The Great Conversion Opportunity

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Should You Convert?

Whether you should convert is highly dependent on your individual situation and the assumptions that you use. Two specific assumptions that need to be made are:

1. whether the income tax rates that apply to you will be higher or lower in retirement than they are today and
2. whether you will need the assets you convert for your retirement and, if so, how many years will pass before those assets are used.

Though the decision to convert is specific to your circumstances, we can provide you with rules of thumb for when a conversion may or may not make sense. The accounts that can be converted include Traditional IRAs, Rollover IRAs, SEP-IRAs, SIMPLE-IRAs, and 401(k)s, 403(b)s, and 457(b)s from a former employer or if in-service distributions are allowed. Thus, higher earners can circumvent the income contribution limits that exist for Roths by contributing to a non-Roth IRA and then converting it to a Roth beginning in 2010. Further, you do not need to convert all of your non-Roth IRA assets.

Factors Supporting Conversion

1. **Income Tax Rate**—if your tax rate will be the same or higher in retirement than it is today.
2. **Age**—if you are young and/or will not need the assets that are converted during your retirement.
3. **Depressed values**—the lower the value of your non-Roth IRA account(s), the lower your taxes will be on conversion.
4. **Cash**—the cash to pay the tax incurred from the conversion will not come from your IRA.

Factors Not Supporting Conversion

1. **Income Tax Rate**—if your tax rate will be lower in retirement than it is today.
2. **Age**—if you are older and/or will need the assets that are converted during your retirement.
3. **Cash**—you do not have the cash to pay the tax incurred from the conversion.

If you decide to convert, pay the income taxes incurred, and then the value of your Roth IRA declines, the IRS allows for a *recharacterization* of your conversion (basically a "do over"). While specific steps need to be followed in a recharacterization, the process allows you to receive a refund of any taxes you paid upon conversion and then reconvert at a later date.

Before pursuing a conversion, COMPASS Wealth Management, LLC strongly encourages you to speak with your tax preparer as the applicable IRS rules are complex and not all of the technical aspects have been reviewed here. Further, your tax preparer can run projections for you, including the impact of converting on your taxable income, tax bracket, and other tax items that are sensitive to the level of your adjusted gross income.

Your Credit Score

Fair Isaac, the company that created the FICO credit score, recently introduced a new version of its landmark credit scoring method that might have serious consequences for you if you are planning on borrowing for a home or establishing any other new credit.

Payment Timeliness

The new version of FICO is focused not only on your payment history, but on your balances too. Reports have indicated that the FICO revision is actually more lenient on a late payment, which might affect more consumers due to the economic downturn. Obviously, this will not rectify a history of late payments, but being late once or twice will not have the same impact as in earlier FICO versions.

Credit Utilization

Consequently, your top priority under this new scoring system should be to reduce your level of debt. Credit utilization—the amount of credit that you tap relative to your credit limit—is more important under the new FICO scoring scheme, especially so as higher balances are more prevalent right now. From a lender's perspective, high balances combined with a tough economy leads to a higher risk of default among customers.

So what is a good target utilization rate for all of your revolving credit accounts? You should target a rate of less than 50 percent of your credit limit for each revolving account. If you are not below the 50 percent threshold, you may want to defer applying for new credit or refinancing if you are able to. The lower your credit utilization, the better your FICO score.

Credit Scores and Reports

The best interest rates and terms from lenders are reserved for those with credit scores of at least 740 (850 is the best possible score). You can purchase your FICO score from either TransUnion or Equifax at www.MyFICO.com for $15.95.

You have the right to obtain all three of your credit reports—from Experian, TransUnion, and Equifax—once a year for free (go to www.AnnualCreditReport.com to order a report). You may not want to order all three at the same time, though. By staggering receipt of each of your credit reports, you will get a continuous picture of how your credit picture looks because the three bureaus feed each other the latest information. Reviewing your credit report on a regular basis will (1) allow you to rectify any errors that appear that could otherwise reduce your credit score and (2) assist you in spotting identity theft.

As perverse as it may seem, once you have paid off a revolving credit account, you may not want to close the account because in the world of credit scoring, closing an account, even one that has not had a balance for years, may reduce your credit score. Why? Lenders prefer to see a long record of credit management even if some accounts have been dormant.