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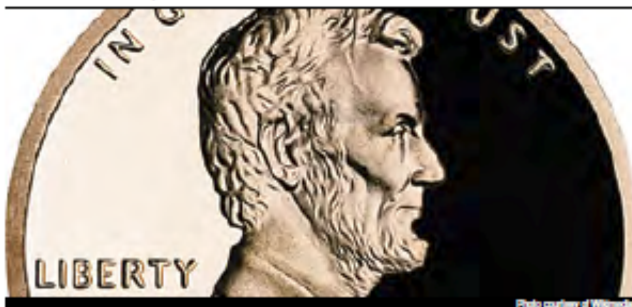

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To convert or not to convert?

That is the Roth IRA question

By DAVID M. TAUBE

With its highly prized feature of creating tax-free retirement income, much attention has been focused on Roth Individual Retirement Accounts (IRAs). The heightened interest in Roth IRAs is due to the removal of the income limitation preventing many owners of Traditional IRAs, or other eligible retirement accounts, from converting all or a part of the account to a Roth IRA. Prior to 2010, investors with an annual adjusted gross income of more than $100,000 were not allowed to convert.

(Note: Income limits still exist on the ability to contribute to a Roth IRA. For 2011, single taxpayers with an adjusted gross income of more than $122,000 ($177,000 if married filing jointly) are not permitted to make Roth IRA contributions.)

With the elimination of the income limitation, does it make sense to convert a Traditional IRA or other eligible retirement balance to a Roth IRA now or in the future?

First, a quick summary of the difference between a Traditional IRA and Roth IRA. With a Traditional, the contribution is typically made on a pre-tax basis, meaning it was not taxed and reduces your taxable income in the year of contribution. The account offers tax-deferred growth potential, but the funds are taxed as income when withdrawn. Things are somewhat flipped with a Roth IRA: the contribution is made on a post-tax basis, meaning it was taxed. The main advantage of the Roth is that, in addition to tax-free growth potential, the funds are tax free when withdrawn.

Another difference is that distributions from a Traditional are mandatory in the year you turn 70 and a half, while there is no distribution requirement for a Roth (the withdrawals are tax free, so the IRS does not care if you ever take the money out).

To convert or not to convert? That is the Roth IRA question.

Although everyone's situation is unique, the main factors to consider before making the conversion decision include:

Future income taxes — the amount converted is taxable income, so you pay taxes on the money now, rather than when you withdraw the money in retirement. If you expect to be in a higher tax bracket when you retire, a Roth conversion may be a smart strategy. In addition, if you expect tax rates to rise, a conversion may be a savvy move. With the burgeoning national budget deficit and debt, is this unlikely? The tax cost is crucial: if you convert, how much tax will you pay now versus what you expect to pay when you withdraw the money during retirement?

Investment time horizon — the benefits of a conversion will generally increase the longer your money remains in the Roth IRA. If your time horizon is less than five years, the conversion probably will not make sense since amounts withdrawn from Roth accounts open less than five years are subject to a 10 percent penalty.

Source of funds for tax payment — you should generally avoid using money from the conversion to pay the taxes and instead use non-retirement funds. Using conversion proceeds reduces the amount that can potentially grow tax free in the Roth IRA. In addition, if you are under 59 and a half, there is a 10 percent penalty. If you do not have enough non-retirement money to pay the conversion income taxes, one option is to convert smaller amounts. Additionally, even if you can afford to pay the taxes on the entire amount, you might want to consider partial conversions over several years so the income from the conversion is not taxed in a higher bracket than your current one.

Although a conversion does finally provide many high-income investors the opportunity to have a Roth IRA, these considerations add complexity to the conversion decision. However, don't worry. If you decide after completing a conversion that you made a mistake, the IRS allows you to undo all or part of the conversion (a process called "Recharacterization") up to Oct. 15 of the year after the conversion.

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