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Is a Roth IRA conversion right for you?

By Laura Barooshian

Beginning in 2010, if you have a traditional IRA, you have the ability to convert it to a Roth IRA, regardless of your income level. Historically, this ability was only available for those with adjusted gross income under $100,000.

Converting to a Roth triggers taxable income for the amount you convert. After the conversion, however, the Roth IRA grows tax-free (vs. the tax-deferral of a traditional IRA). Any qualified distributions from the Roth after age 59 1/2 are also not taxable.

Another benefit of the Roth is that there are no minimum required distributions once you've reached age 70 1/2. Thus, if you do not need to take distributions during retirement, the funds can continue to grow tax free.

Any Roth IRA funds inherited at your death will continue to be income tax-free to your beneficiaries.

Roth conversion basics

A Roth conversion is treated as a taxable distribution from your traditional IRA because you're deemed to receive a taxable payout from your traditional IRA.

You will not, however, be subject to any penalty even if you are under age 59½ at the time of the conversion. You can convert all or a portion of your traditional IRA to a Roth.

In deciding whether to do a Roth conversion, the current tax cost must be weighed against the future benefits of a Roth. To properly analyze this decision, there are a number of factors to consider including the following.

- If you expect your current tax rate to be lower now than in the future, you may lean towards a conversion. Most expect tax rates to increase in the near future, but no one can predict tax rates at any given time.

You would also need to consider your income level at retirement. Even though tax rates may increase, many people have reduced income at retirement, so they may not be impacted by the higher tax brackets.

- The number of years to retirement may impact your decision. The further you are from retirement, the longer the Roth is allowed to build tax-free.

- Will you need the funds during retirement? If no, the Roth is appealing since there are no requirements to take distributions from the Roth as there are with a traditional IRA.

- Are funds available to pay the tax on the conversion without depleting the IRA account? If IRA funds are needed to pay the tax, the depletion of the IRA may outweigh the benefit of a conversion.

Additionally, if any IRA funds are not converted to the Roth account, they would be subject to a 10 percent penalty if you are under 59½.

- If the current value of your IRA is depressed due to recent market activity, it may be an excellent time for a conversion. Ideally, you would want to convert when your IRA is at the lowest value.

Special rule for 2010 only

For Roth conversions occurring in 2010 only, there is an option to report the income entirely in 2010 or report 50 percent in each of 2011 and 2012, subject to tax at the tax rates in effect in those years.

With the anticipation of higher tax rates in the near future, the option to defer to 2011 and 2012 may not be beneficial. The decision, however, needs to be made in the context of your own personal tax situation and may be advantageous for some.

You can reverse a Roth conversion

Another great thing about the Roth conversion strategy is you can change your mind after the fact. If you convert in 2010, you could have until as late as Oct. 15, 2011, to recharacterize (unwind) your 2010 converted account.

For example, if you convert a traditional IRA into a Roth in early 2010 and the value of the account declines, you have until Oct. 15, 2011, (the extended due date of the 2010 tax return) to recharacterize some or all of the account back to a traditional IRA. It's as if it never happened.

The decision to convert is not straightforward and may be appropriate for some, but not others. It is also dependent on each person's specific tax situation. Check with your accountant to see if this is an opportunity you want to address this year.

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