Want a New Convertible in 2010? Think ROTH
Part II of II

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Wouldn't it be nice to have a new convertible this year? Especially if it doesn't cost you a dime in gas and oil? If you read last month's article, you know it's possible! In fact, imagine if you substituted a high car payment for a monthly deposit into your "convertible" Roth IRA account. Now that's advice you can bank on!

In January, I observed that if the market sinks after you convert your IRA, you *do* have options. For example: say you convert a $100,000 traditional IRA into a Roth on January 2, 2010 and in 2011 the value falls to $75,000. This means you could end up paying taxes on $100,000 for an account that has dropped $25,000 in value. Fortunately, the IRS allows you a "do-over" called a "recharacterization". This lets you change the designation of your IRA ***from*** a Roth ***back to*** a traditional IRA.

You have until the tax extension due date of the year following a conversion (10/15/11 in our example) to recharacterize. If you've already filed your tax return, you can amend and get a tax refund. And it gets better: after you recharacterize, you reconvert that IRA ***back*** to a Roth IRA! You must wait 30 days or until the calendar year after the conversion, whichever comes later. In the above example, you would wait 30 days to reconvert at the lower value, and then pay taxes on the balance at the date you reconvert (assuming the above values didn't change, you would pay taxes on $75,000 instead of $100,000).

What if you convert an account and some of the investments have increased in value and others have decreased? This brings up a great planning idea. IRS Notice 2000-39 contains what is called "anti-cherry picking rules". To prevent selecting only those assets that have decreased in value, the IRS makes you recharacterize a proportionate amount of gains and losses over the whole Roth IRA account.

PLANNING TIP: For this reason, I recommend that clients segregate Roth IRAs into specific asset classes. In other words, you might set up one Roth IRA account for bonds (or bond funds), another for sector funds (such as health care, utilities, or real estate), a third for large-cap funds, and another for international funds. This will give you the flexibility to recharacterize only those accounts that have dropped in value and leave untouched those that have grown. Make sense? Sure, it will be a little more work for your investment advisor, but well worth it for you – and that's the whole point, isn't it? By the way, you need to keep these accounts separate only until the time to recharacterize has expired.

PLANNING TIPS: **Consider converting to a Roth if**:

- You can pay the resulting tax bill from ***non***-retirement funds. Otherwise, all the benefits from converting could be lost.
- You believe tax rates will go up in the future. Although no one can predict future rates with certainty, I don't expect to see our current low rates again in my lifetime.
- You have a net operating loss, excess charitable contributions carry-forward or other deductions that can offset the conversion income. **NOTE:** converting your IRA is **not** a capital gain and so cannot offset capital losses.
- You do not expect to need your IRA during retirement. As I mentioned before, you are required to begin drawing down funds from a traditional IRA after age 70 ½.

- ➢ Or…you ***do*** expect to need your IRA during retirement. Because income from your Roth is not taxable, you could owe less tax on Social Security income and may be able to retain other tax benefits that are dependent upon your income level.
- ➢ You have retirement accounts that are significantly undervalued. Conversion to a Roth is an excellent opportunity to pay taxes on this lower amount.
- ➢ You plan to leave your IRA to your heirs. While the ***value*** of a Roth will be included in your estate (just like any other asset), your heirs won't pay income taxes when they take money from the account (as they ***will*** with a traditional IRA). Paying taxes now also removes future asset growth from your estate. NOTE: even though you can leave your Roth withdrawal-free during your lifetime, your beneficiaries ***are*** subject to Required Minimum Distribution ("RMD") rules. In other words, IRS rules will govern the timing of withdrawals from any Roth accounts they inherit.

The following circumstances may preclude conversion to a Roth:

- ➢ If you must use IRA funds to pay any taxes due on conversion.
- ➢ If your income is unusually high this year. ***However***, remember that you have the option to defer payment and split the taxes between 2011 and 2012. If you go this route, be sure to adjust your estimated payments for the increased income. (And do consider that by deferring payment, you expose yourself to the risk that tax rates ***will*** increase in those years.)
- ➢ If the additional income may cause you to pay Alternative Minimum Tax or lose tax benefits that you would otherwise qualify for.
- ➢ If you will need to begin IRA distributions within five years of conversion. (In general, you must wait five years to take tax-free withdrawals from your Roth, but there are many factors affecting this rule so be sure to discuss with your CPA.)

PLANNING TIP: leave a few dollars in your Roth should you recharacterize your account. By paying a some tax now and keeping the Roth in place, you will start the five-year clock for tax-free withdrawals.

This advice is intended for the general public and may not be appropriate for your specific situation so be sure to run these ideas past your CPA and/or financial planner. If a Roth *does* happen to be in your future – enjoy your new convertible (and invest responsibly)!