MONEY TALK

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Too Rich for a Roth? In 2010, That's Going to Change

Next year, individuals with a modified adjusted gross income of more than $100,000 will be eligible to convert a traditional IRA to a Roth IRA. The IRS is offering taxpayers a three-year window in 2010 to pay taxes due on a conversion as part of removing the income limits.

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 ½ and 70 ½. 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 ½ 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.

Keep in mind that conversion might be a good idea for people in lower income tax brackets. Talk to your tax professional about doing a full or partial Roth conversion.

Remember that when you do a conversion, you must pay income tax on the amount you are converting. Since you received a tax deduction on your initial contributions to most traditional IRAs, you must pay the taxes due on those initial contributions and any growth in your IRA. 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 conversion issue is a potentially attractive retirement and estate planning idea for all Americans who want to make sure they maximize the assets they have for themselves and for their heirs on a tax-free basis. And the conversion option isn't available just for traditional IRAs – it can be used for retirement assets held at other employers

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and 401(k) holdings. 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 advisor.

Things to consider:

How close is retirement?: 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.

What will your tax rate at retirement be?: 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 can 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 professional. Why? It may trigger the Alternative Minimum Tax (AMT) due to those high earnings.

Know how the conversion window will work: Keep in mind that 2010 is the actual year you will be able to convert your retirement assets to a Roth, but you'll be able to spread out the tax hit. The Internal Revenue Service has granted taxpayers the option to claim 50 percent of conversion amount as income in 2011 and the remaining 50 percent in 2012. Also, you have to understand that if you choose the conversion period, your tax will be based on the bracket you fit that year. That means swings in income will affect what you pay.

This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Barry L. Dayley, CFP® , a local member of FPA.

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