THE TIME IS NOW FOR THE ROTH IRA CONVERSION OPPORTUNITY

By Jay Cox, CRFA, MSAA.

Here's a flash from Washington: the news is not always bad. Every once in a while we catch a break – but only if we recognize the opportunity and take advantage of it.

Have you ever noticed how people love to dismiss an opportunity by simply saying, "If it looks too good to be true, it probably is"? But in the case of the Roth IRA conversion opportunity, it really is true. It's real, and it's here now. The time is now for the Roth IRA conversion opportunity and the greatest tax break we may ever see.

IRA's (Individual Retirement Accounts) are qualified savings plans created from tax-deductible contributions to employer-sponsored programs like 401(k)'s and 403(b)'s. Balances can be transferred to your own IRA at retirement. Interest in IRA's grows tax-free, but then is taxable upon withdrawal (after age 59 1/2) or when it's paid out in required minimum distributions (after 70 ½.)

A Roth is a type of IRA created in 1997, based upon non-deductible contributions that produce tax- free withdrawals after five years (and 59 1/2.) Roth's also eliminate required minimum distributions, and withdrawals remain tax-free when they transfer to spouses and/or beneficiaries upon the owner's passing.

We've always been able to convert IRA's to Roth's by paying income tax on the amount of growth in the account, but only if our annual income was below $100,000. This shut many people out of the Roth conversion market. But in 2006, Congress passed a law giving us the opportunity of a lifetime: no more income limitations ever again for converting IRA's to Roth's beginning in 2010.

That's now just three months away! Furthermore – as if we needed any more sweeteners – we have two full years after the transfer to pay income tax on IRA's converted to Roth's next year.

That's the only rub: that we must pay tax on the IRA at the time of conversion, rather than when it's withdrawn later. But once we have paid the conversion tax, all future growth and withdrawals from Roth's are tax-free after five years. In the meantime, principal can always be withdrawn at anytime without tax, penalty or limitation, even during the five year build-up.

So if the tax is what's holding you back from converting your IRA to a Roth, you really need to think again. The tax you'd pay for a Roth conversion now is no more than the tax you'd pay if you simply withdrew all your qualified money today.

You're always going to have to pay Uncle Sam eventually; you're just getting him paid now, for the benefit of tax-free growth and income later. Needless to say, the long-term tax-free compounding of growth and interest inside a Roth can be incredible.

If we insist on waiting to pay the tax on IRA withdrawals later, we're not just delaying the pain; we're compounding it with increased future earnings. And the pain will just be that much worse if future income tax rates go up, as many people suspect. That's why we say, "Pay tax on the seed, and let the crop grow for free." It's like lower taxes are on sale today, so pay the lesser amount while you still can.

Based on personal circumstances, there may be good or bad financial reasons to convert your IRA to a Roth now. We all need to consult our tax advisor to make this determination. But consider these three non-financial reasons why it's a good idea to convert today.

First, lower taxable income could mean lower Social Security taxes. Second, more growth means more savings for long-term health care, which few people are prepared or insured for. And third, even if you might never need the additional tax-free income that a Roth conversion can create, that just means more money to be left to your spouse and family when you're gone.

For anyone who may still be skeptical, remember that partial Roth conversions are always permitted. You may only want to transfer a portion of your IRA to a Roth, or just move some of it each year. In fact, this approach may be especially wise in managing your tax bracket.

One last word of advice: just because the income limitation on Roth conversions ends in 2010 does not mean you might need to wait until then to begin tax-free savings. If your income is less than $100,000, you can begin converting your IRA to a Roth now. If you're still working and your income will be less than $120,000 single or $176,000 married filing jointly, you can make a Roth contribution now and get the five year clock started this year.

Even if your annual income ends up being higher than the threshold, you can still re-characterize next year without penalty if necessary.

So what more could you be waiting for? The time is now for the Roth IRA conversion opportunity and the greatest tax break we may ever see.

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