Should You Convert to a ROTH IRA?

Clients should know that the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) facilitates the conversion of IRAs to Roth IRAs **by eliminating the income limit beginning in 2010**. Now the year 2010 is finally upon us. Roth IRAs offer the advantage of allowing for **tax free growth** and **withdrawals are not subject to required minimum distributions during your lifetime**. In addition, Roth IRAs are a better way to build tax-free growth; however, the conversion will increase your adjusted gross income and tax liability for 2011 and 2012.

The first step in whether or not to ascertain a conversion should be to generate a Roth conversion analysis for each household's situation and their particulars. There are many factors to consider, including income, tax bracket, age, total assets, etc.

In the second step you should work with your advisor to develop a plan for setting aside taxes to be paid on the conversion. One simple strategy may be to earmark any expected tax refunds to pay the cost of the conversion or develop an asset allocation to consider the free aspects of the Roth. Do you need growth or income from the Roth? How should it be coordinated with your planning for taxable portfolios?

To deal with the increased income tax that is generated by the conversion, the amount converted in 2010 can be included as income in tax years 2011 and 2012. For example, if $50,000 was converted in 2010, $25,000 of that amount can be included as conversion income in 2011 and the other $25,000 as conversion income in 2012.

In addition, to further assist clients for whom the tax would be a problem, the regulations allow for partial conversion, giving clients a way to establish a Roth IRA with a conversion amount that meets their budget and allocation.

From an estate planning perspective Roth conversions should appeal to older, wealthier clients who do not need their traditional IRAs for income. Assets used to pay conversion taxes will reduce a customer's taxable estate, and in turn, their estate tax. Eventually, clients' beneficiaries will inherit the Roth IRA, from which they can withdraw tax free income throughout their lives. Moreover, a beneficiary who is not a client's spouse would be subject to Required Minimum Distributions (RMDs). The distributions can be stretched over a beneficiary's lifetime and distributions are generally income tax free. This means that the Roth could grow tax free for another generation.

Clients with reduced IRA balances (positions that have declined significantly) should consider that converting now and paying the taxes will result in a lower tax burden and allow the assets to recover in a tax free account. This is a way to diversify your retirement account to address uncertainty of future tax rates. Converting to a Roth IRA may help protect your retirement if, or rather when, income tax rates rise in the future.

If you are interested but hesitant to do the conversion because of fear that the market will drop again; you should know that the law contains a provision called recharacterization which allows you to recharacterize the converted amount back to a traditional IRA – or simply put you are allowed to contribute the money back to the original IRA fund from which it came. This means that those who recharacterize after a conversion may need to file an amended income tax return to receive a tax refund on any tax paid on the conversion or the tax liability will be eliminated if you have not paid the tax. The recharacterization can be done up to the due date of your tax return, plus extensions, which is typically October 15 of the year after the conversion. For example; a conversion done on January 2, 2010; can be recharacterized up until October 15, 2011, (if you file for an extension on your income tax return).

In sum, the changes to the Roth IRA conversion eligibility limits provide opportunity for some individuals previously excluded due to income limits. Of special note this year only, is the Roth Conversion deferral option that allows you to pay any tax liability in 2010, or elect to defer it until 2011 and 2012. This is a one-time tax election. A Roth IRA conversion is by no means a one-size-fits-all investment vehicle. As noted above, various guidelines must be considered such as tax liabilities, the potential source of nontaxable income in retirement as well as legacy planning (accumulating potentially tax free assets for your heirs). As with all investment vehicles a thorough analysis of an individual's financial situation is a must*. It is only then, that clients along with their advisors can make educated decisions and thoughtful, effective, planning can take place.

** You should consult with your tax professional based on your particular circumstances. You and your professional should carefully weigh the options of this investment strategy.*

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