Tough Market: It's a Positive Environment for Roth IRA Conversions

Most of us are not happy about our investments. But, if you are looking for a bright spot, it's not a particularly bad time to consider converting a traditional IRA to a Roth IRA.

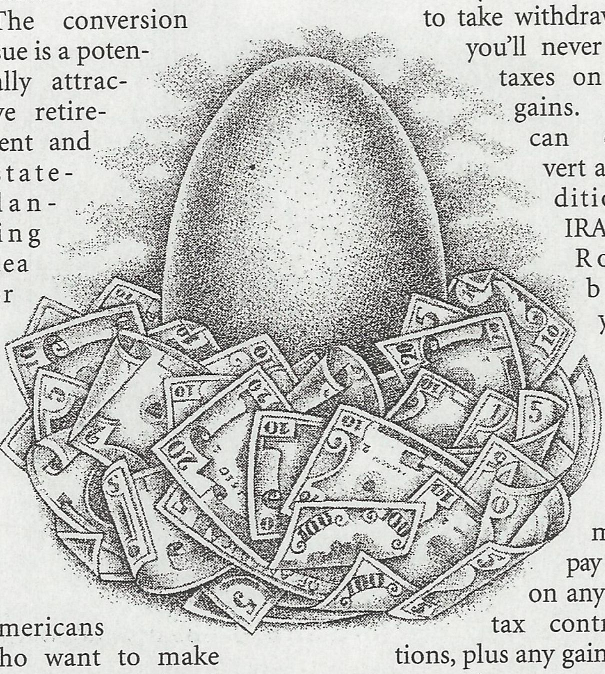
Right now, anyone with modified adjusted gross income of less than $100,000 a year (individual or joint income) can convert a traditional IRA account to a Roth IRA. Higher-income Americans will get the same break in 2010 — with no phase-out cap on income — assuming Congress doesn't reverse its 2006 approval of these provisions in the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

Keep in mind that this also might be a good idea for people who were unemployed or disabled during the past year and therefore had lower taxable income. Consult with your tax professional about doing a full or partial Roth IRA conversion.

Remember that when you do a conversion, you must pay income tax on the amount you are converting, which can be all of the funds in the traditional IRA or just a portion of those assets. But, subject to certain restrictions, you won't pay tax when you finally need to withdraw your money. That's where the silver lining comes in for you — or for your heirs if you pass that money on to them.

The traditional IRA and Roth IRA differences can be somewhat analogous to a farmer. The farmer can either pay no taxes or minor taxes on the seeds for planting and then pay taxes when he sells the crops (a traditional IRA), or he can pay taxes first on the seeds and then pay no taxes when the crops are sold (Roth IRA).

Take another look at your statements and how much your investments are down. Assuming that the markets perform historically and fight their way back, your tax-free amount available for withdrawal could accumulate significantly under that Roth status.



The conversion issue is a potentially attractive retirement and estate-planning idea for Americans who want to make sure they maximize the assets they have for themselves and for their heirs on a tax-free basis. 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.

Things to consider:

The difference between a traditional IRA and a Roth IRA: Traditional IRAs allow investors to save money tax-deferred with deductible contributions (within certain income limits if either spouse is eligible for a qualified plan at work) until they're ready to begin withdrawals anytime between age 59 * and 70 *. 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. If you leave your savings in the Roth for at least five years and wait until you're 59 1/2 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.

Time to retirement matters: 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. 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. Also, the longer they can grow and compound tax-free, the better.

Other Assets: If you have additional assets that you can use for retirement purposes ahead of the Roth IRA retirement assets, this will be more beneficial as it will allow the Roth assets to grow in a tax-free environment longer and thus help to amortize the increased tax payment required to shift the assets from the traditional to the Roth IRA.

Your tax rate at retirement is important: Many people, such as business owners, may be paying taxes now at a fairly low rate. So they might pay higher taxes at retirement. If that's the case, converting to a Roth might make a lot of sense. Additionally, with Social Security benefits being taxable at certain income levels, Roth IRAs may allow you to limit or eliminate such taxes.

A Roth conversion can be expensive: 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 needs to be planned with a tax expert. Why? It may trigger the Alternative Minimum Tax (AMT) due to those high earnings.

David J. Boczar, CFP®, CFA, founder of Emerald Wealth Advisors, is a local member of the Financial Planning Association, with an independent financial planning practice affiliated with Westport Resources Management, an Investment Advisor registered with the SEC and the State of CT. This column is produced in conjunction with the FPA, the membership organization for the financial planning community.