

Conversion of an IRA to a Roth IRA Needs Careful Study

Right now, anyone with an adjusted gross income of less than \$100,000 a year can convert a traditional IRA account to a Roth IRA. However, higher-income Americans were just given a gift – if the next Administration doesn't repeal it – in the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), which passed in May. Starting in 2010, the income limitation on Roth IRA conversions will be removed, and for conversions done in 2010, taxpayers can spread their taxes on that conversion over tax years 2011 and 2012.

The conversion issue is a potentially attractive retirement and estate-planning idea for wealthier Americans who want to make sure they maximize the assets they can pass to heirs tax-free. But anyone considering such a move – regardless of his or her income status -- should first review their current retirement asset strategy with a tax or financial adviser.

Issues to consider:

What's the difference between a traditional IRA and a Roth IRA? Traditional IRAs allow certain individuals to save money tax-deferred with deductible contributions until they're ready to begin withdrawals anytime between age 59 ½ and 70 ½. Roth IRAs don't allow tax-deductible contributions, but they allow tax-free withdrawal of funds with no mandatory distribution age and allow these assets to pass to heirs tax-free as well. Contributions to a Roth IRA aren't deductible, but if you leave your savings in the Roth for at least five years and wait until you're 59 ½ to take withdrawals, you'll never pay taxes on the gains. You can convert a traditional IRA to a Roth, but you must pay taxes on any pre-tax contributions, plus any gains.

Does time to retirement matter? Always. If you have more than five years until you plan to withdraw your retirement funds, conversion of traditional IRA assets to a Roth IRA might make sense. Generally, the longer the time span where earnings can grow tax deferred, the greater the benefit of being able to withdraw those earnings without paying tax on them.

Do you expect your tax rate to drop significantly when you retire? This is a very important question since certain individuals – particularly business owners who may be paying taxes at a fairly low rate – might face higher rates in retirement, which will make the tax-free nature of Roth withdrawals all the more valuable.

What does a Roth conversion cost? It can be a pretty big tax hit. You'll have to pay taxes on contributions that you previously deducted, as well as taxes on the accumulated earnings. Also, you need to be aware that conversion could push you into a higher tax bracket, especially if you've accumulated sizeable earnings over the years. This is why a conversion should be a planned event. A solution could be partial conversions of the funds over a period of time to avoid the lump-sum tax hit or the creation of a fund to pay those taxes before you make the move. If you can avoid it, don't withdraw existing traditional IRA retirement funds to cover the taxes – you'll diminish your savings and be hit with a 10 percent penalty for early withdrawal under age 59 ½.

What are the contribution limits for both types of IRAs? If you are eligible, you can contribute up to \$4,000 annually — \$8,000 for married couples for 2006. You can still contribute to a regular IRA, but your combined total IRA contributions cannot exceed \$4,000 per person. Ask your tax adviser first. For 2006, you can contribute \$5,000 to a Roth IRA if you are age 50 or older at year-end, or \$10,000 for a married couple if both spouses are age 50 or older.

My retirement funds are all over the place. What should I do? The good part about settling the IRA-to-Roth issue is that it should force you to start thinking not only about what you have, but how you'll draw on your retirement assets once you retire. Getting help now will not only give you a status report on how well you've done up to this point, but how you'll withdraw the money most sensibly in the future.

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