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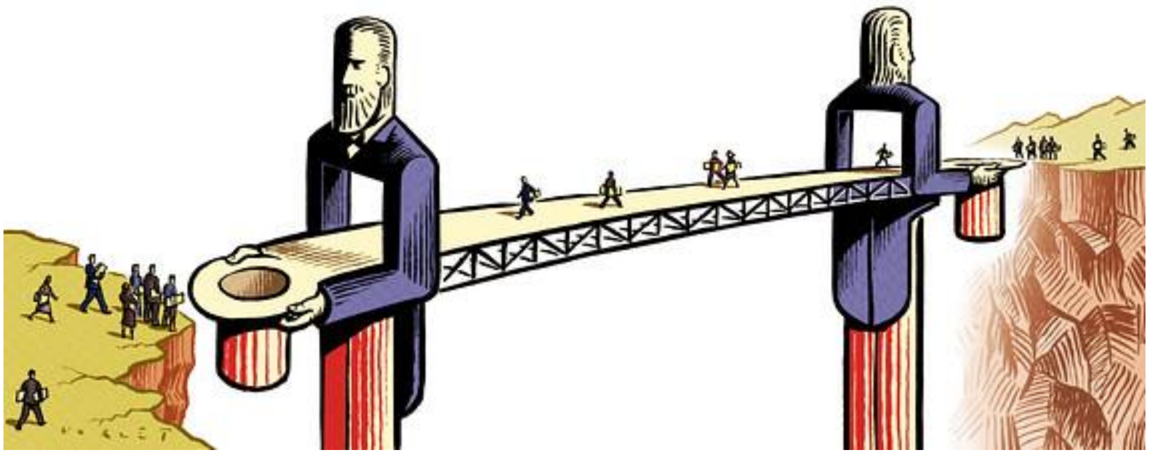
Why You Shouldn't Convert to a Roth IRA

By **ANNIE GASPARRO**



As 2009 came to a close, financial advisers geared up for an expected flood of clients looking to convert their traditional individual retirement accounts to Roth IRAs this year.

Conversions are indeed way up from previous years, thanks to the elimination of the income limit for those wanting to make the switch. But many clients who had expressed interest are deciding not to convert.

Conversion is attractive mainly because withdrawals from Roth IRAs, unlike those from traditional IRAs, are tax-free.

Moreover, Roth IRAs also have no withdrawal requirements; traditional IRAs require investors to begin making withdrawals at age 70½. Several brokerage firms saw conversions by their clients quadruple in the first quarter of 2010, compared with the year-earlier quarter.

However, financial advisers are finding that most clients wouldn't benefit, on balance, from a conversion. Here are the main reasons why:

1. The tax bite is too big.

Clients often come to advisers asking about the Roth IRA conversion opportunity without realizing the immediate tax implications: They will have to pay income tax on any money they move out of a traditional IRA into a Roth account.

"The biggest question advisers have to ask is whether paying taxes is feasible for the investor right now," says Michele Grant, a Roth IRA expert at Wells Fargo & Co.

Investors "don't want to use funds from the IRA to pay the taxes," she says, because that eats into retirement savings. "So do they have the funds elsewhere? And if so, what does that do to them liquidity-wise immediately?"

Ms. Grant says that given the economic downturn, a lot of investors simply don't have the money to pay the taxes up front. But that needn't nix the idea of a conversion altogether, she says. For some investors, converting to a Roth IRA gradually, over a number of years, might spread out the tax impact enough to make it affordable.

Stephanie Ackler, a New York-based financial adviser at Wells Fargo, says that when she discusses the tax expenses with clients, they almost always abandon the idea of converting. "At the end of the day, a lot of folks aren't getting excited about writing a big tax check," she says.

2. Retirement is too close.

Age can make or break an investor's ability to profit from a Roth IRA conversion.

The problem here is that it can take 15 to 20 years for the tax-free growth of a Roth IRA to make up for the taxes paid at the time of conversion, advisers say. And that period can be extended if the investor starts withdrawing money from the account. That makes conversion an iffy proposition for people who are nearing retirement.

"It's not all black and white when it comes to whether or not to do a conversion, but there are some rules of thumb. And the first one is age," Ms. Ackler says. "We've run a lot of scenarios, and almost always if a client is 58 years old or older, it just doesn't make sense."

3. The investor's savings are too concentrated.

Age is even more of an issue for investors who are looking to their IRAs as their primary source of income in retirement. That's because they will need to take distributions from the fund sooner than investors who have other resources, and in larger installments—leaving less time for investment gains to offset the conversion's initial tax bite.

"If a client has a disproportionate amount of assets in retirement plans, it wouldn't be wise to do 100% conversion to a Roth IRA, because they will be pulling the money out to live on soon," says Mitch Drossman, the head of national wealth strategies at U.S. Trust Corp.

Again, though, a partial conversion might make sense for some people. Investors could convert only the portion of their IRA savings that they don't think they will need for a long time, if ever, says Mr. Drossman.

4. Tax brackets often change in retirement.

Interest in conversions is being spurred by anticipation of higher tax rates ahead. Some investors figure they will come out ahead by converting to a Roth IRA now and paying taxes at current rates on the amount they transfer, rather than leaving their money in a traditional IRA and paying taxes at a higher rate when they make withdrawals in the future.

But there's a catch in that scenario: Most people fall into a lower tax bracket when they retire.

"Yes, taxes for the wealthy are going up, but very few people have as much income in retirement as they do in the height of their working years," says Thomas Wiggins, a financial adviser with Rehmann Financial who is based in Troy, Mich. "Even if taxes do go up, investors will likely be in a lower income bracket once they start taking distributions from their retirement fund."

5. The income can change your tax bracket now.

Another tax-bracket issue to consider: For those who aren't in the highest bracket, doing a conversion could bump up their tax rate, because the money being transferred is treated as income, says Chuck Toth, head of product management for Merrill Lynch & Co.'s retirement group.

If an investor is receiving Social Security benefits, the spike in income could force them to pay taxes on their Social Security money, he says. It also could interfere with efforts to receive financial aid for children's college tuition. And, he adds, if an investor is going through a divorce, the additional income could affect the settlement.

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Correction & Amplification:
Traditional IRAs require investors to begin making withdrawals at age 70 1/2. The age in an earlier version of this article was misstated as 59 1/2, which is when an investor can make withdrawals without having to pay a penalty.