Roth IRA Conversions

Should I Consider a Roth IRA Conversion?

In the debate over which is better—

the immediate tax deduction for contributing to a traditional IRA or the potential for tax-free income from the Roth IRA—the answer tends to turn on one's assumptions about tax rates. Conventionally, one expects to be in a lower tax bracket during retirement, perhaps dramatically so. That favors the traditional IRA. These days, however, those at higher income levels have been told repeatedly that their tax rates will be going up in the future, perhaps sharply. If so, the advantage shifts to the Roth IRA.

Those who are convinced that they will face higher tax rates in the future may want to consider converting their traditional IRAs to Roth IRAs, locking in at today's relatively lower income tax rates. Conveniently, Congress has made that possible for everyone, beginning January 1, 2010.

Here are some facts that you should consider as you evaluate your retirement plans and decide whether or not a Roth IRA conversion makes sense for you.

Who is eligible to convert to a Roth IRA?

Beginning in 2010, all taxpayers are eligible to convert their traditional IRAs into Roth IRAs. The $100,000 income limitation that applied in 2009 and earlier years is eliminated. Certain employer-provided retirement accounts will be eligible as well.

What are the advantages of the Roth IRA?

The four most important advantages are:

- tax-free income and asset growth (when the five-year holding period is met), coming in future years when most expect that tax rates will be going up sharply;
- holding on to assets longer, because there are no required minimum distributions during retirement;
- simplification of inheritance issues for heirs; and
- lower death taxes for those families subject to estate or inheritance tax.

Here is a simplified comparison of the traditional and Roth IRAs:

	Traditional IRA	Roth IRA
Contributions	Potentially deductible	Nondeductible
Distributions	Taxable	Potentially tax free
Required distributions?	Yes, at age 70½	Only after death
Age limit on contributions	Yes	No
Tax-free income for heirs	No	Yes

What about 401(k) plans?

Retirees who have account balances in 401(k) plans may convert that money directly into a Roth IRA in 2010. For tax purposes, the transaction will be treated as a lump sum distribution into a traditional IRA, followed by an immediate conversion to a Roth IRA.

How is the conversion to a Roth IRA taxed?

After-tax plan contributions are not taxed in the rollover to a Roth IRA. Otherwise, all contributions and all accumulated earnings must be included in taxable income in the year of the conversion.

What are the special tax rules for 2010 conversions?

In 2010 only, taxpayers will have a choice. They either may report the entire amount of their conversion in 2010 or defer taxes by reporting the income over two years, in 2011 and 2012.

Is there an age requirement or an age limit?

There is no age requirement as such. However, those who are 701/2 and older will need to take required minimum distributions from their traditional IRAs in 2010, and those RMDs are not eligible for conversion to a Roth IRA.

When should a Roth IRA conversion be done?

Any date may be selected for conversion. If markets rise during 2010, one is better off doing a conversion as early as possible in the year. The fact that many investments remain well off their highs may encourage more taxpayers to make an early decision.

Can I convert just part of my IRA?

Yes, partial conversions are permitted. You can consider partial conversions over a period of years so as to keep the tax consequences controlled, but then you run the risk of a higher tax if asset values climb.

What if I change my mind after converting to a Roth IRA?

A decision to convert to a Roth IRA may be cancelled up until the day that the federal income tax return is filed, including extensions. The change of heart is called a recharacterization of a conversion decision. A recharacterization can be for any reason, but the most likely is that the market has fallen sharply, so the taxpayer owes income tax on phantom gains.

Can the income tax be paid out of the IRA conversion?

It can be, but most advisors recommend against this course, if possible. The better path for maximum financial security in retirement is to put as much into the Roth IRA as is legally permitted.

How do I know if the Roth IRA is right for me?

Two Paths below provides some general guidelines, but you should see your tax advisor to learn how this applies to your situation.

TWO PATHS	
Conversion to a Roth IRA may be a good idea if:	**Sticking with a traditional IRA may be the better choice if:**
You have enough money outside of the IRA to cover the income tax cost of the conversion.	You will have to pull money from the IRA to pay the taxes.
You won't need the money for at least five years.	You expect to have to draw on the money in the next few years.
You expect your future income tax rates to be higher.	You expect your future income tax rates to be lower.
You want to avoid required minimum distributions.	You don't mind taking required minimum distributions.
Your heirs will face estate or inheritance taxes.	Your estate will be small enough to avoid death taxes.

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