Making Roth IRAs More Attractive

By Gary Case

Thanks to a little-known tax-law change, more people will be able to convert their traditional IRA to a Roth IRA next year. The change—part of the IRS Restructuring and Reform Act of 1998—could make the Roth IRA a more attractive way for older, wealthy retirees to pass sizeable IRA assets to their heirs.

Starting in 2005, those age 70½ and older who are forced to take required minimum distributions from their traditional IRAs won't have to count those distributions as income when calculating whether they will be eligible for a Roth IRA conversion. Being able to exclude mandatory distributions as income will allow more people to take advantage of the conversion, which is allowed only in a year when modified adjusted gross income is $100,000 or less (not including the additional income from the conversion itself).

Withdrawals from a traditional IRA are taxed as ordinary income. Individuals must start taking distributions from traditional IRAs at age 70½. With a Roth IRA, you aren't required to take any withdrawals during your lifetime and any withdrawals that are taken by your heirs also will be free from federal income taxes.

For many, the biggest hurdle to a Roth IRA conversion is the immediate tax hit on the amount withdrawn from the traditional IRA. Although an IRA that has been beaten up by the bear market may mean a lower tax bill, you should make sure that the tax-free growth you will get by converting will outweigh the upfront taxes you will pay.

When evaluating whether a Roth conversion is for you, consider your expectations for future tax rates and rates of returns. If you expect to be in a higher tax bracket, for example, and believe taxes will only go up, a conversion might make sense. The decision to convert also may be a sensible move for someone who expects to be in a low tax bracket in the year they convert. Be aware that the extra taxable income you trigger by making a Roth conversion could push you into a higher tax bracket, which could make you ineligible to take advantage of certain itemized deductions.

From a planning standpoint, there are several steps to consider before year-end. If you have multiple IRAs and investments, take stock of which account—or how much of each account—you want to convert. You also will want to figure out how you are going to pay the tax—it is best to pay the taxes due on the conversion with funds outside of your IRA. The good news is that the cash you use for the taxes reduces your taxable estate, potentially saving on estate taxes. And remember, with a Roth IRA conversion, you may have until Oct. 15 of the year following the conversion to reverse your decision.

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