Converting to a Roth IRA in 2010: A Foolish Move
You're going to be surprised by what you learn

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There have been a lot of articles over the past year discussing whether people should convert their IRA to a Roth IRA. You would have thought that with all that writing someone would have gotten it right. It is simply amazing how much bad information and bad advice is out there. What makes it worse is that figuring out the answer doesn't take a tax guru or some kind of math expert. It takes about 30 minutes of research and 30 minutes of number crunching. The math isn't even all that difficult. And yet, the really rotten advice is still out there. So I guess the point of this article is two-fold: 1) If you look at the numbers, for most people, converting an IRA to a Roth is a *really* bad idea; and 2) maybe investors should really do more of their own research.

There are three basic components to consider when converting an IRA to a Roth: 1) the investment rate of return; 2) the tax consequences; and 3) life expectancy. The complication, many will tell you, is that since all three components are variables (they can change at any time), it is extremely difficult to get an accurate answer.

Solving an equation for three unknowns can, indeed, be complicated. Luckily, that is not the case here. As my grandfather taught me when I started learning to invest many years ago, "most investing is fifth-grade arithmetic and common sense." Let's consider the three components. For this, we will need an example. The investor for our example will be John and Joanna Smith. They are in the 33% tax bracket (federal) and they each have $500,000 in an IRA, for a total of $1 million (unfortunately, they refused to adopt me for making them famous through this article).

Investment Rate of Return. If the Smiths move their money from their IRAs, the tax on the $1 million will be approximately $400,000 (including state and local). There are two ways in which they can pay this tax: out of their IRAs or from cash that they have available outside of retirement plans. The whole point of the conversion has to be to end up with more total wealth than you would have if you left everything in the IRA, but by doing the conversion, the Smiths are already 40% in the hole.

Now for a little common sense. There are no logical reasons for the investment results in the IRA to be different from those in a Roth IRA. Once can invest in the same types of securities and employ the same strategies, so we must assume, whatever the rate of return achieved, it would be the same in an IRA or Roth IRA. Thus, given that converting the Smiths' IRAs to Roths would start them 40% lower, there is no way to make up the returns through their investments. They will start to catch up over time because investors are required to start to take distributions from their IRA starting at age 70-½. Thus, investment rates of return turn out to be an irrelevant variable.

Tax consequences. Next, the experts say, "well of course you don't pay the taxes with your IRA, you pay them with taxable savings that you have!" But how does this help? The Smiths, if they happen to have $400,000 hanging around, probably would have invested those funds, too, wouldn't they? And unless the Smiths are dramatically more successful with their investments outside of their IRA (which doesn't make much sense), it will take even longer to make up the 40% loss because of the taxes on any of the gains. The sum of the Smiths' savings include all forms of savings, tax-deferred or otherwise. Thus, they are $400,000 in the hole, regardless of which pot they draw from to pay the taxes.

The only possible tax advantage of the Roth is that for some very high-net worth investors, there are potential estate tax benefits. This is a complicated issue and far from my expertise, so I will leave it that an investor should discuss this issue with an estate tax expert if they feel their estate is large enough.

Life Expectancy. This is the last of the unknowns and truly this *is* an unknown. What we do know is that the average life expectancy for an adult in the U.S. today is about 85 years old, slightly older for women, slightly younger for men. This takes us back to the issue of required distributions at age 70-½ in IRAs. The breakeven between the IRA and Roth can be calculated because the IRS has standard tables for the distributions. Since rates of return are expected to be the same, it is easy enough to calculate how long it takes to make up the tax loss from the initial conversion. If we expect tax rates to remain the same, the breakeven age is 85 years. If, however, we argue that taxes will be substantially higher, say going from 33% to 50%, we find the impact is relatively minimal: the breakeven age becomes 82 years.

This is not terribly surprising, though, because the distribution tables for the IRA are based on life expectancy! And since the Smiths will be pulling out only a small amount each year, it will take a long time, regardless of the tax rate, to reach the breakeven.

In addition, we have not taken inflation into account. While Uncle Sam's goal is to get you to pay them as much in taxes, as soon as possible, to offset huge budget deficits, your goal should be to keep your money for your family as long as possible and to pay those taxes as slowly as possible. The Smiths can pay $400,000 now or they can pay it a long time in the future in small amounts. Since inflation typically rises over time (there are relatively few periods in history of deflation), you don't want to pay taxes with current dollars but with future inflated (i.e., less valuable) dollars.

The Bottom Line. Except for a few people who will pay no taxes for converting because of large losses or no income, or for those few that may be able to benefit from estate tax issues, the vast majority of investors do not benefit from converting an IRA to a Roth IRA; but Uncle Sam and those companies that make fees by convincing you to change do.

As Benjamin Franklin noted: "In this world, nothing can be said to be certain, except death and taxes." But he didn't say you had to pay taxes early.

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Harmony Asset Management is a Registered Investment Adviser serving high net-worth individuals and smaller institutions through customized investment strategies and portfolio management based on proprietary research. Mr. Rosenfield has been in the securities industry since 1983; as manager of the Pacific Advisors Income Fund, a public mutual fund, he earned the #1 ranking in his category by Morningstar. Dr. Feller has 20 years of research experience and has published articles on corporate social responsibility, corporate fraud, and strategy.