Timing's right for converting to a Roth IRA
Tuesday, December 30, 2008
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NorthJersey.com
BLOOMBERG NEWS

There's no time like this week for converting to a Roth IRA to fuel future tax-free growth, financial advisers say.

The strategy is for those who earn less than $100,000 a year and are betting that tax rates in retirement will be higher than they are now.

"It's becoming more clear they're going to have to raise taxes, not only at the federal level but the state and local level, too," said Jeremy Portnoff, a fee-only financial adviser in Union. "Tax rates have been low, by historical standards, for quite a while now," he said.

Contributions to a traditional IRA are tax deferred and taxes are paid when money is withdrawn, which can begin at age 59 1/2 and is mandatory by age 70 1/2. When savers put money into a Roth IRA, the contributions aren't tax deductible and withdrawals are made tax free.

Conversions to a Roth IRA must be made by Dec. 31 and contributions can be made up to April 15 to apply to 2008, according to Doris Merrick, tax director at Brinton Eaton Wealth Advisors in Madison.

Portnoff said eligible clients should transfer as much money as possible into Roth IRAs. Taxes paid now will end up saving investors money in the long run, in the event tax rates climb in the future, he said.

For a traditional IRA worth $50,000, that would mean an immediate tax bill of $14,000, for a person in the 28 percent federal tax bracket. Roth IRA conversions are often tailored with tax brackets in mind, Portnoff said, taking care not to transfer so much that an investor lands in a higher bracket.

U.S. IRAs held $4.5 trillion in assets at the end of the second quarter, according to a Dec. 23 estimate by the Washington-based Investment Company Institute. That compares with $2.9 trillion in so-called 401(k) savings plans and $16.9 trillion in all types of retirement assets.

The Roth IRA strategy will especially pay off if stock markets are near a bottom, said Morris Armstrong, a financial adviser in Danbury, Conn. If markets take off, leaving the money in a traditional IRA risks large taxable gains. Even so, it can be a hard sell to take the short-term pain.

"Anytime you advise someone to prepay taxes, they want to know why," Armstrong said. "It will help you in the long run. It's like an estate-planning issue."

A Roth conversion may be part of an effort to protect against future legislation increasing taxes and personal circumstances, said Don Martin, owner of Mayflower Capital in Los Altos, Calif. Financial advisers call it "tax diversification," he said.

He encourages clients to hold a combination of investments with different tax treatments, including 401(k)s, traditional IRAs, municipal bonds and insurance products. He said there's a strong likelihood taxes will be going up over the next decade.

"I think it's pretty obvious," Martin said. "There's a political pendulum that swings back and forth. It's probably time for taxes to go back up."

Roth conversions aren't for everyone. There are IRS limitations — only taxpayers with less than $100,000 in adjusted gross income are eligible. In 2010, the income restriction is scheduled to be lifted. The contribution limits for both traditional IRAs and Roth IRAs are $5,000 in 2008 and 2009 for people under 50, with an additional $1,000 catch-up for people aged 50 and over.

There's a risk to the Roth strategy, said Jay Hutchins, a fee-only planner in Lebanon, N.H. If the government is under budget pressure, they may remove or curtail Roth tax breaks. Tax rules have been changed on municipal bonds and Social Security benefits in the past, Hutchins said.

Making a good decision on tax strategy without knowing all the final details is an "exercise in futility," said Bedda D'Angelo, a fee-only planner in Durham, North Carolina. It's much better to take a look at a portfolio each year with an eye toward what the actual rules say.