Should you convert to Roth IRAs? Some pros and cons

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Tax free retirement money! Higher income taxes are coming! With all the hype, you'd think the Roth IRA conversion was a godsend. I'd advise you to step back from temptation, and enlist your CPA and financial advisors to undertake a careful and thoughtful analysis of this chimera-like opportunity.

Much of the excitement is because high-income people can join the Roth-conversion-camp – the income test no longer applies this year. Previously, you could convert an IRA to a Roth, as long as your modified adjusted income didn't exceed $105k (single) or $167k (joint). Future retirement monies withdrawn from a Roth are generally income tax-free (vs. IRA withdrawals are taxable). However, there's no free ride. Converting an IRA to a Roth triggers income taxation, and anticipated revenues to our deficit-laden government would be $6.4 billion.

Congress has offered other 'sweeteners' to Roth conversion. They include:

- Deferral of tax of 2010 conversions to 2011 and 2012
- Providing a 'do-over' option (e.g. say you do the conversion, trigger the tax, but the account value drops later in the year – remember Rothing at sky-high dot.com levels in the late 90's, only to have a large tax bill and depressed account values with the tech-wreck? – you can opt to re-characterize back to the IRA by Oct. 15 of this year)
- Direct rollover of 401k into Roth IRAs are easier
- Non-spouse 401k beneficiaries might be able to convert to inherited Roth IRAs

However, there are some traps, and 5 of the biggies are:

- No crystal ball – Who can predict with accuracy, tax policy and rates over the lifetimes of you, your spouse and beneficiaries? Will you bet that tax rates will rise, and remain high, for the future Presidents and Congress' to follow?
- If you defer taxation, you're splitting 'income,' not the tax – Say you're thinking of converting a $250k IRA and deferring the taxes to '11/12… Are you going to be in higher tax brackets with post-recession recovery, plus $125k of additional taxable income to report in each of those 2 years?
- You are retired, or have kids in college – Increased income may result in higher Medicare premiums, subject more Social Security benefits to taxation, or reduce student financial aid
- 10% penalty – If you're under 59-1/2 and use some of the monies withdrawn to pay the income taxes
- Partial conversions involving after-tax contributions – Requires prorating

My summary recommendations and comments:

- Good resources are online. There are numerous 'calculators' (caveat: they vary in complexity… I recently ran similar scenarios on 2 household name brokerage company sites, and got different 'conclusions'). I like reading Ed Slott's IRA Advisor site.
- Some broad generalizations for possible conversion candidates include younger investors, affluent investors who will only need to withdraw required minimum distributions from their IRAs, and partial conversions that will not push you to a higher bracket.
- Get expert advice from your CPA and advisors. Everyone has a unique situation and rules are complex. DIY'ers beware!