Retirement Portfolios: If Tax Diversification Is The Key, Conversion Of A Traditional IRA To A ROTH IRA In 2010 May Be The Answer

Kay Klahre Aprea

Lowenstein Sandler PC

Modern portfolio theory states that a diversified portfolio has lower overall risk than a portfolio that is invested in a single asset or asset class. The reason for this is that different types of assets react (i.e. experience changes in value) differently to external factors. For example, when conditions are favorable for the stock market, the bond market often declines. Therefore, according to modern portfolio theory, an investment portfolio that comprises both stocks and bonds will have lower overall risk than a portfolio of stocks alone.

The same can be said for a retirement portfolio. Consider a retirement portfolio to consist of all the assets that may provide income during retirement: social security payments, 401(k) accounts, pension plans, individual retirement accounts ("IRAs"), the equity in a home, a possible inheritance, investment accounts, etc. The risk that retirement income will suffer significant fluctuations due to external factors can be reduced by relying on a variety of sources for retirement income instead of just one. This is because each source of retirement income provides unique benefits and reacts differently to external factors.

Social security and pensions offer a fixed income stream for life, but carry the risk that the amount of income may be reduced or potentially eliminated altogether – i.e. social security benefits could be delayed or reduced or the pension fund could go bankrupt. If you were to rely solely on social security or a pension for income during retirement, you would have significant exposure to this risk.

In contrast, investment accounts (including IRAs and 401(k)s) are not designed to provide a fixed income stream. Instead the taxpayer can withdraw assets from the account on an as-needed basis. Unlike social security or a pension, investment accounts are subject to market risk. The financial crisis and recession have shown us just how vulnerable these accounts are, especially if the account loses significant value just before or just after an individual retires. If you rely solely on investment accounts for retirement income you run the risk that you will outlive your retirement assets.

Although investment accounts are subject to market risk, a large percentage of retirement portfolios are made up of tax-favored investment accounts. There are two primary types of tax-favored retirement accounts: the tax-deferred account (i.e. the 401(k) and the traditional IRA) and the tax-free growth account (i.e. the ROTH 401(k) and the ROTH IRA). For purposes of this article, I will limit the discussion to traditional and ROTH IRAs.

***Kay Klahre Aprea,** Counsel to Lowenstein Sandler's Trusts and Estates group, focuses her practice on developing and implementing complex estate plans, estate administration, post mortem planning and business succession planning for high net worth clients.*

Kay Klahre Aprea

The traditional IRA is often funded with pre-tax dollars, and the assets in the account (including the gain on the assets) will not be subject to income tax until they are withdrawn from the account.[1] This tax-deferral allows the account to grow faster than it would if it were not tax-favored but comes with a price. If the taxpayer takes distributions from the account prior to reaching age 59 1/2, the distribution will not only be subject to income tax, it will also be subject to a 10 percent early withdrawal penalty.[2]

Like all investment accounts, traditional IRAs are exposed to market risk, but they also carry nonmarket risk – specifically, the risk that income tax rates will be *higher* during retirement years than they were during the years when the taxpayer made deductible contributions to the account (the "working years"), thereby subjecting the assets in the account to a higher rate of tax. Additionally, a taxpayer who is at least age 70 1/2 must take mandatory distributions from a traditional IRA, whether or not the taxpayer needs the funds.[3] The mandatory distribution, coupled with the taxpayer's other income, could push the taxpayer into a higher tax bracket.

The ROTH IRA, on the other hand, is an individual retirement account that is funded by the taxpayer with after tax dollars.[4] As there are no mandatory distributions from a ROTH IRA, a taxpayer can continue to make contributions to a ROTH IRA even after he reaches age 70 – so long as he has compensation during the tax year.[5] Additionally, the taxpayer can withdraw his contributions to the ROTH IRA (but not the growth on said contributions) at any time, without penalty and free of income tax.[6] A ROTH IRA grows tax free, but more importantly distributions from a ROTH IRA are not included in the taxpayer's income so long as they are qualified.[7]

Because a taxpayer funds a ROTH IRA with after tax dollars, a ROTH IRA carries the risk that income tax rates will be *lower* during retirement years than during the working years. This risk is directly opposite of the non-market risk associated with traditional IRAs – that income tax rates will be *higher* during retirement years. Therefore, diversifying a retirement portfolio with both a traditional IRA and a ROTH IRA can help hedge against changes in income tax rates.

