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The New York Times

Retirement

THURSDAY, OCTOBER 15, 2009

Deciding Whether a Roth Is Right

By DEBORAH L. JACOBS

STARTING in 2010, anyone can convert a traditional Individual Retirement Account to a Roth I.R.A. That's great news for people who previously were shut out of a Roth because their adjusted gross income was more than $100,000.

Especially if you want to leave retirement assets to family or friends, a Roth conversion is one of the simplest, best planning tools available. You avoid the requirement to take yearly minimum distributions starting at age 70½, and that can leave more for beneficiaries if you don't use the money yourself. And subject to certain restrictions, no tax is assessed when the money is withdrawn, so income can compound tax-free.

But this technique has a hefty price tag. You owe income tax on the amount you convert, which can be the entire account balance or part of it. And some people worry about what might happen years from now if Congress eliminates the Roth.

One possibility is that those who have already converted will have their gains untaxed, said Christopher R. Hoyt, a professor at University of Missouri-Kansas City School of Law. Another is that only the investment earnings — not the amount converted — will then be taxable.

For now, many lawyers and financial advisers have put that thought aside and are strongly recommending Roth conversions to clients who can afford to pay the income tax. Yet this advice can be hard medicine to take, for it goes against the conventional wisdom that one shouldn't pay a penny of tax sooner than necessary, and the idea of writing large checks to the Internal Revenue Service for an uncertain future benefit makes many clients queasy.

The strategy also requires substantial paperwork and monitoring to avoid pitfalls and get the best results. Here are some guidelines that I.R.A. experts have devised to get clients over the obstacles:

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BE PRUDENT *Natalie B. Choate, an estate planning lawyer, advises some to start small with a Roth I.R.A.*

A great planning tool with a hefty price tag and potential pitfalls for the unwary.

HEDGE INVESTMENT BETS Ed Slott, a certified public accountant in Rockville Centre, N.Y., said he planned to convert his entire traditional I.R.A. on Jan. 4 — the first business day of 2010 — to start the tax-free earnings growing. Assuming the assets increase in value after that, the income tax cost of converting will turn out to be a bargain.

But if investments tank, the tax code offers "a money-back guarantee," Mr. Slott said. You can reverse the transaction — a process called recharacterization. You're allowed this do-over any time until Oct. 15 of the year after you do the conversion. So converting early in 2010 gives you almost two full years to decide whether you're pleased with your strategy.

SET UP MULTIPLE ROTH I.R.A.'S For each I.R.A. or asset class that you convert, open a separate account, said Barry C. Picker, an accountant and financial planner with Picker, Weinberg & Auerbach in Brooklyn. This makes it easier to monitor performance (for instance, of growth stocks, value funds or bonds) and recharacterize if necessary.

Another approach is to simply convert portions of your I.R.A. at various times throughout the year (say, 20 percent in January and another slice in April), Mr. Picker said. The goal is to compensate for market fluctuations, just as you might by laddering a bond portfolio with different maturities.

You can consolidate accounts one by one as the window to undo each conversion closes.

After you have recharacterized, you are not permitted to do another conversion with the same assets until the next year or 30 days after the first conversion — whichever is longer.

TIME THE TAX For conversions done in 2010, the law gives you a choice of when to pay the tax. One possibility is to count the amount converted as 2010 income and pay a lump sum. The other option is to divide the income equally in the following two years, in which case you must use installments — half with your 2011 income tax return and the remainder with the 2012 one, at the rates in effect for each of those years. You have until you file your 2010 tax return to decide, so if you request an extension you can wait until Oct. 15, 2011, said Michael J. Jones, a lawyer and C.P.A. with Thompson Jones in Monterey, Calif. By then it may be clear whether tax rates are going up. If they are, it might be better to pay the tax in a lump sum before they do.

But whether you request an extension or not, remember that your tax is still due on April 15, 2011, and if you pay it late there is a penalty. In addition, you need to have made quarterly estimated tax payments during 2010 (it's sufficient that they total 110 percent of your tax bill for the previous year). If you have made all these payments for 2010 and decide at the last minute to spread the income over the subsequent two years instead, you can get a refund.

