

ROTH IRA CONVERSIONS FOR 2010

A unique opportunity for IRA owners.

provided by DAVID P. GATESMAN

In 2010, anyone may convert a traditional IRA to a Roth IRA. No income limits will stand in the way of the conversion.¹ Should you do it? Here's why it may (or may not) make sense for you to go Roth this year.

Why you might want to consider it. A Roth IRA permits tax-free growth *and* tax-free income distributions in retirement (assuming you are age 59½ or older and have held your Roth account for 5 years or longer). You can contribute to a Roth IRA after age 70½, without having to take mandatory withdrawals. While contributions to a Roth IRA aren't tax-deductible, the younger you are, the more attractive a Roth IRA may seem.²

However, older investors have reason to go Roth as well - especially if they don't really need to withdraw IRA assets. Under present tax law, converting an untapped traditional IRA to a Roth will shrink the size of your taxable estate, and careful estate planning could foster decades of tax-free growth for those IRA assets.³

Currently, if you name your spouse as the beneficiary of your Roth IRA, your spouse can treat the inherited IRA as his or her own after you die and forego withdrawals. So those Roth IRA assets can keep compounding untaxed across the rest of your spouse's life.⁴

If your spouse then names a son or daughter as a beneficiary, that heir has the choice to make minimum withdrawals according to his or her life expectancy, all while the assets continue to compound tax-free. Currently, withdrawals from an inherited Roth IRA are not subject to income tax.³

Why you may want to think twice about it. The IRS regards a traditional IRA-to-Roth IRA conversion as a distribution from a traditional IRA - a taxable event.⁵ You'll need to pay taxes on the entire amount of the conversion.

Guess what, though: the federal government is giving you a tax break this year. If you do a Roth conversion in 2010, you can choose to divide the taxes on the conversion between your 2011 and 2012 federal returns. So you won't have to finish paying them until April 2013.⁶

If you talk to your local tax preparer, CPA or financial planner, you will probably find all of them agreeing on one thing: federal income tax rates are likely to be higher in the future than they are now. This is another reason why 2010 may be a good time to convert.

You could simply do a partial Roth IRA conversion if converting the full amount would send you into a higher tax bracket. If you think you have more IRA assets than you need, a partial Roth conversion could result in a more manageable short-term tax impact as you pursue the objectives of having some tax-free retirement income or leaving some IRA assets to your heirs.

You may be tempted to use the current IRA assets to pay the conversion tax, but should you? If you're younger than 59½, you're looking at a 10% penalty on the amount you withdraw, and you'll lose the chance for tax-free compounding of those assets within the Roth IRA.⁶

Be sure to consult your tax advisor before you convert. This is a very good idea before you arrange any rollover, trustee-to-trustee transfer, or same-trustee transfer of your IRA assets. There are many variables to consider, and they differ greatly from person to person. In any year, you should fully understand the potential tax impact of a Roth conversion on your finances and your estate.

Also, remember that while the income limit on Roth IRA conversions will go away in 2010, the income limits on Roth IRA *contributions* still apply next year and for the foreseeable future. So high-income IRA owners can make the conversion, but they may not be able to pour new money into the account. For 2010, the MAGI phase-out limits kick in at \$105,000 for single filers and \$167,000 for joint filers. However, those income limits don't prevent you from contributing to a traditional IRA in 2010 and converting that IRA to a Roth.⁷

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Citations.

¹ kiplinger.com/magazine/archives/2009/01/sweet-deal-on-roth-ira-conversion.html [1/09]

² thetstreet.com/print/story/10505164.html [5/26/09]

³ smartmoney.com/personal-finance/retirement/estate-planning-with-a-roth-ira-7966/ [1/22/09]

⁴ smartmoney.com/personal-finance/retirement/roth-iras-to-convert-or-not-7965/ [1/10/08]

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⁶ cnbc.com/id/34511917 [12/21/09]

⁷ northjersey.com/news/business/82334757_Make_a_New_Year_s_to-do_list_to__bring_home_the_bacon__.html [1/22/10]