

Roth conversions

With asset values low, some owners of traditional IRAs may be wondering whether this might be a good time to convert their accounts to Roth IRA status. There is a significant tax cost associated with the transaction, because the full amount of the conversion is taxable at ordinary income tax rates. The benefit that makes the price worth paying is the potential for tax-free growth in all the years following the conversion, coupled with freedom from the required minimum distribution rules.

But what happens if the account does not grow after the conversion? What happens if it actually falls in value? For a limited period of time, the taxpayer is allowed a change of heart and can negate the conversion.

The conversion “do-over”

Here’s a fictitious example, one tied to recent financial market experience. Fred converted a \$500,000 traditional IRA to a Roth IRA in July 2008. He had second thoughts in March 2009, when the value of the account had fallen to \$325,000, but he nevertheless paid income taxes on the \$500,000 conversion. Although the account has bounced back somewhat, Fred really regrets the decision.

Fred can still change his mind, until October 15.

To reverse course, Fred needs to arrange for a trustee-to-trustee transfer of the Roth IRA balance back to a traditional IRA. The question many have is, how can Fred return \$500,000 to an IRA when so much of the account has evaporated? The answer is that IRS requires any return of funds to a traditional IRA to be accompanied by “net earnings attributable” to the conversion contribution. “Earnings” includes losses. So if Fred sends the entire Roth IRA balance to a traditional IRA, he will be considered to have transferred back the entire initial \$500,000 that was converted to Roth IRA status. Fred should keep in mind that the election to recharacterize a Roth IRA is irrevocable (unlike the decision to convert to a Roth IRA).

Partial recharacterizations of Roth IRA conversions also are permitted, but they must include a proportionate share of the earnings or losses of the entire Roth IRA.

Reconversions

Now that Fred has flipped his Roth IRA back to a traditional IRA, can he reconvert that traditional IRA back to a Roth IRA using the lower, now-current asset values?

Not immediately, but yes. Recharacterizing a Roth IRA back to a traditional IRA does not lock one into the traditional mode for life, but there is a waiting period before the recharacterized IRA can be reconverted. Fred must wait for 30 days or until the taxable year following the year of the original conversion, whichever is later.

Regular contributions

Ordinary annual IRA contributions also may be recharacterized.

For example, Emily contributed \$5,000 to a traditional IRA and took the tax deduction. Upon reflection, Emily concluded that she is never likely to be in a lower marginal tax bracket than she is in now. She is permitted to move the contribution to a Roth IRA, and she must include the earnings on the \$5,000 when she does this.

Looking ahead

The biggest barrier to conversions to Roth IRAs has been the limit on income eligibility. Only those with adjusted gross income of less than \$100,000 are permitted to make this election. The \$100,000 cap applies equally to singles and to marrieds filing jointly.

This barrier is scheduled to be eliminated in 2010. Many tax planners have been alerting their clients to the coming opportunity for the realignment of their retirement savings. Roth conversions will be simplified somewhat; for example, for those who have consolidated many IRAs into a single account.

One might think that as Congress looks to ways to increase taxes on those at the highest income levels, this future tax break could be vulnerable. As of this writing, no one has suggested that the income cap be retained. Perhaps that's because those who estimate tax revenues have projected a windfall for the Treasury when the cap is removed.

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