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More people can convert to Roth IRAs; is it a good idea?

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A new law that lets high-income investors convert traditional individual retirement accounts and 401(k) plans to Roth IRAs is generating a lot of business for mutual fund companies — and baffling many investors.

"I work in finance, and I think I'm pretty astute about things, but there seem to be so many rules, and some seem so arbitrary," says Joe Tortorelli, 40, of Germantown, Md., who has most of his savings in 401(k) plans.

At Fidelity Investments, the USA's largest mutual fund company, more than 19,000 customers converted their individual retirement accounts to Roths last month, more than four times the average for January. At T. Rowe Price, Roth conversions rose 4½ times over a year earlier. Roth conversions at Vanguard Group were up sevenfold from January 2009.

Contributions to a Roth aren't deductible, but earnings are tax-free, as long as the Roth owner is at least 59½ and has owned the Roth for at least five years. Brokerage firms and mutual fund companies are eagerly promoting this opportunity to clients who have lots of money sitting around in traditional IRAs and 401(k) plans. There's even an iPhone app for Roth conversions.

But to secure tax-free earnings, investors will be required to pay a tax bill — potentially a very large one — upfront. That "really goes against the grain of what we normally tell investors, which is to defer taxes as long as possible," says Maria Bruno, investment analyst for the Vanguard Group. "There are tradeoffs to this decision."

Roth IRAs were created in 1997 to encourage more Americans to save for retirement. The 1997 law also let investors convert traditional IRAs to a Roth as long as they paid taxes on any contributions or earnings that hadn't already been taxed.

Congress also imposed income constraints on Roths, making them off-limits to high-income taxpayers. Until this year, the income limits on conversions were even more restrictive: Single or married taxpayers with modified adjusted gross income of more than $100,000 couldn't convert. That restriction kept many dual-income couples from converting their traditional IRAs to a Roth.

The income limits on Roth contributions are still in place, but as of Jan. 1, the restrictions on conversions have disappeared. Even savers who don't already have traditional IRAs to convert can take advantage of the rule by contributing to a non-deductible IRA — which has no income limits — and then converting it to a Roth.

Still, just because you've been unable to convert to a Roth in the past doesn't mean you should now.

Reasons not to convert

Why converting to a Roth might not be right for you:

•**You can't pay the tax bill.** When you convert a traditional IRA or 401(k) to a Roth, you're required to pay taxes on any money that hasn't already been taxed, which could be the entire amount. Money to pay the tax bill should come from a fund outside your IRA, says Pamela Villarreal, senior policy analyst for the National Center for Policy Analysis, a conservative think tank. If you withdraw money from your IRA to pay the tax bill, you'll be hit with taxes and possibly penalties on the amount you withdraw. "It would take a lot to recover from that," she says.

Taxpayers who convert in 2010 will have two choices: pay the entire tax bill when they file their 2010 tax returns, or split the income from the conversion between 2011 and 2012.

At first, that decision seems like an easy one, because it's usually better to delay taxes as long as possible. But not all investors would benefit by spreading out taxable income from the conversion, says Stuart Ritter, a financial planner for T. Rowe Price. Under the Obama administration's budget proposal, top rates for wealthy taxpayers would increase to 36% and 39.6% from 33% and 35% in 2011. Even if Congress prevents that from happening, an increase in your income could make a conversion more expensive in 2011 and 2012, Ritter says.

"If for some reason you know with some level of certainty you're going to be in a lower tax bracket in 2010 or 2011 — maybe you're unemployed for a couple of months in 2010 — you may want to pay it in 2010," Ritter says.

Fortunately, you won't have to decide how you want to pay your taxes until you file your 2010 tax return, says Tim Steffen, financial and estate planning manager for Baird's Private Wealth Management Group. By that time, you'll probably have a better idea of where tax rates are headed in 2011.

