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Roth conversion makes sense if you meet right criteria

An unprecedented financial planning opportunity arrives in 2010 and you might want to start planning for it now. Starting in January, anyone, regardless of level of income, can convert assets in pretax retirement accounts to a Roth IRA.

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Converting to a Roth requires you to pay ordinary income tax on the amount converted but gives you an asset that has no future taxation as long as you wait five years before taking withdrawals. Roth IRAs also do not require annual minimum distributions starting at age 70½ as do pretax retirement accounts.

The opportunity to convert to a Roth has never been available to individuals with annual taxable income greater than $100,000. And the opportunity coincides with an environment where current tax rates are almost certainly lower than future rates will be as we pay for economic stimulus, Medicare fixes and Social Security solvency.

You can convert partial accounts to a Roth. There's no all-or-nothing provision. You might want to convert only enough to take you to the top of your current tax bracket, or just enough to meet your ability to pay the additional tax. If you receive a year-end bonus or a tax refund, you might want to earmark those dollars to pay the conversion bill. You'll forgo instant gratification of spending that money but the reward will be much more flexibility and control of your retirement assets.

If you meet one of the following situations, you should consider the long-term benefits of a Roth IRA. In any case, the benefit of converting only makes sense if you have money outside of retirement accounts to pay the tax due upon conversion. This is the only way to preserve the full benefit of long-term growth in the Roth.

Conversion is attractive if:

- You expect your current effective income tax rate to be the same or higher in retirement.
- You are willing to pay taxes now to combat against the likelihood of higher tax rates in the future.
- You plan to pass your IRA on to heirs and don't need withdrawals from it to meet retirement expenses.
- You own a small business and have a net operating loss.

The net operating loss tactic is among several conversion considerations that deserve more attention. Consider these opportunities:

NET OPERATION LOSS

Small-business owners who have negative taxable income because of business losses that flow through to their personal tax return can convert without paying any tax on the conversion or the future growth of the Roth. This is limited to the amount of the negative taxable income. Considering the economic climate, many business owners will be eligible for this tax-free conversion.

IN-SERVICE WITHDRAWALS

The Roth conversion is not limited to assets that currently reside in a traditional IRA. There are a few ways to take money out of your employer-sponsored retirement plan even while you are still working and contributing to the plan. If you convert these dollars to a Roth IRA sooner than later, you have the opportunity for more years of tax-free compounded growth. Anyone who has reached age 59½ can take an in-service withdrawal. If you're younger than 59½, you can withdraw any dollars that you rolled into your current employer plan from a previous employer. Many employer-sponsored plans also have other provisions that allow in-service distributions. Check your summary plan description or contact your company's retirement plan administrator to confirm your options.

RECHARACTERIZATION AND RECONVERSIONS

The IRS is very generous with Roth conversions. If you decide after the conversion that you wish you hadn't converted, you can get a penalty-free do over. Maybe you realize you don't have enough money to pay the tax due on the converted amount. Or, your account value falls after you convert, meaning you paid tax on more dollars than the account is worth. You can then recharacterize back to a traditional IRA as if the conversion never happened. The deadline to recharacterize a Roth conversion is the tax filing deadline for the year of conversion, plus any extension. You can then reconvert to a Roth after a brief waiting period.

ESTATE PLANNING

If wealth transfer is an issue, you will be better off paying taxes on a traditional IRA at current income tax levels instead of at higher estate tax levels. The value of either type of IRA would be included in your estate. But if you convert to a Roth, the ultimate estate tax would be reduced by the amount of the income taxes paid on the conversion.

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