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Title

Converting to a Roth IRA

Potential Benefits of Converting Tax-Deferred Retirement Plan Assets

It is widely believed that mounting pressure to control the nation's skyrocketing debt may cause the government to raise taxes in the years ahead. Converting tax-deferred retirement assets to a Roth IRA could help shield your retirement income from potential tax increases in the future.

> You may want to weigh the potential advantages of converting to a Roth IRA this year versus later when taxes could be higher.

Although you may benefit by making pre-tax or tax-deductible contributions to tax-deferred retirement accounts [such as 401(k) plans and traditional IRAs] during your working years, all contributions and earnings will be taxed as ordinary income when withdrawn.

By contrast, a Roth IRA will incur no further income tax liability for the rest of your lifetime, regardless of how much growth the account experiences (under current tax law and assuming all conditions are met). To qualify for a tax-free and penalty-free withdrawal of earnings (and converted assets), Roth IRA distributions must meet the five-year holding requirement and take place after age 59½ or result from the owner's death, disability, or a first-time home purchase ($10,000 lifetime maximum).

Although nondeductible *contributions* to a Roth IRA are subject to income eligibility limits, there are no income limits associated with converting assets to a Roth. Thus, a Roth IRA conversion may be especially valuable if you expect to be taxed at a higher rate in retirement or if you are not eligible to contribute to a Roth IRA because of your income.

TIMING THE TAX BILL

If you are considering a Roth IRA conversion, you may want to weigh the potential advantages of converting this year versus later when taxes could be higher.

Tax-deferred assets converted to a Roth IRA from a traditional IRA or from a former employer's 401(k), 403(b), or 457 plan must be declared as income on your tax return in the year of the conversion. This could result in moving you up to a higher tax bracket and might result in the loss of certain tax deductions (such as college tuition tax credits) for the year of the conversion.

Another important decision is how to pay the taxes. If you are younger than 59½, paying taxes with money from your tax-deferred retirement assets could trigger a 10% early-withdrawal penalty. Therefore, it's generally wise to use money that is held outside of your retirement accounts.

If you are older than 59½, your personal circumstances may determine whether it makes sense to pay the taxes from the account you are converting or to use other assets. Of course, you might achieve the most benefit from a Roth IRA if you don't use money from the account you are converting to pay taxes. When qualified distributions are made in retirement, any future earnings in the Roth account after the conversion will be tax-free.

If the tax liability on converted assets is hard to swallow in a single year, you might consider partial conversions over two or more years, which divides the tax liability into smaller increments. However, there could be some drawbacks. The longer it takes to convert all the assets, the more likely it is that future potential gains will be taxed when the conversion takes place. Meanwhile, less of your savings will be at work in the tax-free Roth IRA.

BUILDING A LEGACY

An additional Roth IRA benefit is that there are no required minimum distributions (RMDs) after age 70½, as there are with tax-deferred plans. This enables you to leave the account assets to your designated beneficiaries if you don't need the money during your lifetime.

Roth IRA beneficiaries can also receive tax-free qualified distributions. Although spouse beneficiaries have the option to move an inherited IRA into one of their own and delay RMDs, nonspouse beneficiaries must start taking RMDs by December 31 of the calendar year after the original account holder's death.

FLEXIBLE PROVISIONS

Changes in your financial situation, portfolio losses, or other unforeseen circumstances might cause you to rethink a Roth IRA conversion. Fortunately, you have a grace period in which you can change your mind.

The deadline to undo ("recharacterize") a Roth IRA conversion is generally October 15 of the year following the year of the conversion. If you've already paid taxes on the converted assets and meet the tax filing deadline (including extensions), you will receive a refund of the taxes paid.

A Roth IRA conversion may not be appropriate for everyone, so you might consult with your tax professional regarding your personal situation.

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