

CONVERT TO A ROTH IRA? WHY NOW MAY BE THE RIGHT TIME

By Phil Zimmerman, CFP®

Next year, the IRS lifts income restrictions for those converting traditional IRAs or 401(k)s to Roth IRAs. Is the opportunity right for you?

Since its introduction in 1997, the Roth IRA has enjoyed great popularity. If eligible, Roth IRA owners can make after-tax contributions and withdraw them, tax-free, at any time if certain conditions are met. Once the account has been open and funded for five years, distributions will be income-tax- and penalty-free provided the account holder is at least age 59½ or meets one of the other circumstances for making a qualified distribution. In addition, Roth IRAs are not subject to required minimum distributions (RMDs) during the holder's lifetime.

One of the Roth's few drawbacks has been its income restriction for converting from a traditional IRA. Currently, anyone, whether married or single, who earns more than \$100,000 is not permitted to make a conversion. However, starting in 2010, the IRS is lifting this income restriction. If you're focused on saving for retirement, this is good news. But anyone considering converting to a Roth IRA needs to understand the less obvious effects of this decision. For instance, the conversion involves an up-front tax liability that may be worth assuming, depending on your circumstances and retirement income strategy.

Typically, it makes most sense to convert when:

- The balance of the traditional IRA you're converting is substantial
- You expect to occupy a higher tax bracket in retirement than you do now
- You expect your beneficiaries to move to a higher tax bracket after they inherit your IRA assets
- You can pay the taxes on the conversion from assets other than those being converted

Consider these questions when you speak with your financial advisor about Roth IRAs:

- How would I benefit during retirement from a Roth conversion now?
- What assets do I have available to cover any tax liability I incur from converting my IRA or 401(k)?
- How would converting my IRA or 401(k) to a Roth IRA affect my beneficiaries?

There are two other factors you may want to consider as you mull over the choice. First, recent market turbulence may have primed your IRA or 401(k) for conversion—a lower account balance generates a lower tax burden. Second, for conversions made in 2010, the IRS allows you to spread the tax payment over a two-year filing period.

Another way to potentially mitigate the taxable burden is to convert only a portion of your assets. However, it's wise to explore the ramifications beforehand. Converting a portion of IRA assets is more complex than it seems at first blush. Investors may be under the impression that it's possible to convert only after-tax IRA contributions to a Roth and thus avoid having to pay any taxes on the conversion. As nice as that would be, it's not possible because of the way the IRS views IRA assets. Even if you have after-tax money in your IRA, the IRS won't allow you to convert only those contributions. Instead,

the IRS looks at all your IRA accounts together and prorates the taxes you owe based on both taxable and nontaxable assets.

Of course, all the earnings on your contributions are still subject to tax upon conversion. Taxes on earnings are not prorated—it doesn't matter whether those earnings came from deductible or nondeductible contributions.

In the right situation, converting to a Roth IRA can be extremely beneficial to your retirement plans. It's important to talk with your financial advisor. He or she can help you determine whether this brand-new opportunity can help you achieve your retirement savings goals.

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Phil Zimmerman, CFP® is an Assistant Vice President and Wealth Management Advisor at Merrill Lynch.