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Money At Work

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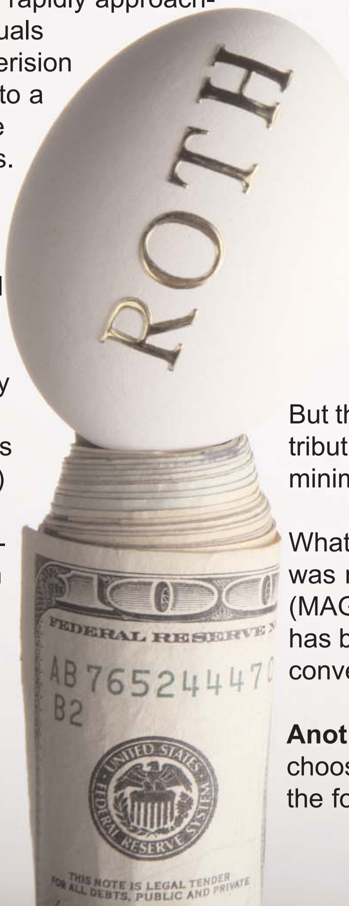
Roth IRA conversions: it's decision time

The end of the year is rapidly approaching. For many individuals contemplating a converision from a traditional IRA to a Roth, it's time to make some critical decisions.



Let's start with a brief comparison. Distributions from a traditional IRA are generally taxed at ordinary income rates, currently reaching as high as 35%. (Future tax rates are scheduled to rise.)

The taxable portion includes earnings within the tax-deferred account and amounts attributable to deductible contribuitons.

In contrast, "qualified distributions" from a Roth IRA are completely tax-free. A qualified distribution is one from a Roth in existence for at least five years that is made after you have reached age 59 1/2; upon death or disability; or to pay for first-time home-buyer expenses (up to a lifetime limit of $10,000).

Other distributions are treated as coming first from Roth IRA contributions, second from amounts transferred to the Roth, and third from earnings.

In effect, a conversion of assets from a traditional IRA to a Roth is treated as a withdrawal for tax purposes. So you are generally required to pay the usual amount of tax when you convert.

But the current tax cost may be worth it in exchange for future tax-free distributions. Furthermore, unlike a traditional IRA, you don't have to take minimum distributions from a Roth after age 70 1/2.

What's been holding some people back? Prior to this year, a conversion was not allowed in a year in which your modified adjusted gross income (MAGI) exceeded $100,000. However, beginning in 2010, this restriction has been removed. Therefore, high-income individuals may be eligible to convert to a Roth for the first time.

Another incentive: For a conversion in 2010 - and 2010 only - you can choose to have the taxable income from the conversion split evenly over the following two years: 2011 and 2012.

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Roth IRA conversions: it's decision time

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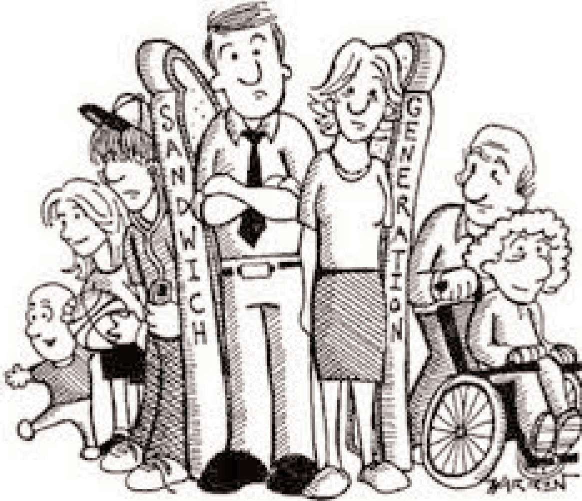
But there are potential drawbacks to a conversion. For instance, if you have to use funds from your IRA to pay the resulting tax, it will likely dilute future benefits. Similarly, you might not choose the two-year tax deferral if you will be in a low tax bracket this year or anticipate being in higher tax brackets in the future. Other key factors to consider include:

- Your age, your spouse's age (if married) and the ages of the beneficiaries
- The value of the assets in your IRA
- The need to receive Roth IRA distributions in the future
- The projected investment rate of return
- Any state and local tax implications
- Whether nondeductible amounts were contributed to the traditional IRAs and, if so, how much

These factors will have a substantial impact on your decision. It requires a careful analysis of your situation. Be wary of online calculators that leave out critical factors.

Finally, note that a conversion is not necessarily an all-or-nothing proposition. If it suits your purposes, you might opt for a partial conversion. In any event, obtain expert professional guidance.

Issues for the "sandwich generation"



Are you part of the "sandwich generation"? That is the name bestowed on individuals who are raising young children and facing the responsibilities of caring for elderly relatives. You will often find yourself stuck in the middle.

In particular, you may have to deal with a number of sensitive matters, including the long-term needs of elderly parents or inlaws. One practical approach is to organize a family "forum" covering critical estate-planning issues. Here are a few points you might discuss in your get-togethers:

Financial documents: Where do the parents keep financial statements, bank account records, mutual fund statements, life insurance policies, etc.? Let them know that this discussion is not being held to invade their privacy, but that they must make provisions to ensure they will receive all the money they are entitled to if they suffer an illness. Write down important names and numbers (and make a copy for the parents to keep).

