Retirement Income
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Dubya's Lingering Gift

By Kerry Pechter *Wed, Nov 18, 2009*

Tax rates are obviously northbound. So high-bracket folks should convert to Roth IRAs next year, right? Not necessarily, advisors told us.

One of the holiday gifts that the 43rd president left behind for upscale taxpayers this year is the clause in his Tax Increase Prevention and Reconciliation Act of 2005 that removes the income limit on Roth IRA conversions.

Starting on January 1, 2010, even those who earn more than $100,000 a year can empty a traditional deductible IRA, pay income tax on the distribution, and call it a Roth IRA. After a five-year wait, all distributions from the Roth will be tax-free.

The arrival of this tax-saving measure is well timed. Many people expect the government to raise income tax rates to defray the debt created by two wars, the Wall Street bailout and the stimulus package. A Roth conversion would let traditional IRA owners settle all their tax obligations at today's rates.

Nobody really knows how the tax rates might change. Financial advisors told RIJ they regard the conversion as a chance for high-earning clients to increase their after-tax incomes in retirement or to transfer IRA money—including IRA money rolled over from a 401(k)—money to their children tax-free.

But, even though they have a one-time chance to spread taxes on the conversion over 2010 and 2011 (and as late as October 15, 2012, with extensions) advisors aren't rushing their clients into Roths. A National Underwriter survey last August showed, in fact, an underwhelming interest in conversions.

More than one tax basket

"In the short run, it seems fairly clear that taxes are going up," said Russell Wild, a fee-only financial planner in Allentown, Pa. "I think the conversion is something everyone should look at. It should be particularly helpful to those already retired, who don't currently have any money in a Roth."

Russell Wild

But he doesn't recommend it to everyone. "It depends on the circumstance," Wild said. "I'm getting calls from people who want to convert who are still working, and in a high tax bracket today. So even if taxes go up they might still be in a lower tax bracket in retirement.”

Wild believes in not having all your savings in any particular tax basket. “In any given year it’s optimal that you have a taxable and non-taxable basket, so that you can take from the taxable basket only to the point where you leave the 25% bracket,” he said.

For Antoine Orr, a fee-based advisor in Greenbelt, Md., and author of the new personal finance book, “In the Huddle,” a Roth conversion might be an opportunity for investors to correct the mistake of putting too much money in tax-deferred accounts to begin with.

Orr has been recommending for years that people shouldn’t only put enough money into a 401(k) to maximize the employer match. “We don’t know what tax rates will be down the road. You might be putting money in when taxes are lower. I’ve been saying that for 15 years, and people are now beginning to listen.”

Antoine Orr

Unlike many advisors, he also recommends drawing down tax-deferred money before taxable money in retirement. While the money in tax-deferred accounts may be compounding, he said, “The taxes are compounding too. The concept comes from Don Blanton’s Moneytrax.”

Orr and Wild both noted that it makes little sense to convert a traditional IRA to a Roth IRA unless you pay the tax bill with money from a separate after-tax account. Otherwise you’ll simply reduce the balance in the Roth and undermine the purpose of the conversion. You might also owe taxes and a penalty on the distribution.

Segmented wisdom

“Whether Roths make sense depends heavily on individual situations, particularly for retirees or near-retirees,” said Elvin Turner, managing director of Hartford-based Turner Consulting, which counsels financial services companies. “This is an issue that is begging to have a financial plan around it. It is only in the context of a full plan that I believe people get to a correct decision on these types of opportunities.

“Again, this is heavily dependent on individual situations or at least on the situations of groups of people in similar segments. For retirees, the situations of retirement will be so different—working in retirement, semi-work, leisure, all of the above—that statements of conventional wisdom that purport to apply broadly will be way off of the mark.

"For example, the decision about whether to spend tax deferred dollars now or later depends heavily on whether you plan to work in retirement. The traditional models assumed little or no work related income in retirement. For retirees, what we are really seeing is the death of "conventional wisdom" and the rise of "segmented wisdom"—where strategies make sense for one or more segments, but never across the board."

Do advisors think that taxes are going up? Yes and no. Cliff Draughn, president of Excelsia Investment Advisors, a Savannah, Ga., firm that manages money for those with about $4.5 million, has no doubt that taxes are going up. "They're going to let the Bush tax cuts expire. That's step one," he told RIJ. "There's the cap and trade legislation, which is really a carbon tax. That will hit every individual out there.

"There's mandatory participation in health care, which could be interpreted as a tax," Draughn added. "I think they're going to raise the capital gains tax to 25%, and the 15% tax on dividends will be gone. Dividends will be taxed as ordinary income. The taxability of foreign income is something else that Obama has been talking about."

"The average citizen just doesn't understand economics. There are now more people receiving government benefits than there are people paying into the system. It won't just be the rich who will be affected by the tax increases. It will affect the person earning $40,000," Draughn said.

Wild is fairly sure that taxes will go up, he's not sure which ones. "Yes, given the deficit and national debt, it's mostly likely that income taxes will go up. But that shouldn't be seen as a must-happen… Government may address the debt in other ways, such as a levying a VAT [valued-added tax]. And while it's safe to assume that the rates for the most affluent will go up, it doesn't necessarily mean your taxes will go up."

Orr says clients expect him to be a tax soothsayer, even though he's not. "I'm always asked, 'What will the Chinese do?' I say, 'Even if I were in the President's cabinet, I still wouldn't now.' I do know that we're in world of hurt. It will take some time. It will fall on future generations to pay all this back."

Note: After-tax contributions to a Roth IRA can be withdrawn from the account penalty-free and tax-free at any time. Earnings on contributions to a Roth IRA cannot be withdrawn penalty-free until the account has been open for five years and the account owner is age 59½ or older.