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Why ROTH Conversions Are Not For Everyone

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Despite the vaunted advantages of ROTH conversions, they are not for everyone. This is especially true in circumstances where the taxpayer has to pay a lot in taxes upfront for conversion and the taxpayer is near retirement. Let us further analyze this important topic.

SOME BACKGROUND

Withdrawals for ROTH IRAs - unlike traditional IRAs - are tax free. This is because taxpayer pays the tax upfront at the time of investing in such investment vehicles. Moreover, ROTH IRAs have no withdrawal requirements. In fact, traditional IRAs require investors to start making withdrawals at age 70 1/2. ROTH IRAs could be advantageous because you pay taxes on what you invest and then you do not have to pay taxes on accumulated interest at the time of withdrawals. This is noteworthy, there are income limitations for ROTH IRAs; nonetheless, Congress has recently eliminated such income limitations for some period of time.

CAVEATS

1. BE WARY OF HEFTY TAXES UPFRONT

This is extremely important to understand converting your traditional IRA into a ROTH IRA will cause you to pay income taxes on the withdrawal. Now, the question is whether the investor has the money to pay for such taxes and even if the money is available, paying such taxes makes sense. In fact, most investors might be worried about their liquidity and wary of dispensing with their cash in the form of taxes in such tight credit market. In addition, even if the investor has enough money to cover for taxes and is not concerned about liquidity, it is prudent to mull whether the taxes paid will be recovered in the remaining years for the investor with some modicum of interest.

In fact, it often takes 15 to 20 years to recover the taxes paid on ROTH conversion. This period could even be extended if investor makes early withdrawals. Hence, people nearing retirement needs to carefully assess whether they need their money relatively soon and if not whether they have the money to pay for taxes.

2. BE WARY OF BUMPING UP YOUR INCOME TAX BRACKETS

This is an especially important and prudent consideration for people not in high income brackets. In fact, as soon as you convert from traditional to ROTH IRA, the money converted is treated as income. Hence, your income is substantially increased and your tax bracket.

This consideration could be even more important for people receiving social security benefits, as they might have to pay taxes on their social security money. In addition, if investors have children receiving financial aid for their college tuition, this conversion could complicate such efforts.

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