Roth IRA Conversions

Eight Factors To Consider Before Converting

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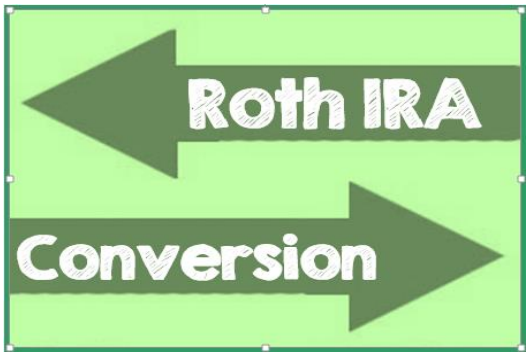
Named after the late Senator William Roth of Delaware, Roth IRAs were created with the Tax Relief Act of 1997. Major changes to Roth IRA restrictions in 2010 encouraged many financial firms and companies to discuss conversion to Roth IRAs.



Prior to the year 2010, there were income limits to both contributing and converting to Roth IRAs. However, the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 made some modifications to those rules, which started in 2010 and still apply today.

Since their introduction over a decade ago, Roth IRAs were available only for individuals under certain income limitations. Income restrictions still exist in terms of contributions to a Roth IRA, however, starting in 2010, changes removed income restrictions for Roth IRA conversions. These changes opened a window for investors who were previously excluded from converting to a Roth IRA to consider this conversion.

Like every important financial decision, considering converting your existing IRAs to Roth IRAs is best decided with extreme care and should be determined based upon your specific situation. Any investor that already has a traditional IRA or retirement plan might find it is best to discuss with a financial professional whether converting to a Roth IRA is the right move before making any decisions.

Here are eight factors to consider that can help you with your decision.

1. The income limitations for Roth IRA conversions were removed.

Prior to 2010, households with modified adjusted gross incomes exceeding $100,000 were not eligible for Roth IRA conversions. While income restrictions still exist for contributing to a Roth IRA, there is no longer an income limit on who can convert an existing traditional IRA or employer plan to a Roth IRA. As we mentioned earlier, this is a major financial decision and it is typically in your best interest to discuss your situation with someone who understands all of the moving parts involved.

2. Married couples who file separately are now allowed to make Roth IRA conversions.

Prior to 2010, married couples who filed separately were not allowed to convert to Roth IRAs (unless they have lived apart for more than one year). Due to the rule changes that started in 2010, married couples who filed separately could now convert to a Roth IRA.

3. You can make a partial Roth IRA conversion.

Making a Roth IRA conversion does not have to be an all or nothing decision. Although the rules surrounding partial conversions can be complex, a competent financial professional can help you understand the tax impacts and rules that govern converting some, all, or none of your existing IRA to a Roth IRA. Like any other decision, all of the variables of your particular situation should be considered. You should consider running the numbers for your situation to best determine the impact of making a full or partial conversion to a Roth IRA.

4. What is your age and time horizon?

Should you elect to convert to a Roth IRA, there is a 10% federal penalty on any withdrawal made within the first five years from that Roth IRA. Also, like with other retirement accounts there is a 10% federal tax penalty on any withdrawal made prior to age 59 ½ (unless an exception applies). This needs to be factored in when making your decision as to whether or not you should convert all or some of your IRA funds to a Roth IRA.

An advantage of the Roth IRA is that investors over the age of 70 ½ are not subject to Required Minimum Distributions (RMDs). Therefore, those investors who do not need to use the money to live off, can continue to grow these funds tax-exempt. A qualified financial professional can help you map out, based on your age and time horizon, a strategy that is most likely to avoid or minimize the impact of penalties involved with Roth IRA conversions.

Contribution and Conversions

There are two ways to establish a Roth IRA:

Roth IRA Contribution

A Roth IRA contribution is merely placing your yearly allotted amount into a Roth IRA instead of a traditional IRA. Your contributions are limited depending on many factors, including your Modified Adjusted Gross Income (MAGI), filing status, and whether or not you are currently participating in a retirement plan at work. (See Table 2 below). There have been no changes in the tax laws regarding Roth IRA contributions, which still have income restrictions for 2014.

Roth IRA Conversion

A Roth IRA conversion is the moving of funds from a traditional IRA, IRA rollover, SIMPLE, SEP-IRA, 401(k), or any other workplace savings plan from a former employer, to a Roth IRA. You do not have to convert 100% of your traditional IRA to a Roth IRA; partial conversions are allowed. As noted earlier, tax legislation that went into effect January 1, 2010, removed any income restrictions when converting retirement funds to a Roth IRA.