If tax diversification is so beneficial, why don't more taxpayers have ROTH IRAs as a significant component of their retirement portfolio? There are several reasons. As stated previously, contributions to a ROTH IRA are not deductible for income tax purposes. This in essence makes it more expensive, at least psychologically, for the taxpayer to fund a ROTH IRA as opposed to a traditional IRA. Additionally, not all taxpayers can contribute to a ROTH IRA. While all taxpayers can contribute up to $5,000 a year to a traditional IRA regardless of income,[8] the amount a taxpayer can contribute to a ROTH IRA is phased out ratably for taxpayers filing joint returns with modified adjusted gross income between $166,000 and $176,000.[9] Finally, under current, law taxpayers with modified adjusted gross incomes of more than $100,000 are prohibited from converting a traditional IRA to a ROTH IRA. However, the income restriction on conversions is being lifted starting in 2010.

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Starting in 2010 taxpayers with a modified adjusted gross income of over $100,000 will be able to add a ROTH IRA to their investment portfolio by converting their traditional IRA to a ROTH IRA.[10] In fact several factors make the conversion of a traditional IRA to a ROTH IRA in 2010 a golden opportunity for some taxpayers. First, taxpayers who convert a traditional IRA to a ROTH IRA in 2010 have the ability to defer including the converted assets in their income until 2011 and 2012, thereby delaying the payment of the income tax.[11] Second, because many traditional IRAs have lost significant value due to the financial crisis and/or recession, converting these accounts while asset values are still depressed will generate less income tax liability upon conversion. Finally, given the increasing deficit and the recent decrease in tax revenue, it is likely that income tax rates will increase in the near future, at least for wealthier taxpayers.

All of these factors make 2010 the perfect storm for converting a traditional IRA to a ROTH IRA. While there are several criteria that must be examined when making the decision to convert a traditional IRA to a ROTH IRA, generally the best candidates for a conversion will be taxpayers who have enough assets outside of the traditional IRA to pay the income tax liability and (1) are currently, and will likely remain, in the highest income tax bracket, (2) will have a taxable estate upon their death, or (3) are currently in a low tax bracket, but will likely be in a higher tax bracket during retirement. While converting a traditional IRA to a ROTH IRA may not be right for everyone, it is one diversification strategy that is worth investigating.

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[1] *Contributions to a traditional IRA may or may not be deductible for income tax purposes. Deductibility of contributions will depend on whether or not the taxpayer can contribute to a retirement plan, as well as the taxpayer's income and filing status. I.R.C. Sections 219(b), 408(o).*

[2] *There are some exceptions to this rule. For example, a taxpayer can take a penalty-free early distribution if the taxpayer becomes disabled. I.R.C. Sections 408(d), 72(t)(2).*

[3] *I.R.C. Sections 408(a)(6), 401(a)(9).*

[4] *Contributions to a ROTH IRA are not deductible for income tax purposes. I.R.C. Section 408A(c)(1).*

[5] *I.R.C. Section 408(A(c). A taxpayer cannot make contributions to a traditional IRA after he reaches 70 1/2. I.R.C. Section 408(0)(2)(A).*

[6] *I. R.C. Sections 408A(d)(4).*

[7] *For a distribution from a ROTH IRA to be qualified, it must be made to (1) the taxpayer after the taxpayer reaches 59 ?, (2) the taxpayer's beneficiary after the taxpayer's death, (3) the taxpayer after the taxpayer becomes disabled, or (4) the taxpayer for a qualified purchase of a home if the taxpayer is a first time buyer. I.R.C. Section 408A(d)(2)(A).*

[8] If the taxpayer is age 50 or older, he can also make an additional "catch up" contribution of $1,000. As stated previously, contributions to a traditional IRA may or may not be deductible for income tax purposes.

[9] *I.R.C. Section 408A(c)(3). For single taxpayers the contribution is phased out ratably for modified adjusted gross income between $105,000 and $120,000.*

[10] *Section 512 of the Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222.*

[11] *Alternatively, the taxpayers can elect to pay all of the income tax liability in 2010.*

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