NAPIER'S NOTES:

A Couple Minutes Is All It Takes.

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ROTH CONVERSION: NICE GIFT OR TROJAN HORSE

After the event, even a fool is wise

—Homer

Has your mailbox been filled with information on converting your retirement accounts to Roth retirement accounts? Most of those publications sing the Sirens' Song of the benefits of converting your retirement accounts to a Roth in 2010. Many view Roth conversions as being a gift from the government. However, it may be a Trojan horse. Before you embark on this conversion odyssey, here are some things to consider.

You have probably heard of the benefit of converting in 2010 and deferring the income tax payments to 2011 and 2012. Is this cause to celebrate? Or is it a Trojan horse causing more taxes later?

Conventional wisdom expects income tax rates to rise in 2011 and beyond. If that is the case, might that be the Achilles' heel of this idea? Would a person converting a traditional IRA to a Roth IRA in 2010 be advantaged by deferring income tax payments? Probably not.

Those who do choose to convert in 2010 should be aware that they have the right to pay their taxes on their 2010 income tax filing. While this might seem counterintuitive, it may be one instance where it makes sense to pay your taxes early, rather than paying them later at potentially higher income tax rates. (Have your financial or income tax advisor review IRC § 408A(d)(3)(A)(iii).)

Further, many more affluent taxpayers intend to leave their retirement accounts to their family foundations. They realize that, because their estate is federally taxable, their IRA will bear a tremendously heavy tax burden. Specifically, the IRA will pay both estate taxes and income taxes. Therefore, rather than paying so much in tax, they leave this asset to charity. If that is the case, converting to a Roth provides no benefit —except to the government when it collects the income tax due from the conversion. A true Trojan horse!

Remember, too, Illinois currently does not tax retirement account distributions. However, if you reside in another state which does tax those distributions, that factor should be considered in your conversion analysis.

Also, despite the likelihood of higher marginal tax rates in 2011 and beyond, it is possible that you, personally, may actually be in a lower tax rate when you eventually take distributions from your IRA. That may be because you are heavily invested in municipal bonds, or because the political pendulum has swung back and tax rates are lowered.

A Roth conversion may be most tax efficient for those individuals who can pay the income tax on the conversion from non-IRA assets. Financial advisors generally state that there is a substantial return on investment from converting a Roth IRA in 2010 and paying the taxes from non-IRA assets. You may want to confer with your financial advisor to determine if that is true for you.

And, of course, much has been said about the ability to re-characterize the IRA in the event the conversion from a traditional IRA to a Roth IRA does not work. Understand that re-characterizing involves time and timing issues, and may require you or your financial advisor to closely monitor your converted Roth IRAs. If you were to cut your IRA into many separate Roth IRAs, you may be overwhelmed by this potentially Herculean task.

In tax law, the only constant seems to be change. Therefore, one may want to assess the likelihood of the government changing the current Roth tax rules in the future. Of course, there are no guarantees.

It is wise to consider the negatives, as well as the positives, when evaluating a Roth IRA conversion. While the apparent gift is enticing, there is the possibility that Roth IRA conversion could be your Trojan horse.

The "gift" Trojan Horse is cheered in Troy!