For planning purposes, it is helpful to revisit the rules prior to the change (pre-2010 rules) on Roth IRA conversions and the current rules.

	Old Rules (pre-2010)	Current Rules
Contributing to a Roth IRA	• Individuals with modified adjusted growth income (MAGI) below $120,000 or married couple with MAGI below $176,000 are eligible to contribute, assuming they have earned income equal to at least their contribution.	• Individuals with modified adjusted growth income (MAGI) below $131,000 or married couple with MAGI below $193,000 are eligible to contribute, assuming they have earned income equal to at least their contribution.
Converting to a Roth IRA	• An individual can convert a traditional IRA or employer plan to a Roth IRA if their MAGI is $100,000 or less. • Married couples who file separately cannot convert to Roth IRAs (unless they have lived apart for more than one year).	• The income limit disappeared in 2010. • Married couples who file separately are now allowed to convert.

5. The impact of the conversion on your current income tax rate.

By converting to a Roth IRA you are immediately recognizing income in the year of your conversion that could propel you into a higher marginal tax bracket. The only way to really sort this challenge out is to crunch the numbers and try to make the best decision based upon your current tax bracket versus your future income tax bracket expectation.

6. Potential estate planning opportunities.

Roth IRAs can, in certain situations, offer estate planning opportunities. For investors that have other sources of retirement income and do not need to use their traditional IRA monies during their lifetime, a conversion can help leave income tax-free Roth IRA monies to heirs for gift and estate planning purposes. Because you pay the income tax on a Roth IRA up front, your heirs inherit this Roth IRA free of income taxes. When considering a Roth IRA for estate planning purposes, please keep in mind that the conversion will immediately reduce your IRA assets if you cannot pay the conversion tax with non-IRA assets and therefore you may have less money available to grow in your retirement plan. Roth IRAs offer tax-free earnings which can be more attractive than the tax-deferred earnings of a traditional IRA. However, if you have less money in your retirement account, this may not bring the results you desire.

7. Tax laws are always subject to change.

Remember, tax laws are always subject to change. Therefore, it is advisable for anyone making this decision and/or other decisions to stay in contact with a financial professional who is current and informed of these rules. When making financial decisions that involve tax laws it is always advisable to think about the "what ifs" and make sure you make the most informed decision.

8. Roth IRA Conversions Can Be Recharacterized

Under current federal tax laws, all taxpayers have the option of recharacterizing or "undoing" a Roth IRA transaction. When you choose to recharacterize a Roth IRA, you are essentially making an election to place your retirement funds back to the way they were before the conversion.

This process can be completed no later than October 15th of the year following your conversion. Please remember that under current tax laws, there are restrictions on how you must handle a partial recharacterization of a Roth IRA. You cannot choose to recharacterize only those investments that have declined in value. This is not allowed under the Anti-Cherry Picking Rules.[1] The Anti-Cherry Picking Rules were specifically designed to prevent people who converted to a Roth IRA from recharacterizing only those investments that declined in value. The effect of this rule is to pro-rate all gains and losses to the entire Roth IRA regardless of the actual stock or investment recharacterized. One strategy that is allowed is for an investor to break up their IRA into two separate IRAs and then convert to two separate Roth IRAs. You should familiarize yourself with the IRS laws regarding recharacterization in order to implement this strategy. As a financial advisor who understands these rules, we have experience in guiding clients in this area.

Summary

In conclusion, we realize the decision to convert some or all of your retirement account to a Roth IRA is complex. While this article is for informational purposes only and should not be deemed tax advice or an individualized recommendation, we hope that some of these points are helpful to you.

Should you convert to a Roth IRA? If so, how much and when? These are good questions that require an examination of your personal situation

[1] As identified in IRS Notice 2000-39

and goals. This is where we can potentially help and add value.

If you have any questions on whether or not you should contribute or convert to a Roth IRA, we welcome the opportunity to help you map out a strategy that will be best for your situation. Saving for retirement has and always will be a priority for most investors. We enjoy helping clients and prospects explore all of their options.

Complimentary Financial Check-up

If you are currently not a client of Tracy Wealth Management, we would like to offer you a complimentary, one-hour, private consultation with one of our professionals at absolutely no cost or obligation to you.

To schedule your financial check-up, please call Kevin at (360) 452-9080 and we'd be happy to assist you.

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