Additionally, you can minimize the tax bill by converting just a portion of your IRAs or 401(k)s. There are numerous calculators on the Internet that will help you estimate your tax bill, but if you're contemplating a large conversion, you should consult with a financial adviser.

Investors who have a mix of deductible and non-deductible IRAs can't avoid taxes by converting just the IRAs funded with non-deductible contributions, Bruno says. "The IRS doesn't allow you to cherry-pick which IRAs to convert," she says. Instead, the IRS will aggregate all of your IRAs — even if they're with different financial institutions — and calculate your taxes on a pro-rated basis.

For example, suppose you have $25,000 in a non-deductible IRA that hasn't generated any earnings and own deductible IRAs worth $225,000. If you converted $25,000 to a Roth, 90% of the conversion would be taxable, because 90% of your combined IRAs were funded with deductible contributions.

•**You're close to retirement**. Steve Batey, 59, of Forest Acres, S.C., plans to retire in seven to 10 years, so he's not sure whether converting to a Roth is a good idea. "There's more mystery than there needs to be," he says.

Even if the tax cuts expire, there's a good chance your tax rate will decline when you stop working. In that case, you're better off leaving the money in your traditional IRAs and paying taxes on the withdrawals, Ritter says: "It doesn't make sense to pay taxes at 28% to avoid having to pay them at 15%."

•**You plan to leave your IRA to charity**. Some seniors who don't need their IRAs for income plan to leave the money to charity. It doesn't make any sense to convert to a Roth, because the charity won't have to pay taxes on the money, says Joe Spada, managing director of Summit Financial Resources in Parsippany, N.J. "If a client has a lot of money that they're not going to need, and they're philanthropic and plan on leaving money to charity, we never recommend a Roth," he says.

Reasons to convert (maybe)

Even with these drawbacks, many savers would potentially benefit from converting all or a portion if their IRAs to a Roth. Consider converting if:

•**You don't plan to take withdrawals from your IRA for many years**. Suppose you're 30 and convert your IRA to a Roth. In exchange for an upfront tax bill, you'll enjoy more than 30 years of tax-free earnings.

"The longer you can leave money in the Roth, the more effective the conversion will be," Steffen says.

In addition, converting now will enable you to take advantage of historically low tax rates. Even if your income doesn't increase in the future, there's a good chance overall tax rates will rise because of the ballooning federal deficit, Villarreal says.

The advantages of converting aren't limited to the young. A 65-year-old could benefit from a conversion if she doesn't plan to take withdrawals until she's 85 or 90, Ritter says.

In addition, once you convert to a Roth, you won't have to wrestle with required minimum distributions. Owners of traditional IRAs are required to take mandatory withdrawals when they turn 70½, whether they need the money or not.

•**You don't need the money and want to leave your IRA to your heirs**. Richard Ley, 53, of Columbia, Tenn., says he doesn't think he'll need income from his IRA for retirement. Instead, he'd like to leave it for his children and grandchildren.

That could make Ley a good candidate for a Roth conversion, financial planners say. Children or other "non-spousal" heirs who inherit a traditional IRA are required to take annual distributions from the account and pay taxes on the money. Heirs who inherit a Roth are also required to take annual distributions, but they don't have to pay taxes on them, Steffen says.

•**All of your IRAs are non-deductible**. Financial planners generally frown on non-deductible IRAs because they offer few of the benefits of deductible IRAs and all of the drawbacks. But as 2010 approached, some advised high-income clients to contribute to a non-deductible IRA so they could convert it in 2010.

If you took that advice, or just did this on your own, converting is a layup. The only taxes you'll pay are on any earnings you generated since contributing to your account. And unless Congress changes the rules, you can continue to contribute to a non-deductible IRA every year and then convert it to a Roth. There is, however, a limit on how much money you can slide through the back door. In 2010, the maximum individuals under 50 can contribute is $5,000; for individuals 50 and over, the maximum is $6,000. You must have earned income to contribute to an IRA.