

Congress has designated calendar 2010 as a one-time window of opportunity for people who have regular IRA accounts to convert all or a part of them into Roth IRAs. Before going further, it bears emphasizing: this is not an all-or-none decision; you may convert any part of your regular IRA to Roth under the new rules, in 2010, just as in other years under the old rules.

The two special 2010 rules (1) allow people regardless of Adjusted Gross Income to make a conversion, and (2) allow a choice of whether to declare the income and pay the resulting tax with their 2010 federal tax returns, OR to add half the income onto their 2011 returns and the second half onto their 2012 returns and pay the resulting taxes then. That decision may be largely driven by your forecast of your income and resulting marginal tax brackets for the three years.

While the mechanics of an IRA-to-Roth conversion are easy and will happily be handled by your account custodian, the decision about whether to act on the special 2010 opportunity can be a bit involved. This article focuses on that issue. Consultation with appropriate experts is recommended. But you can figure out the general parameters for yourself in a first-cut approach.

Why convert? All future increase in value of a Roth IRA account is free of federal tax. And Roths are not subject to annual minimum required distributions (MRDs) once the owner reaches age 70.5 years old. While this is great, the piper will not go unpaid. When you convert, the value less your proportional undeducted contributions is subject to regular-rate taxes. (And that formula must be applied across all separate IRA accounts you have on a combined basis, not allowing you to cherry-pick the least appreciated.) The gain is added to your federal income tax return. And you pay tax accordingly. This has implications that differ among people and also involves some overall future uncertainty. It would be ideal to convert (again, all or part!) in a year when your income will be lower than in the future, since your tax bracket will be lower. The uncertainty, of course, is more than merely personal: what will the current and future Congresses do to tax rates? Most people are betting that rates are unlikely to fall. But we cannot know for sure.

One point is for certain: if your IRAs show a loss against their undeducted basis, converting to Roth costs zero tax and should be done without question -- unless you have less than five years left before drawing down assets.

One general rule of thumb is that the younger you are, the better it is to convert -- since you are buying more years of tax-free future gains. Many registered investment advisors think you should have at least 7-10 years before you plan to withdraw assets in order to make converting and paying

tax now a good deal. Our view is that, assuming equal tax brackets/rates in the future, a shorter timeline is OK. Suppose you pay 25% tax (plus maybe 5% at the state level) to convert. If you earn an average rate of 7.5% on the converted assets annually, you break even in just four years (without allowing for compounded interest on the tax paid, for the purists). If rates generally or yours personally should rise, the value of an earlier conversion becomes more compelling and the breakeven or payback period gets shorter.

Converting assets when the market is low is also great timing. Would that we all knew then that the second week of 2009 marked a meaningful bottom, and had converted then. Lower amounts converted mean smaller taxes due.

We now must add one (favorable) further aspect to consider. You can "re-characterize" (IRS lingo for "undo") a conversion until October 15 of the year in which it is made. Thus your decision is reversible. So if the market goes down, you could undo an early-2010 conversion and then re-do it when the market is lower. And there is also a convenient way to improve that benefit. You cannot cherry-pick specific converted assets if they are all in the same Roth. But you can set up several parallel Roths for different asset classes, segregating stocks from bonds from commodity-oriented ETFs/stocks etc. That way, if one asset class falls in value by October 15, you can recharacterize only that specific Roth and then re-convert and pay lower taxes. If you deal with a discount broker and/or no-load fund family (which we highly favor), there should be no added fees for having multiple accounts. At worst, you can merge all the Roths after October 15 and avoid any multiple fees thereafter.

One point that all commentators agree on is this: it is highly desirable to pay the conversion-driven tax out of personal funds rather than withdraw IRA assets to pay it. Why? The withdrawal itself drives tax on its value, and the withdrawn money is then absent and so unable to grow taxfree for the rest of your life. One possible strategy to consider might be to sell stocks or funds in which you have losses in your personal taxable account (creating a tax benefit on up to \$3,000/year), which would help offset the tax due for the conversion.

Two other complications are worth mention: adding reportable income via a conversion can affect other tax items: taxability of Social Security benefits; the income-based premiums you pay for Medicare Part B; the 7.5%-of-AGI exclusion for medical deductible costs; and in higher brackets the phase-out of some deductions. In addition, for taxpayers otherwise in a 15% or lower bracket, the extra "income" reported due to the conversion might bump your

taxable income above the important threshold at which capital gains get preferred-rate treatment and qualified dividends are taxed at 0% again in 2010. So it would be very wise to do a mocked-up 2010 return in advance and see what happens given various amounts of conversions. For many people, this means consulting with a tax advisor. But remember that a conversion is not irreversible because you can undo it on or before October 15, 2010. So the risk of taking action is not a carved-in-stone risk.

A past Congress has given us an opportunity to consider. It is in each person's interest to run the numbers and decide. Whether the window will be extended beyond 2010 is between questionable and doubtful. And again, it is not an all-dollars-or-none choice! Happy computing.