

IRA damage control

Although the stock market has been doing better lately, it is still well off the highs of 2007. Many IRAs have been hard hit by the fall in asset values. However, even bad markets can create tax planning opportunities.

Conversion to a Roth IRA

If you've ever been attracted to the idea of converting your traditional IRA to a Roth IRA, this may be the time to do it. Key benefits of the conversion are fully tax-free portfolio growth and freedom from the minimum distribution requirements at age 70½. The cost of the conversion is payment of ordinary income tax at rates of up to 35%. When the values of IRA assets are down, this cost goes down as well. As the markets recover and assets appreciate in value, all that growth can be tax free. For maximum tax benefit, it's best to pay the tax on the conversion from assets other than the IRA.

Unfortunately, not everyone is permitted to make a Roth IRA conversion. For the 2009 tax year, you can't convert if your adjusted gross income is more than \$100,000 (whether single or married). Under current law the cap will be eliminated in 2010. It is possible that Congress will revoke that change before it takes effect, although under the revenue-scoring systems in place, such a revocation will lose revenue.

The Roth conversion "do-over"

What if you did a Roth conversion in 2008, when asset values were high, and now you regret that decision? You are permitted under the tax law to change your mind, up until the due date (with extensions) for filing your 2008 tax return (October 15, 2009). The process is called a "recharacterization," and it must be carried out with the assistance of the IRA trustee.

Let's say that Taxpayer converted a \$100,000 traditional IRA to a Roth IRA, but the account is now worth only \$70,000. How can he return the \$100,000 to the traditional IRA? He doesn't have to. When the money is returned to traditional IRA status, it must be accompanied by the "net earnings attributed to it" while it was in Roth IRA status. Net earnings can include losses. If the entire \$70,000 is recharacterized as a traditional IRA, Taxpayer has met the requirement. The key benefit for Taxpayer is that ordinary income tax on the \$100,000 conversion need not be paid.

Should Taxpayer decide to recharacterize, he must wait for the later of 30 days or the next tax year to do another Roth conversion.

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A Division of Salisbury Bank and Trust Company

19 Bissell Street
Post Office Box 1868

Lakeville, Connecticut
06039-1868

t: 860.435.9801
t: 800.222.9801

f: 860.435.5224
www.salisburybank.com

trust@salisburybank.com