

# R - retirement O - options T - to H - hang your future on

By Keith McKenzie

With apologies to Shakespeare, the question on wealthy investors' minds in 2010 is "to convert or not to convert." The lifting of the income limitations on converting a traditional Individual Retirement Account (IRA) to a Roth IRA has created an opportunity to access what can be a very potent retirement and estate-planning vehicle. However, like most opportunities, there is no "one size fits all" approach and the potential benefits of a Roth conversion will not apply equally to everyone.

## ANALYZING THE TRADE-OFF

Roth IRAs have two primary benefits over their traditional counterparts. First, whereas distributions from a traditional IRA are taxable as ordinary income, withdrawals from Roth IRAs are generally tax-free. Second, Roth IRAs are not subject to required minimum distributions, allowing their owners to keep the money in a tax-deferred environment for longer periods of time. Of course, these benefits do not come free – they must be "bought" through the up-front payment of income tax on the amount converted. While it seems counterintuitive to pay taxes any earlier than absolutely necessary, it may be a price well worth paying in the right circumstances.

## CONSIDERATIONS FOR CONVERSION

- *Can the conversion taxes be paid from non-IRA assets?* Since the whole point of a conversion is to keep as much money as possible in the IRA, the last thing an investor should do is spend IRA dollars to fund the tax bill.

- *Does the owner of the IRA need the money?* The less chance an investor will need to draw on IRA assets to fund their own lifetime spending needs, the greater the potential benefit to the ultimate beneficiaries of the assets (generally the investor's children or grandchildren, who can "stretch" the account to extend the tax benefits even longer).

- *Where are income tax rates going?* In some ways, a conversion is a bet that the investor's (or beneficiary's) effective tax rate at the time the assets are withdrawn will not be significantly lower than at the time the conversion is undertaken (and taxes are paid).

## ASSET-SPLITTING ROTH CONVERSIONS

Generally speaking, investing decisions don't allow for "do-overs" if things don't work out as planned. However, an investor who converts to a Roth (paying taxes on the converted amount), then experiences investment losses in the account can, within a certain time period, "recharacterize" the account as a traditional IRA, recoup the tax paid, and try the conversion again the next year. You can leverage the potential benefits of recharacterization by splitting a converted IRA into multiple accounts, each of which holds a separate asset class (U.S. stocks, international stocks, bonds, REITs, etc.). Given that each asset class will likely behave differently in terms of performance, the investor



can selectively recharacterize only those amounts invested in any "losing" asset classes, ensuring that tax is only paid on the "winners". Of course, careful monitoring of such a strategy is essential to make sure that the investor's overall asset allocation is kept intact.

Roth conversions can, in appropriate circumstances, be a powerful tool for growing and passing on wealth. They are not, however, an investment panacea. Investors considering a conversion should consult with their professional advisors to analyze the various pros and cons before coming to a final decision.

\*\*\* Delphi Private Advisors does not provide tax, legal or accounting advice, and nothing herein should be construed as an endorsement of any particular strategy. Before making any decisions regarding a Roth conversion, investors should consult with their own tax advisors.

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