



Roth IRA Conversions

A Roth IRA is an account in which post-tax contributions are made. These contributions will grow tax free within the Roth account over an eligible investor's lifetime. However, unlike traditional IRAs, distributions at retirement are made tax free and there are no required minimum distributions. While maybe not being appropriate for all investors, it is another tool that offers flexibility in retirement.

Beginning in 2010 the income limits that apply to the conversion of a traditional IRA to a Roth IRA will be eliminated. This decision will open up the possibility for many to convert and have the benefit of the tax free growth of their retirement dollars.

While this presents an exciting opportunity for some, it should not be a decision that is made in haste. There is a variety of complexities to the conversion itself, as well as the appropriateness of conversion for each individual.

In this article, we will offer both some important information as well as questions to ask to determine if a full or partial conversion is appropriate. Ultimately, it will be a decision made with the consultation of both your financial planner and your tax preparer.

Eligibility

Investors with a Traditional, Rollover, SEP, SARSEP, or SIMPLE (if the assets are in the account for more than two years) IRA or a Qualified Retirement Account (such as a 401-k) are eligible to convert.

For tax year 2010 and beyond, the income and tax filing status restrictions will be lifted and all of the above account holders will be able to convert. (Note: Contribution limits will still apply for IRAs for 2010 and beyond)

Deadlines

December 31st to qualify for current tax year for a conversion.

Tax Consequences

A conversion from a Traditional IRA to a Roth IRA is a taxable event in the year of conversion and the amount could increase one's tax bracket.

However, in 2010, one who converts may apply 50% of the conversion amount to the 2011 tax year and 50% to the 2012 tax year, or may apply it all to the 2010 tax year. If taxes are paid out of IRA funds, it is considered a distribution and one could incur a penalty for early distribution of 10% if under the age of 59-1/2.

Non-deductible IRAs will only have the growth taxed as basis may be excluded in the calculation. However, if one has non-deductible IRAs as well as traditional type of IRAs any conversion amount must be pro-rata regardless of which account is converted.

Considerations

The converted assets must remain in a Roth IRA for a 5-year holding period before assets are distributed as the distribution may be subject to penalties.

Recharacterization

One is able to recharacterize the conversion back to its original account for any reason (market adjustment, tax status change, eligibility issues), but it must be done by tax filing deadline (plus extensions) or one will face penalties on the amount converted. You may not convert to a Roth, recharacterize back, and then re-convert the same IRA in the same year. You must also wait 30 days, regardless of calendar year, before reconverting again to a Roth IRA any funds that had been converted and later recharacterized.

Questions One Must Ask?

Do I have enough liquidity outside of the IRA to pay the taxes on the conversion?

What is the impact of the conversion amount on my taxable income and the potential increase in tax bracket?

What is my current tax bracket and how will this compare to my tax bracket at retirement based on my retirement spending estimates?

What is the timing of my tax payments after the resulting conversion?

Should I wait to convert until later? Could the conversion window close?

What is my other income going to be approximately in the year of conversion?

How much should I convert, if any?

How will my retirement distribution plan be affected?

Will I be leaving my IRA to charity? If so, this is a tax-free event.

How does a conversion affect my estate plan, my beneficiaries, and my exclusion amount?

What is the timing on my conversion? Should I convert as early as possible in the year?

At what point would I consider recharacterization?

Conclusion

While the attractiveness of tax free growth within a Roth IRA is appealing, there are many issues to think about within the framework of conversion. As you can see, the answers will be different for each individual situation. Because of this, it will be important to ask your financial advisor and tax advisor for their recommendation. There is no perfect right or wrong answer, as the true impact of this decision won't be known until all distributions are made in retirement.

We do know that one must prepare for the future and take a good look at their retirement plan. A conversion will positively affect many overall retirement plans, but may not affect others as much. It is important to decide whether your plan will benefit from a conversion.