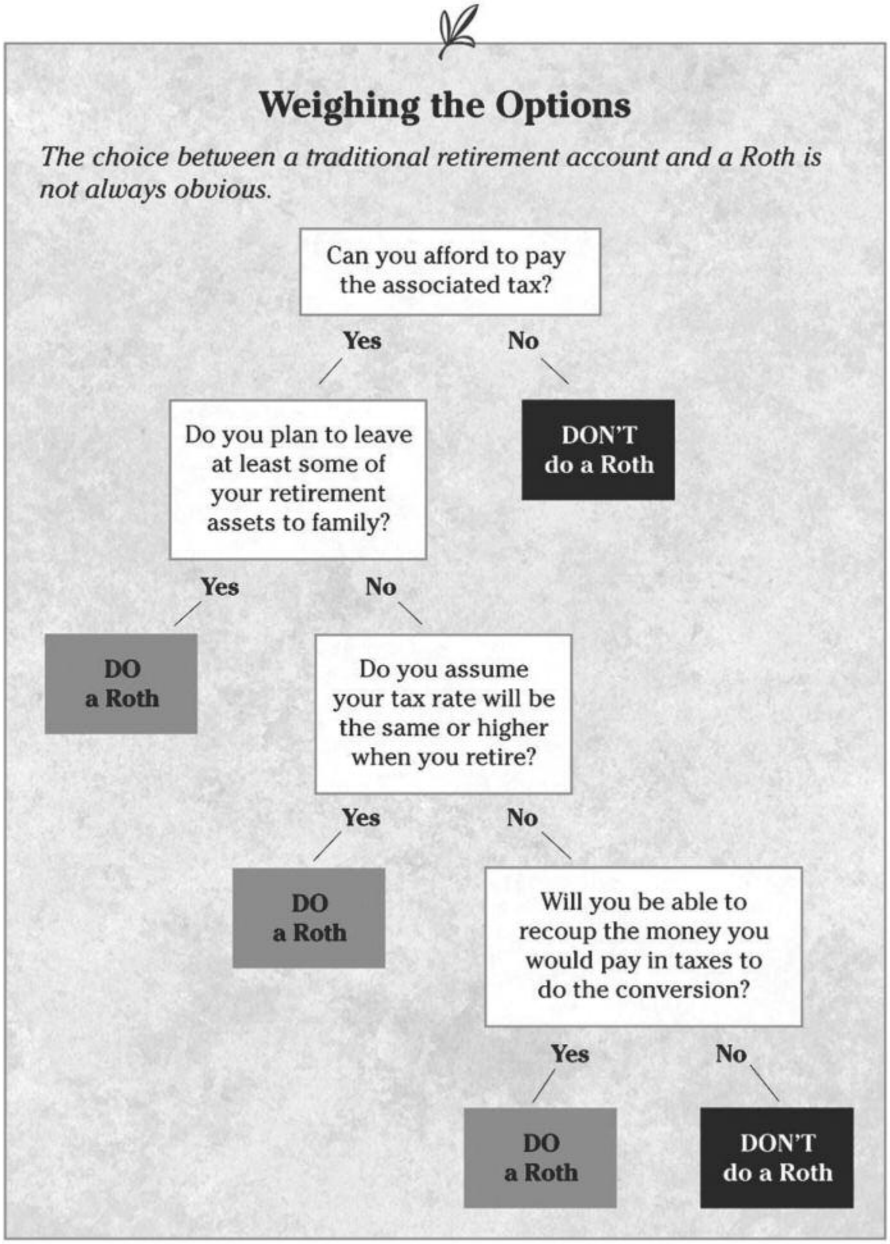
FACTOR IN PERSONAL CIRCUMSTANCES Someone who now lives in a state with an income tax, like New York, but plans to retire to a state without one, like Florida, might want to postpone the tax until the year after moving, said Robert S. Keebler, an accountant with Virchow, Krause & Company in Green Bay, Wis. People who are collecting Social Security — or plan to start in 2011 or 2012 — should ask tax advisers whether extra income from the conversion in a given year would cause Social Security benefits to be taxable.

Remember that if you are older than 70½ and want to do a conversion in 2010, you must take your required minimum distribution first, and this could also affect your tax bracket.

START THE FIVE-YEAR CLOCK If you withdraw investment income from any Roth within five years of setting up your first Roth I.R.A. (either by conversion or through annual contributions), you need to pay income tax on that withdrawal. So even if you're not gung-ho on the idea of a conversion, if you don't already have a Roth, convert a small sum now to start the "marinating period," said Natalie B. Choate, a lawyer with Nutter McClennen & Fish in Boston. That way, if you want to convert more funds later, at least part of the five-year period will have passed.

Note that even once you meet the five-year requirement, you may still have to pay tax on account income plus a 10 percent penalty if you take the money out before you are 59½ (subject to certain exceptions).

DO THE PAPERWORK Money in I.R.A.'s cannot be distributed by a will. Instead, it goes to the people you name on the beneficiary designation forms that you fill out when you open the accounts or later amend. You need a separate form for each account. So you will need to do this paperwork for each Roth I.R.A. that you set up, and repeat the process if you merge the accounts once the recharacterization period is over, Ms. Choate said.



FROM "ESTATE PLANNING SMARTS: A PRACTICAL, USER-FRIENDLY, ACTION-ORIENTED GUIDE," TO BE PUBLISHED IN DECEMBER. COPYRIGHT 2009 DEBORAH L. JACOBS.

COVER EVERY CONTINGENCY What if you die after the conversion but before the time to undo it has expired? Under the federal regulations on I.R.A.'s, the next steps fall to your executor — the individual or institution that takes charge of your estate after you die. You can express your wishes in a codicil or amendment to your will, which must be signed with the same formalities as the will itself.

If the I.R.A. and the rest of your estate are payable to the same person, this precaution probably is not necessary, Ms. Choate said. But it's prudent if, for example, you leave most of your estate to your spouse, and a Roth I.R.A. to your children of a previous marriage. That could create a sticky situation, especially if your executor is your spouse.

If the I.R.A. remains a Roth, your estate will have to pay the income tax on the conversion, and less money will go to your spouse, Ms. Choate said. In contrast, an executor who undoes the conversion puts more money in your spouse's pocket. Your will can let everyone know where the chips should fall.