

Financially Speaking

With Trisha Arndt, CFP®

To Convert or Not to Convert

A very smart man that I know (ok, it's Jim Ferolie, let's give credit where it is due) recently forwarded me an article about Wisconsin's current lack of conformity with the federal tax rules pertaining to conversions of Traditional IRAs to Roth IRAs in 2010.

I was aware of the issue but it was interesting to see the political spin being used to try and explain why Wisconsin is the only state to not have adopted new rules that follow the federal ones. In the political world I guess we can count on Wisconsin to even miss the chip shot once and awhile.

So what are the new federal rules?

Through 2009 only those with adjusted gross income of less than \$100,000 were able to convert qualified dollars to a Roth IRA. Beginning January 1st, however, the \$100,000 limit was eliminated so anyone that elects to do so is now able to.

When money is converted to a Roth IRA income taxes (but no early withdrawal penalties for those under age 59 ½) must be paid on the taxable dollars converted. Typically these taxes will be due in full for the tax year of the conversion, however 2010 offers an additional special opportunity. For eligible individuals the taxes due on amounts converted in 2010 may be spread out into two equal installments and may be deferred into the 2011 and 2012 tax year. In other words, money can be converted to a Roth IRA in 2010 with 50% of the related taxes deferred to 2011 (generally due by April 15, 2012) and the remaining 50% deferred to 2012 (generally due by April 15, 2013).

Unlike Traditional IRAs (as well as Traditional contributions to 401ks, 403bs, SEP IRAs, etc.) which defer income taxes until money is withdrawn, qualified Roth IRA distributions are tax-free under current law. The tax-free treatment applies to both the amount contributed to the Roth and any earnings it has, regardless of dollar amount. For those planning for a retirement that could potentially span several decades the ability to take tax-free income withdrawals can become a very attractive feature.

For those that believe that their personal income tax rate will increase over time – either because they expect to have higher relative income going forward or because they expect to see a general income tax rate increase – then converting today can be viewed as a way to hedge against the possibility of rising tax rates.

Another potential benefit of Roth IRAs is that required minimum distributions beginning at age 70 ½ are not imposed on them. This allows those that do not need the income from the accounts in retirement to keep all of the money invested beyond age 70 ½ and avoid the annual income tax burden that can exist with required minimum distributions.

Roth IRAs can also be a very efficient way to pass assets on to heirs. Just as distributions from Roth IRAs are tax free to the original owner, so too can they be to an individual inheriting the account as long as all applicable rules are abided by.

There are many potential benefits of converting to a Roth IRA, but whether or not it makes sense for you will depend on your situation. There are a number of calculators on-line to help assist with the decision (including one linked to my website, www.wealthstrategies.biz) but on-line calculators never take the place of personal advice in my opinion. You should always consult with a financial professional and/or a qualified tax advisor before making elections of this nature and converting money to a Roth IRA is no exception.

Unless the Wisconsin legislature gets its act together and passes a bill to follow the federal rules those of us blessed to live in the Dairy state may not have this conversion opportunity as readily available to us. Let's hope that they take a break from passing bills naming the state motorcycle to do something that could have huge potential significance for many residents.

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