

Take a look at tax law when converting an IRA

Over the next two years, you are likely to see more people convert assets from Traditional Individual Retirement Accounts to Roth IRAs.

Three considerations make understanding the IRA to Roth conversion more important for many investors:

- Lower values of most IRAs as a result of the market correction.
- The prospect of increased taxes in our future.
- The elimination of an income limit in 2010.



Gary Brooks

With a Traditional IRA, when you take withdrawals of your contributions and earnings, they are subject to ordinary income tax. Also, once you reach 70½ you are forced to take annual distributions. (These required minimum distributions have been waived for 2009.)

With a Roth IRA, as long as you're over 59½ and have held the account for five years, the assets grow tax free, there's no tax on withdrawals and no requirement to take annual distributions if you don't need the income. This way, more potential growth may be available for your later years or for beneficiaries of the account.

Determining whether or not to make this conversion can be complicated. You need to weigh the short-term consequences vs. the long-term impact. In order to make the conversion, you have to pay income tax on the amount converted. But if you can afford that hurdle, the long-term benefits may be worthwhile.

For many, a Roth conversion makes sense if you expect income tax rates, or those of your heirs, to rise. An increasing personal tax burden seems likely given the rapidly growing fiscal deficit due to bailout and economic stimulus packages.

There are different reasons driving Roth conversion decisions in 2009 and 2010. This year, investment declines during this recession have presented a more immediate opportunity. If your modified adjusted gross income is less than \$100,000 in 2009 (filing jointly or single), you are eligible to make the move from Traditional to Roth IRA. And for many, the tax bill associated with the conversion will be significantly less than it would have been to make the same conversion at this time last year.

For example, if at the beginning of 2008 you had \$100,000 in a Traditional IRA and wanted to convert it to a Roth, you would have had to pay ordinary income tax on the amount being converted. In a 25% tax bracket, the tax bill would have been \$25,000.

But say that the value of your Traditional IRA decreased by 30% in 2008, and is now worth \$70,000. Converting \$70,000 in the 25% tax bracket would cost \$17,500. A big bite, no doubt, but it would be the end of taxation on the amount converted. If you wait until your IRA has regained some of its lost value, the tax bill for the conversion will rise.

A second compelling point arrives next year. Starting in 2010, there will be no income limit that prohibits

high-income earners from making the conversion. If you convert in 2010, you will also have the opportunity to spread the associated tax bill out over 2011 and 2012.

Whether making the conversion in 2009 or 2010, it's important to plan in advance so that you have the liquid assets to pay the tax bill. Make sure you can pay the conversion taxes from savings outside of the IRA. If you use assets within the IRA to pay the tax bill, the potential benefits of the conversion may be lost as fewer dollars take advantage of the tax-free growth going forward.

For some people, it will be wise to spread a conversion out over multiple years to avoid moving into a higher tax bracket as the converted dollars are added to gross income. If your income is predictable it's not difficult to determine what level you can convert without changing your tax bracket.

There are many intricacies of IRA distribution rules and tax laws that you'll want to consider based on your individual circumstances. If an IRA conversion seems to fit your situation, be sure that you understand both short-term and long-term tax impact.

Gary Brooks is a certified financial planner and the president of Financial Life Design, a consulting firm in Tacoma. Reach him at gary@yourFLD.com.