Taxation Tidbits

Depressed Stock Prices – Converting a Traditional IRA to a Roth IRA

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The stock market has lost a lot of luster. A popular adage is "If life hands you lemons, make lemonade." Many people have a traditional Individual Retirement Arrangement (IRA). One thing is fairly certain – when you take money out of your traditional IRA or other tax-deductible retirement account – you'll owe ordinary income tax on the withdrawal. On the other hand, a major advantage of a Roth IRA is withdrawals are not subject to income tax. Now may be an opportune time to convert (rollover) a traditional retirement account that is invested in the stock market to a Roth IRA. This transfer will allow the future gain in value of the account to accumulate and to be distributed tax-free.

For example, if your traditional IRA has decreased in value, let's say from $180,000 to $130,000 -- you've suffered a $50,000 paper loss. If you convert this traditional IRA to a Roth IRA and it later recovers to $180,000 – that $50,000 gain in value will be available to you tax-free. If you don't make the conversion to the Roth IRA and the value recovers back to the $180,000 – you'll pay tax on the $50,000 value increase when you withdraw those funds.

For 2008 and 2009, you can convert amounts from a traditional IRA to a Roth IRA if your modified adjusted gross income is not more than $100,000 and you are not a married individual filing a separate return. Modified adjusted gross income is basically your adjusted gross income, not including the income from the conversion and not including any deductions for traditional IRA contributions. Conversions can be completed in one year or spread over a number of years to avoid being forced into a higher tax bracket. For taxpayers with AGIs above the $100,000 limit – this limit will be eliminated starting in 2010.

Factors that tend to favor conversion are:

1. The younger you are
2. The lower your current tax bracket to your future anticipated tax bracket
3. The less likely you are to need the funds during retirement
4. The desire to pass the funds on to your heirs
5. You have separate funds to pay the tax on the conversion

Again the take-home message is distributions from a traditional IRA or tax-deductible retirement accounts are taxable in the year of distribution. Thus, when you believe the stock market has bottomed, consideration should be given to converting these traditional retirement accounts to a Roth IRA and paying the income tax on the converted amount. Later distributions from the Roth IRA which would include any capital growth and accumulated earnings of the Roth IRA can be distributed without any additional income tax liability.

The chart on the reverse side is an IRS chart that provides information on the ability to rollover one type of retirement account to another. For more detailed information on converting your IRA get the free IRS Publication 590 "Individual Retirement Arrangements" by calling the IRS toll free number 1-800 TAX FORM.