

# Should You Convert to a Roth IRA?

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*Millions of Americans are saving for retirement in 401(k)s and Individual Retirement Accounts (IRAs). These accounts allow people to invest pretax dollars, but require them to pay taxes on their deposits and accumulated earnings at the time of withdrawal. By contrast, a Roth account allows people to deposit after-tax dollars, but withdraw the accumulated balances tax-free.*



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As of 2010, individuals may convert traditional IRA accounts to Roth accounts, paying the taxes now and withdrawing the funds tax-free upon retirement.

### The History of Roth IRAs.

The Roth method of taxation was proposed by the National Center for Policy Analysis and the U.S. Chamber of Commerce in 1991. America was in a recession, and policymakers were desperately looking for ways to spur economic growth through increased savings and investment. The NCPA/Chamber proposal contained five pro-growth tax changes, one of which included a new IRA (later called the Roth IRA).

The NCPA/Chamber proposal became the basis for several congressional bills, and eventually the package formed the core tax ideas in the 1994 “Contract with America.” Named after sponsor Senator William Roth (R-Del.), Roth IRAs allow savers to avoid future tax hikes, and proposals have been made over time to broaden and strengthen them.

**Traditional versus Roth IRAs: Benefits and Restrictions.** Both traditional and Roth IRAs grow tax-free, and both allow withdrawals

at age 59 and one-half years without penalty. However, people with ordinary IRAs must stop making deposits when they reach age 70 and one-half and begin making minimum withdrawals. People with Roth IRAs can contribute at any age and are never required to withdraw funds.

The maximum contribution is the same for both accounts: \$5,000 per year (\$6,000 for people ages 50 and older) — but there are income restrictions on who can participate in a Roth IRA. A single tax filer with an adjusted gross income (AGI) of more than \$120,000 (\$176,000 for a couple) cannot contribute to a Roth IRA. Moreover, Roth contributions are limited if a single filer’s adjusted gross income falls between \$105,000 and \$120,000 (\$167,000 and \$176,000 for a couple).

### The New Roth Conversion

**Rule.** Previously, individuals could convert a traditional IRA account into a Roth account, provided their household incomes did not exceed \$100,000. They could pay the taxes on the traditional IRA amount (either using some of the IRA funds or other funds) and deposit the balance in a Roth IRA account. However, the “Tax Increase Prevention and Reconciliation of 2005” permanently lifted the household income threshold for conversions beginning in 2010, meaning there are no restrictions on conversions. A Roth IRA conversion is ideal for those who:

- Can pay the taxes using money from nonretirement funds.

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- Expect that their federal income tax rate when they retire will be much higher than it is today — because their income will be higher and the burden of government will be higher.
- Face little to no federal income tax burden today — so a conversion would cost very little to complete.

But assuming an individual meets any or all of these conditions, are there certain income levels that would benefit from a Roth conversion more than others?

**Roth Conversions and Living Standards at Retirement.** NCPA scholars used a financial planning model (ESPlanner) developed by Senior Fellow Laurence Kotlikoff to determine who would benefit from a Roth conversion, as measured by the amount of spendable income (after mortgage, taxes, insurance and savings) a household would have at retirement. Representative 40-year-old couples with different annual incomes (\$50,000, \$100,000 and \$200,000) were modeled using the following assumptions:

- Property and sales taxes are based on estimated tax rates in Chicago, Illinois.
- Each couple has a 12-year-old child and pays a portion of college expenses for four years beginning in 2016 (expenses are scaled up based on annual household income).
- Each couple has mortgage payments (scaled up according to annual income) that end at age 60.
- Both spouses have an existing traditional retirement account but no employer-sponsored 401(k) accounts; each spouse makes the maximum allowable annual contributions (\$5,000 adjusted for inflation) until age 66.

### Percentage Change in Spendable Income at Age 67

Annual income level at age 40	Baseline: No Roth conversion with continued traditional IRA contributions (annual spendable income per adult at age 67)	Roth conversion only with continued contributions to a traditional IRA	Roth conversion with continued Roth contributions
\$ 50,000	\$24,644	+ 9 percent	+ 15 percent
\$100,000	\$38,640	+ 9 percent	+ 15 percent
\$200,000	\$58,349	+ 7 percent	Roth contributions not allowed due to income limit

Note: Author's calculations using ESPlanner financial planning software. The model automatically adjusts to keep the family's standard of living uniform over time. Roth conversion amounts from traditional tax-deferred IRAs are scaled per income level as follows: \$50,000 a year couple converts \$100,000; \$100,000 a year couple converts \$150,000; \$200,000 a year couple converts \$200,000.

- It is assumed that income taxes will be 30 percent higher for households by the time they reach retirement; for the couple earning \$200,000, an income tax increase will take effect next year.

At all three income levels, couples who convert their traditional IRAs to Roth IRAs this year expect to have a higher standard of living (more spendable income) if they retire at age 67. Couples with moderate and moderately-high incomes have the most to gain from a Roth conversion. As the table shows:

- Couples with an annual household income of \$50,000 will increase their standard of living 9 percent just from a Roth conversion, even if they continue contributing only to a traditional IRA.
- If they convert to a Roth IRA and continue contributing to that account (instead of a traditional IRA), they will increase their standard of living 15 percent.

For couples earning \$100,000 a year:

- The Roth conversion will increase their standard of living 9 percent,

even if they continue contributing only to a traditional IRA.

- But with continued contributions to a Roth, their standard of living will increase 15 percent.

For high-income earners (those with annual household incomes of \$200,000 or more), converting their existing accounts to Roth IRAs increases their retirement standard of living 7 percent; however, these earners exceed the allowable income threshold for making additional Roth contributions. Thus they are limited to converting existing IRAs.

**Conclusion.** It is difficult to predict how high tax rates will be in the future, and the best vehicle for retirement savings depends on individual circumstances. But observers expect growing government debt will cause taxes to increase significantly for future retirees. For households who are still years away from retirement, Roth conversions protect a portion of retirement income against future tax increases.

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