Converting Retirement Money to a Roth IRA May Make Sense

By Gary Case

You'd have to be nuts to consider accelerating the payment of taxes on your retirement nest egg, right? Sure--under ordinary circumstances—but let's face it, nothing much that's happened lately falls under the category of ordinary! The point is that very soon most of us will have access to a tax planning opportunity that is especially compelling when asset values are depressed: a Roth IRA Conversion.

Thanks to a law passed in 2005 (TIPRA), the income restriction on Roth IRA conversions is set to be lifted as of January 1, 2010. This opens the door for most taxpayers to consider converting their tax-deferred IRA and 401(k) assets. Unlike conventional alternatives, Roth IRA contributions are made with after-tax dollars versus tax-deferred/tax-deductible contributions to traditional IRAs and 401(k)s. However, Roth IRAs allow taxpayers to accumulate earnings on a potentially tax-free basis. For Roth IRA earnings to qualify for tax-free "qualified distribution" at least five years must elapse from the time of the Roth IRA owner's first Roth IRA contribution, and the IRA owner must generally be at least age 59 ½.

The Roth IRA conversion option allows taxpayers to convert some or all of their traditional IRA, 401(k), 403(b), or 457(b) savings to Roth IRA savings. To do so, the taxpayer must include the taxable portion of the traditional savings as taxable income in the year of conversion. That's no minor feat for anyone looking to convert a sizable sum (conversions made in 2010 may elect to defer the year in which income from converting must be claimed). But once the traditional assets are converted, all future growth within the Roth IRA accumulates on a tax-free basis (assuming "qualified distributions" are taken).

Paying taxes now may seem counterintuitive, but consider that tax rates are currently near historic lows and it is not difficult to conceive higher tax rates in the future given the unprecedented financial challenges likely facing the nation in future years.

Roth Advantages: A Roth IRA adds diversification to retirement savings in terms of tax treatment. When most of one's retirement savings are taxable on withdrawal (as is the case with all traditional retirement savings accounts), retirement income and spending flexibility are limited. A Roth IRA owner can generate additional retirement income with no federal income tax liability. Finally, Roth owners are not required to take minimum withdrawals, which can assist in legacy planning. Potential benefit: it is not difficult to conceive of a nominal gift of a Roth IRA to a grandchild (as beneficiary) transforming into a substantial income over the lifetime of that grandchild.

If your financial planner has not discussed Roth IRA conversion options with you, it may be time to look for one who will!

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