the amount of volatility you’re willing to accept. From the happy heights of late 2007, the Standard & Poor’s 500 stock index lost 55% of its value by March 2009, and much of the damage came sickeningly fast, with a 40% freefall between September and November of 2008. Then came a dizzying recovery, as the S&P rallied 60% between March and December 2009. Yet even after the comeback, the large-company index remained some 30% below its record high.

How your portfolio has fared during this remarkable period depends on how much risk was built into your investments, and on how you responded when conceptual risks became all too real. Many investors, lured into volatile areas of the market when most investments were rising, were shocked when numerous sectors suddenly dropped by more than half. Some of these investors watched helplessly, unable to sell as holdings kept plummeting, while others got rid of everything, determined to stick with cash for the foreseeable future.

Neither predicted outcome was good or anticipated. The purpose of determining your risk profile is to use it to build a portfolio that minimizes disruptive surprises. If you think you can handle a 15% annual loss but would be apoplectic if your investments dropped twice that much, then you need a portfolio that, in most economic and market scenarios, wouldn’t dip by much more than that “comfortable” 15%.

But markets don’t always behave as predicted. The recent financial crisis highlighted the reality that assets under duress can move together. All manner of stocks—from shares of enormous, normally rock-solid companies to those of small, fast-growing firms and stocks in once-hot emerging markets—headed down together. And while some bonds fared a little better, Treasuries fared the best as safety-obsessed investors bid up prices and caused yields to decline considerably. And alternative investments, including real estate, commodities, and hedge funds, had major issues of their own.

As a result, most investment portfolios did worse than expected, and that exacerbated the problems of investors who had taken on too much risk. Panicking, many sold when investment values were at their lowest point, and with losses locked in, they’ve missed out on stocks’ historic rally.

Reassessing your risk profile now, and making appropriate portfolio adjustments, could help you prepare for the next financial upheaval. This process may involve several steps. The first is to understand how you really feel about risk. How did you react in September and October of 2008, when account balances slid lower almost every day? Were you able to take a long view, assuming that even this bear market would pass, or did you treasure safety above all else? Would you rather stick with less volatile investments even if that means accepting lower long-term returns?

Your answer to that last question depends in part on what you need your portfolio to achieve, and re-examining your financial needs is step two of this process. Perhaps the prospect of postponing retirement or spending a little less during your later years seems like a reasonable trade-off for the comfort of holding less volatile investments.

Once you’ve figured out how much risk you’re willing to accept, and how much you need to reach your goals, the third step of the process is to incorporate your readjusted risk profile into a formal “investment policy statement.” This document puts your strategy in writing and commits you to the discipline of a plan built around your financial objectives, risk profile, and investing timetable.

You’ll also need to rebalance your portfolio, selling some holdings and buying others, first to get in line with your new risk profile and then to keep allocations steady as markets fluctuate. Finally, it’s important to monitor your investments, periodically re-evaluating what you own in light of your evolving personal circumstances.

We have the tools, experience, and expertise to help investors successfully complete this crucial post-crash process, helping position investments for a potentially smoother ride through the next crisis and steady progress toward financial goals. If you would like to speak with us about your portfolio, please give us a call. ●

contributions to Roth IRAs. Also, surviving spouses who complete a rollover to a Roth IRA may treat the Roth IRA as their own.

• If funds in a designated Roth 401(k) account are rolled over to a Roth IRA, the rollover isn’t taxable, whether or not the transfer is a “qualified distribution.”

• Other transfers, except for amounts representing after-tax contributions to your plan, are taxable.

• If you own company stock in a 401(k), you will not be taxed on the “net unrealized appreciation” (NUA) of the stock when it’s distributed. But you can’t avoid tax on the NUA by rolling over assets directly to a Roth.

• If you’re married, you no longer need to file a joint return to benefit from the rollover provisions.

This is just an overview. We can work with you to weigh the merits of a Roth conversion and help you follow the rules governing such transfers. ●

All Or Nothing Proposition

(Continued from page 1)

- The current value of the IRA assets
- The IRA's projected investment return
- Whether you'll need withdrawals and the projected amounts of withdrawals during your lifetime
- The date of the conversion

Suppose a couple—he's 55 and she's 50—has IRA assets totaling $750,000 ($500,000 in his and $250,000 in hers). Assume the account earns a 4% annual rate of return, they are currently in the 33% tax bracket, and they'll take monthly IRA distributions of $1,000. Their only child is age 25.

According to the Roth IRA Conversion Optimizer, a tool used by wealth management professionals to calculate the impact of different conversion scenarios, if the couple transfers the entire $750,000 IRA to a Roth in 2010, they'll realize a $1.42 million net benefit over a consumption period of 29 years—the difference between converting to a Roth and keeping the traditional IRA. This is based on the assumption that they remain in the 33% tax bracket and their child is in the 28% tax bracket in the future. Note: The "net benefit" doesn't reflect the opportunity cost of using the funds that are paying taxes for other investment purposes.

Other variables could affect the outcome, however. For instance, this initial calculation assumes the couple is able to pay the entire tax on the conversion with funds not in the IRA. If they have to dip into IRA assets to foot the tax bill, it will dilute the conversion's benefit. For instance, if they need IRA funds to pay half of the tax, the net benefit of converting all of the assets is reduced to $809,000. In this case, the optimal net benefit of $921,000 would be achieved by converting 60% of the assets.

Remember that other wild cards—rising tax rates, inflation, state and local taxes, and changes in tax laws, for starters—could also influence this calculation. For many people, the optimal solution may be to convert only part of the traditional IRA. You might decide to leave the money you'll need during retirement, and convert the rest to a Roth. We can help you decide what makes the most sense in your financial situation. ●

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