

ROTH IRA CONVERSIONS IN A DOWN MARKET

Today, the conversion will cost you less than it did in the past.

Provided by Holly Kiper

Is it time for a break - that is, a tax break? With the stock market down 25-40% from its fall 2007 highs, it's certainly a time to consider converting your traditional IRA to a Roth IRA, especially if you're not planning on retiring soon.

You will pay a one-time tax on the conversion. (See below for one exception to this.) But with the market down, many IRA values are lower than they have been in years. So if you convert your deductible IRA to a Roth in 2009, it will almost certainly cost less than it would have in 2007 or 2005. The conversion will also allow you to have more flexibility with your money when you are ready to use it.

In 2009, you can fund a Roth IRA with distributions from a traditional IRA. In years past, you couldn't convert a Required Minimum Distribution (RMD) from a traditional IRA into a Roth IRA. You could convert any portion that was not part of the RMD. That is, if you withdrew more than the required amount from your traditional IRA, you could elect to convert the excess amount into a Roth, provided you were eligible to do so. Otherwise, you were prohibited from pouring cash from one IRA into the other.

However, the federal government has suspended mandatory IRA withdrawals for 2009.¹ Since no one has to take an RMD from a traditional IRA this year, any traditional IRA withdrawals made during 2009 become elective. This year, any withdrawals from a traditional IRA can be used to fund a Roth IRA.²

In 2009, you can fund a Roth IRA with after-tax contributions to a 401(k), 403(b) or 457 retirement savings plan. This year, you can take those contributions and convert them to a Roth IRA tax-free, provided your adjusted gross income is \$100,000 or less. More good news: there is no limit to the conversion amount.³

Are you eligible to make a Roth conversion? In 2009, you can make the conversion if your AGI is less than \$100,000.² In 2010, there will be no income limits - next year, anyone can convert a traditional IRA to a Roth IRA.³

Are you eligible to contribute to a Roth IRA? In brief, individuals who make up to \$120,000 and married couples who make up to \$176,000 may contribute up to \$5,000 to a Roth IRA in 2009 (\$6,000 if they are past age 50).³

The pros of a Roth conversion. A Roth IRA gives you two huge benefits: tax-free growth and tax-free income distributions in retirement (providing you are age 59½ or older and have held your Roth IRA account for 5 or more years).⁴ Additionally, you can still contribute to a Roth IRA after age 70½ - and you don't have to take mandatory

withdrawals from it.⁵ These facts alone might motivate you, especially if you are in your thirties or forties.

A Roth IRA conversion can also be useful for older investors who don't need their IRA assets. If you don't think you'll need to tap your IRA, you might consider doing a Roth conversion and leaving the Roth IRA to your heirs. Untouched, those Roth IRA assets can keep compounding tax-free across the rest of your life (and subsequently, the rest of your surviving spouse's life). Here's another advantage: converting that untapped traditional IRA to a Roth will lower your taxable estate.⁶

The cons of a Roth conversion. On the downside, the conversion does normally trigger a tax, and you'll need the money to pay it. You will pay tax on any earnings and pretax contributions in lieu of paying taxes upon subsequent withdrawals from the Roth IRA.

Don't think about using your current IRA assets to pay the conversion tax - if you're younger than 59½, you're looking at a 10% penalty on the amount you withdraw, and you'll throw away the chance for tax-free Roth IRA compounding of those assets. (If the amount you want to convert might send you into a higher tax bracket, you could simply do a partial Roth IRA conversion.)

You also don't want to do this if you think you'll drop into a much lower tax bracket after retirement. For example, if you're in the 25% federal tax bracket now and the numbers seem to indicate you'll be moving into the 15% bracket after you retire, you'll be paying income tax on the conversion at your current 25% rate. If you're moving down only a handful of percentage points (from, say, the 28% bracket to the 25% bracket), then it's a different story.

For the record, contributions to a Roth IRA aren't tax-deductible.⁵

Your do-over option. Should the market perform poorly through 2010, you could reverse (or "re-characterize") your decision to convert your traditional IRA to a Roth IRA, which could end up dramatically lowering your taxes on the Roth conversion. The recharacterization deadline on 2009 Roth conversions is October 15, 2010.⁷

Talk to your CPA or tax advisor before you make a move. Keep in mind that the tax code isn't exactly set in stone right now, and who knows what will happen with parts of the tax code after 2010. So consult your CPA or tax advisor before arranging any rollover, trustee-to-trustee transfer, or same-trustee transfer of your IRA assets.

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Citations.

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² kiplinger.com/magazine/archives/2009/01/sweet-deal-on-roth-ira-conversion.html [1/09]

⁴ smartmoney.com/personal-finance/retirement/roth-iras-you-wanted-to-know-7967/ [1/9/08]

⁵ irs.gov/publications/p590/ch02.html#d0e9214 [10/31/08]

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⁶ money.cnn.com/2009/01/08/pf/expert/Roth_recharacterization.moneymag/ [1/8/09]