

The Ins and Outs of Roth IRA Conversions

If you are thinking about making a Roth IRA conversion in 2006, now is the time to make sure that distributions from your traditional IRA are completed before year end. Yes, you have until April 15, 2007 to make a 2006 contribution to your Roth IRA, according to Ed Slott, publisher of *Ed Slott's IRA Advisor*, but Roth IRA conversions work a bit differently. According to Slott, the Roth IRA conversion will count for the year as long as the funds are withdrawn from the traditional IRA before year end. And that's true even if withdrawn funds are not contributed to the Roth IRA until early in the following year.

It is important to note also that a Roth IRA conversion is considered a rollover and thus the distribution from the traditional IRA must be deposited to the Roth IRA within 60 days of receiving the distribution. Otherwise, there's a penalty. To avoid a penalty, Slott recommends that taxpayers convert their funds to the Roth IRA in the same year as the distribution from their traditional IRA. That way, all the tax reporting for the year matches up. What's more, Slott advises taxpayers to use what's called a direct rollover (a trustee-to-trustee transfer) so they won't have to worry about the 60-day rule. With a direct rollover, the funds in the traditional IRA are transferred directly to the Roth IRA.

Why should taxpayers do a Roth IRA conversion before the end of 2006? To be sure, taxpayers who qualify can convert any time they want. In order to qualify for conversion of traditional IRA funds to a Roth IRA, a taxpayer's Modified Adjusted Gross Income (referred to by the IRS as "MAGI") cannot exceed \$100,000 and the taxpayer cannot file as married, filing-separate. Of course, come 2010, the tax law will change such that everyone will qualify for a Roth IRA conversion.

There are many reasons why a taxpayer might convert in 2006. For instance, taxpayers who expect their income to be below \$100,000 this year but not in future years should consider a 2006 Roth IRA conversion. Slott also notes that taxpayers who may be in a lower tax bracket this year than they expect to be in the future will pay less tax on a conversion if it is done this year. Just to be on the safe side, those who have already done a Roth IRA conversion this year should double-check to make sure the conversion funds actually were deposited into the Roth IRA.

Taxpayers who qualify for MAGI and who are under age 59½ have another reason why they may want to convert this year. Conversion starts what the IRS calls the five-year clock. Funds put in a Roth IRA, even in December 2006, are viewed as being deposited on January 1 of 2006 for purposes of the so-called five-year requirement. According to "Ultimate IRA Resource" by William Wagner, amounts distributed from a Roth IRA are generally received tax-free if the distribution is made more than five years after the creation of the Roth IRA and the distribution occurs after the individual turns age 59½. Other qualifying circumstances include the owner's death or disability, or if the distribution is for a first-time home purchase. Distributions that don't meet the requirements are, according to Wagner, generally subject to an early distribution penalty tax and includable in income, unless an exception applies.

By converting now, taxpayers under age 59½ can start the five-year clock running and increase the odds of being able to make a penalty-free withdrawal from their Roth IRA. Slott suggests that having tax- and penalty-free access to a Roth IRA is a much better alternative than having

to start a 72(t) payment schedule in order to get penalty free funds from an IRA before reaching age 59½.

For example, funds converted to a Roth IRA in December 2006 are deemed converted as of January 1, 2006 and that starts the 5-year clock. Thus the five-year period will end on December 31, 2010.

To be sure, there are some taxpayers who don't know if they will be eligible to convert or they may not even be sure if they want to convert. Slott suggests that taxpayers have nothing to lose and everything to gain by converting before year end. This is because a Roth IRA conversion is one of the rare "second chances" taxpayers receive under the tax code. Roth conversions can be reversed or "recharacterized" up to October 15 of the year after the conversion for any reason. Thus, a 2006 Roth conversion can be recharacterized at any time up to October 15, 2007.

Typically, Roth IRA conversions are recharacterized when a taxpayer converts from a traditional IRA and the value of the Roth IRA investment declines. According to Slott, taxpayers who want or need to recharacterize their Roth IRA conversion should deposit this year's converted funds to a new Roth IRA (separate from any other Roth accounts they may have) until the time to recharacterize has expired. Thus, if the investments decline in value, the taxpayer can recharacterize just those investments and not have to take any other Roth IRA funds into account. Funds that commingled with an existing Roth IRA can complicate the recharacterization.

Slott also recommends setting up separate Roth IRA accounts that would contain similar types of investments. Thus, there would be a separate Roth IRA for large-cap value stocks and one for large-cap growth stocks and one for technology stocks and so on. That way, the taxpayers can "cherry-pick" which Roth IRAs to recharacterize. The taxpayer would recharacterize the Roth IRAs that have declined in value and hold the Roth IRAs that have gained in value. After the time to recharacterize expires (October 15 of the next year), Slott notes that the taxpayer can go back and consolidate all of the Roth IRA funds remaining for that year in one Roth account.