When to Roth

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MY 10-YEAR-OLD son and I had a chance encounter last month with the commissioner of the Boston Police Department. After saying hello, he bent down and offered my son this advice: “Stay in school,” he said, “and listen to your parents.”

Often, the recipe for childhood success is just that simple. Ditto when it comes to managing money. The basic principles are usually pretty straightforward. But there’s one topic that often leaves people with a headache. That’s the question of whether, or when, to do a Roth conversion. At the risk of giving *you* a headache, that’s the issue I’m tackling today.

If you’re not familiar with it, here’s the idea behind a Roth conversion: Individuals can choose, at any time and at any income level, to move money out of a traditional IRA and into a Roth IRA, where the money will grow tax-free thereafter. There’s a catch, however. In the year that you do a conversion, you must pay income tax on the taxable amount you convert. The bet you’re making is that your tax rate today will be lower than it will be later on, when you otherwise would start taking money out of your IRA.

That involves several unknowns. Not only do you have to estimate your future income, but you also need to guess whether Congress might change the tax code again. And if you think your children might ultimately inherit your IRA, you’ll need to factor in their tax situation. Worse yet, as of this year, Congress took away taxpayers’ ability to “recharacterize”—or undo—a conversion, so you really want to be confident you’re making the right choice before you go ahead.

Absent a crystal ball, there’s no foolproof way to make the decision. But these are the steps I would recommend:

Step 1: Determine your current marginal tax rate. The term “marginal” refers to the tax rate on the last dollar that you earn. Typically, this isn’t difficult. But because new rules went into effect in January of this year, you might ask your accountant for help, if you have one.

Step 2: Try to estimate, however roughly, what your income will look like in retirement. Conventional wisdom says that your income, and therefore your tax rate, will always be lower in retirement than while you’re working. But you’ll want to test this assumption rigorously. The following formula is a starting point for estimating your taxable income in retirement:

- Social Security income
- Plus: Required minimum distributions from your IRAs
- Minus: Qualified charitable distributions from your IRAs
- Plus: 3% of the value of your taxable investments (allowing for dividends and interest)
- Plus: Pension or annuity income
- Plus: Income from part-time work, rental properties or other passive income
- Minus: Standard deduction
- Equals: Estimated taxable income in retirement

Now, compare your current tax rate to the rate that would apply in retirement. If you're confident that your future tax rate will be demonstrably higher than it is today, consider doing a conversion now. Otherwise, I would wait.

Step 3: If you're currently in the highest bracket, or if a Roth conversion would put you in the highest bracket, then you probably won't want to do a conversion. There are, however, two exceptions to consider.

Exception No. 1: If you believe Congress will raise rates in the future, it's possible that your tax rate could be even higher down the road. It may seem hard to imagine, but as recently as 1981 the top tax bracket was 70%. I wouldn't base a decision on this kind of speculation. But some people feel strongly that our fiscal situation will require higher tax rates, so it's something to consider.

Exception No. 2: If your assets are likely to make you subject to the federal estate tax—meaning you have more than $11 million and you're single or over $22 million and you're married—it might make sense to do a Roth conversion during your lifetime, even if you're in the highest tax bracket. That's because the income taxes you would pay to do the conversion would reduce the size of your estate, and hence your estate's tax bill, thusincreasing your estate's after-tax value for your children.

Step 4: Be sure you can afford it. Unless you are older than age 59½ when you do a Roth conversion, you'll need additional funds to pay the associated tax—because you can't dip into your IRA to pay the taxman without triggering tax penalties.

Step 5: If the calculations you do in steps 2 and 3 don't favor a Roth conversion today, that doesn't mean it will *never*make sense. For planning purposes, it's worth forecasting when the math might work out. For most people, there's a brief window, just after you stop working but before age 70, when your income may be low enough to accommodate a conversion.

To evaluate this, I suggest using the above formula to estimate your tax rate during those early retirement years. If you foresee a period of low-tax years, you may want to mark your calendar and plan for a series of conversions during those years. Keep in mind that, if you do a Roth conversion in your 60s, you may not only increase the income taxes on your Social Security benefit, but it could also boost the Medicare premiums you pay.

As you can see, the Roth conversion question isn't easy. For that reason, my overall recommendation is this: After working through these steps, I wouldn't do a conversion unless the numbers clearly and conclusively favor it. If the math is at all inconclusive, I would wait and revisit the question each year in the future.

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