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A taxing decision
Time is right to convert to a Roth IRA
If you have the cash, current conditions make it a smart move

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CORRECTION: CORRECTIONS, CLARIFICATIONS: In Monday's Business section, an article on Individual Retirement Accounts should have included the information that conversions to a Roth IRA are limited to taxpayers - single or married filing jointly - with adjusted gross income of $100,000 or less. (Ran: Wednesday, August 13, 2003)

Everything else being equal, the decision to keep your money in a traditional Individual Retirement Account or a Roth IRA comes down to one question: Do you think your income tax rate will be higher now, when you're working, or later, when you're retired?

With the traditional IRA, you invest with pretax dollars, and you're taxed on the money only when you withdraw it in retirement. With the Roth, you invest with after-tax dollars and don't pay any taxes on withdrawals in retirement. Simply put, it's a question of when you pay the taxes.

On the fifth birthday of the Roth IRA, with a tax cut in effect and the possibility of higher rates in the future, some financial experts say now may be a good time to convert to a Roth.

"This is definitely a carrot out there do that," says Michael W. Busch, a certified financial planner and president of **Vogel Financial Advisors** LLC in Dallas. "Rates now are going to be as low as they're going to get. ... They may even go higher."

What's more, the slump in the stock market knocked down the value of traditional IRAs, so if you convert now, you would be paying tax on a smaller amount.

"It's a lot less painful to make that kind of conversion than it was a couple of years ago, so you have less of a gain and you have lower taxes," says Brian Mattes, spokesman at Vanguard Group, a major mutual fund firm.

But paying the tax up front - there's the rub. In order to convert a pretax,

traditional IRA to an after-tax Roth IRA, you have to pay taxes on the value of the conversion.

(That's assuming all the contributions to your traditional IRA were deductible. If part of your contributions were nondeductible, that portion would not be taxed in a conversion because you've already paid tax on it.)

"The primary disadvantage of conversion is that you trigger an immediate tax bill," Mr. Busch says.

And that's "a big hit for most people," says Marcia Mantell, vice president of retirement products at Fidelity Investments, the giant mutual fund company.

"If you're going to do the conversion, the way you benefit the most is if you can afford to pay the tax bill from another source," she says, discussing a hypothetical person with $100,000 in a traditional IRA. "You want that full $100,000 to be working toward your retirement savings."

Theoretically, you could use part of the money you're converting to pay the tax, but that might be shooting yourself in the foot.

"If any of the IRA funds are used to pay the tax, those amounts could possibly be subject to both regular income and a penalty tax," says J. Richard Joyner, a partner at Ernst & Young LLP in Dallas.

Economy's effect?

If you can handle the tax bite, many experts say, a conversion makes sense right now. But in today's economy, the tax issue kills the decision for many people.

That may be one reason why Fidelity hasn't seen many conversions to Roth IRAs.

"During the past IRA season [January through April 15 of this year], it was the first time since the Roth launched where we saw more new IRAs being opened in traditional IRAs than Roth IRAs," Ms. Mantell says. "It was 51 percent to 49 percent."

The shift surprised her. One reason may be that people need the tax deductions; they don't think they can afford to pay taxes now on their retirement savings, even if they think the tax will be higher later.

"I wonder what the true impact of the economy is on people, with the decision whether to deduct today or get the tax-free distribution tomorrow," Ms. Mantell says. "There are just too many more external

considerations now with the economy being so tough. It's not as straightforward as it had been back in 1998, when things were going quite well in the market and people were gainfully employed."

The Roth IRA was created under the Taxpayer Relief Act of 1997 and became available in 1998.

You don't pay tax on Roth IRA withdrawals if you've had the account for at least five years and you're 59 1/2 years old or older. Other conditions apply.

With a traditional IRA, taxpayers are subject to a 10 percent early-withdrawal penalty, in addition to regular income tax, on amounts withdrawn before 59 1/2.

But the Roth has an advantage on withdrawal rules: With a traditional IRA, you're required to start making withdrawals at age 70 1/2, so Uncle Sam can start getting his cut. With a Roth, you can delay taking withdrawals until whenever you want.

"A Roth IRA may provide higher benefits over time with regard to money growing tax-free for longer durations," says Shashin G. Shah, a certified financial planner at Financial Design Group in Addison.

That brings us back to the key question: What will your tax rate be in retirement?

IRAs and 401(k)s were sold to the public with the suggestion that your tax rate would be lower in retirement, when you'd have less income. But some tax experts believe that rates will have to continue their long-term upward trend, in order to deal with the rising deficit and to keep Medicare and Social Security solvent as the Baby Boomers retire.

The Jobs and Growth Tax Relief Reconciliation Act of 2003, which became law this summer, accelerated reductions in regular tax rates that weren't set to kick in until 2006.

However, the rate reductions expire after 2010 unless Congress makes further changes in the tax laws. If Congress does nothing, the tax brackets in 2011 will revert to their 2000 levels.

One more concern

Another concern is something that's tripping up more retirees every year - the rule that triggers taxes on Social Security payments. If retirees make enough money, their effective marginal tax rate on 401(k) withdrawals can jump to as high as 50 percent. In other words, their taxes on the savings could be higher than if they hadn't sheltered it in a 401(k) at all.

"If you know you're going to be in a higher tax bracket, in almost all cases, it's going to make sense to convert," Mr. Busch says. "That's a no-brainer."

Even beyond the fears of rising tax rates, if you think tax rates will be the same when you retire, you still can benefit from a conversion.

"If your expected tax rate in retirement is lower, but not by much, you may still benefit from converting," Mr. Busch says. "If you're going to be in a much lower tax bracket in retirement, then it becomes a lot higher hurdle to overcome, paying that tax up front."

The fact is, we have no way of knowing for sure what will happen to tax rates in the future - it's possible they could be much lower. So some financial advisers suggest diversifying your retirement assets between the two tax situations - pretax and after-tax. That way you'll have the flexibility in retirement to make some withdrawals that won't create a taxable event.

If you're thinking about converting your IRA, keep in mind that you don't have to convert the entire amount.

Converting in pieces

"Consider whether the income from a conversion will put you into a higher tax bracket in the year of conversion," Mr. Busch says. "If so, remember that a conversion isn't an all-or-nothing proposition. You may want to only convert up to the amount that would force you into a higher tax bracket.

"If you take this approach over several years, you may be able to convert your entire IRA without paying taxes at a higher rate."

For example, let's say you have $100,000 in your traditional IRA and you are $20,000 away in additional income from being bumped into the next highest tax bracket. You could convert one-fifth of the $100,000, or $20,000 a year, over several years, if that would keep you in your current tax bracket.

"When you're done you've converted the entire $100,000, but you've converted it all at your regular tax rate by doing it over that several-year period," Mr. Busch says. "If you did it all in one year, only $20,000 would have been at your regular tax bracket and everything else - $80,000 - would have been at the higher tax rate."

That example is for simplicity's sake and assumes that your income doesn't change each year and you're always $20,000 away from the next tax bracket.

Realistically, because your income most likely will change each year, you will have to calculate each year how far away you are from the next highest tax bracket.

How many years it will take you to convert gradually will depend on the size of your traditional IRA and how many dollars away you are from the next tax bracket, Mr. Busch says.

The benefits of the Roth caused many people to convert when it was first offered five years ago. The current tax situation has many financial advisers recommending conversion again.

"The Roth IRA still has great appeal to many investors because the tax-free nature of the withdrawal is a powerful incentive ... particularly if you're investing for many years," says Mr. Mattes at The Vanguard Group. "The idea of total tax-free compounding is so compelling as to make it worthwhile for many investors."

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