

ROTH CONVERSIONS BECOME MORE ATTRACTIVE FOR RETIREES

Affluent retirees who have wanted to convert sizable traditional individual retirement accounts into Roth IRAs but weren't eligible because of income restrictions may find 2005 the year to make the conversion.

Starting in 2005, an obscure provision in a 1998 federal tax act allows retirees age 70 1/2 or older to exclude from their income the required minimum distributions from traditional IRAs when determining conversion eligibility. Consequently, conversions should become a possibility for some affluent retirees, say financial planners.

To understand how this all works, let's quickly compare traditional and Roth IRAs. A traditional IRA is funded with pre-tax dollars, it grows tax deferred, and withdrawals are taxed at the owner's ordinary income tax rate. Furthermore, the owner must begin taking minimum mandatory withdrawals after turning 70 1/2. These minimum withdrawals eventually drain the IRA account.

A Roth IRA is funded with after-tax dollars and grows tax deferred. Withdrawals are tax free as long as the account has been open for at least five years and the owner is 59 1/2 or older. Furthermore—and this is the key for affluent retirees—there are no mandatory distributions beginning at age 70 1/2. It can be left untouched until death and passed on income-tax free to heirs.

This makes Roth IRAs especially attractive to affluent retirees who may want to pass IRAs on to their heirs or who may want to conserve IRA assets until much later in life to pay for such things as high medical or long-term care expenses. So, if you have traditional IRAs you may want to convert them to Roth IRAs. The catch is that you have to pay income taxes on the amount you convert, and you can't convert in a year in which your modified adjusted gross income (before the conversion) exceeds \$100,000.

That's where the 1998 provision helps. Those required withdrawals are often a significant source of income for affluent retirees—even if they don't need the money at that time. And until now, those mandatory withdrawals counted toward the modified AGI. But they won't starting in 2005.

Assume that you earn \$70,000 in non-IRA income, you are age 72, and you have \$800,000 in a traditional IRA. Your required minimum distribution for that IRA is \$31,250. Because your total modified AGI is \$101,250, you wouldn't qualify for a Roth conversion in 2004. But you would qualify in 2005 because that \$31,250 no longer counts toward the \$100,000 conversion limit.

But even if you now qualify for a conversion, you need to weigh other factors in deciding whether to convert. First, all that money that comes out of the traditional IRA for a conversion will count as income for that year, and may push you into a higher tax bracket. You could end up with a hefty tax bill.

On the other hand, argue some tax experts, tax rates are not likely to go any lower, and some believe that they may rise in the future to offset the growing federal deficit. So it may be a matter of gettin' while the gettin's good.

It's best if you can afford to pay that tax bill with money from outside the IRA withdrawal. That allows you to roll the full amount into the Roth IRA. Other tax factors include the conversion's impact on state income taxes and the alternative minimum tax, so you'll want to work closely with a tax expert.

Are potential creditor lawsuits a risk for you? Federal law does not shield IRAs from creditors. Many states do, but not all include Roth IRAs in that protection, so you may want to see what your state's laws are before converting.

Lastly, keep in mind that if you do convert, you have until October 15 of the year after the conversion to switch back to the way things were (your conversion tax will be refunded). You will want to do this if your income for the conversion year unexpectedly exceeds \$100,000. You may also want to consider reconverting if the value of your new Roth has dropped substantially since the conversion. You would reconvert to a traditional IRA, wait 30 days, and convert again with the lower account value (thus incurring lower conversion taxes than you incurred in the original conversion).

December 2004—

This column is produced by the Financial Planning Association of Southern Wisconsin. We can be a continued resource for your personal finance coverage. If you use this column in whole or part, please credit the chapter or one of our CERTIFIED FINANCIAL PLANNER™ members.

CFP®, CERTIFIED FINANCIAL PLANNER™ and the federally registered CFP (with flame logo) are certification marks owned by Certified Financial Planner Board of Standards, Inc. These marks are awarded to individuals who successfully complete CFP Board's initial and ongoing certification requirements.

Formatting Guidelines

Edit *MONTH YEAR* in footer
Font (Title) - Times New Roman (14 pt)
Font (Text) – Times New Roman (11 pt)
Indentation – First Line (0.3")
Para Spacing – Before, 6 Pt.
Line Spacing - Single