Tax information: Similarly, you need to have access to the tax information of elderly parents (e.g., past returns, current transactions, required filings, etc.) Review their situation periodically and do not hesitate to consult professional tax advisers. **Note:** Following the death of a parent, complications may arise from "income in respect of a decedent."

Investments: If elderly relatives have been handling their own investments, it may be a good time for the family to sit down with a professional investment adviser. The advisor can help balance their portfolio to achieve all their objectives.

Wills: With a legally enforceable will in place, the parents may be able to ensure that their assets will be distributed according to their wishes. Their wills can be reviewed periodically to reflect changes in their personal circumstances., tax law revisions, etc. For instance, if another grandchild has been born, they will probably want to make sure that he or she receives a fair share of the assets.

Health Care: Talk to elderly parents about their preferences in the event that one or both of them becomes disabled. Some of the possible choices are home health care, a nursing home, a continuing-care retirement community or living with a family member. Even if the parents are still in good health, it will not hurt to investigate some of the possibilities in the locations they prefer. Some parents have prepared "living wills" that eliminate some uncertainty.

These issues may be difficult to talk about, but they should not be ignored. Rely on your professional advisers to help guide you along.

Taking year-end investment action

The end of the year is often the optimal time to examine your investments. This review may enable you to reduce your current tax liability while repositioning your portfolio for the coming year. Here are several year-end investment moves to consider:

Review your portfolio. This may be a good time to adjust the various percentages of different types of investments among your holdings. For instance, if one investment class has declined in value, it could represnt a lower percentage of your portfolio than you intended. Contemplate buying opportunities for that class and/or selling opportunities for other assets. In any event, you might rebalance your portfolio before December 31. ***Caution:*** Asset allocation techniques do not protect against losses in a declining market.

Harvest tax losses. Your capital gains for the year offset capital losses and vice versa. In addition, excess capital losses can offset up to $3,000 of ordinary income in 2010. If you have realized capital gains from securities sales earlier in the year, you might recognize capital losses at year-end to offset those gains. Of course, tax implications should not be the sole reason for transactions, but they are a significant incentive.

Avoid the "wash sale" rule. The wash sale rule prohibits you from claiming a tax loss on the sale of securities if you acquire substantially identical securities within 30 days of the sale. To avoid complications, wait at least 31 days to buy back securities you have sold at a loss. If you believe certain securities are poised to rebound right away, you might acquire more shares first and then wait at least 31 days to sell the original block of shares.

Calculate your tax "basis". Your basis for tax purposes is generally your original acquisition cost plus certain adjustments, such as commissions. Note that you may use an average costs per share for mutual funds or stocks when you own multiple shares. Alternatively, you might identify certain shares as the ones being sold (see box below). Astute planning at year-end may increase a taxable loss or decrease a gain to your benefit.

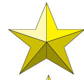
Give gifts of securities to a qualified charitable organization. Charitable gifts at year-end can reduce your current tax liabilitiy. If you give away appreciated securities, you can generally deduct the fair-market value of the securities if you have held them for more than a year. Otherwise, your deduction may be limited to the cost of the securities.

Consult your professional advisers concerning all the ramifications of these investment moves.

New Basis Reporting on Deck

Beginning next year, financial institutions must provide the IRS with your tax "basis" for securities' sales. But these new reporting rules are being phased in over three years. They take effect

for corporate stock shares acquired after 2010

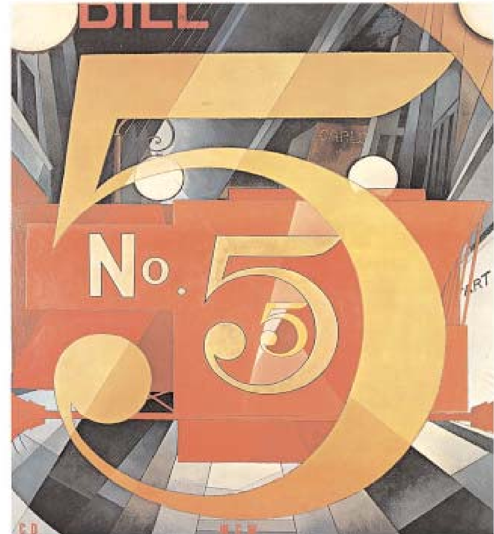
 for stocks in a mutual fund or dividend reinvestment plan acquired after 2011

for other securities acquired after 2012

Caution: Do not discard your tax records just yet. For instance, the records may be needed to establish your basis for stocks and mutual funds acquired before 2011.

Guard against five 401(k) mistakes

The 401(k) plan is the most popular retirement plan in the land. So there's a good chance that you or your spouse, perhaps someone else in your family, is eligible to participate in this type of plan. If that's the case, you may want to avoid five common mistakes that have plagued individuals in the past.



Mistake #1: You sit on the sidelines.

All too often people who are eligible for participation just say "no." But this is an opportunity to salt away money for the future without any current tax erosion. For 2010, the tax law allows you to defer up to $16,500 to your account, plus an extra $5,500 if you're age 50 or older. What's more, your employer may "match" your contribution up to a stated percentage of salary. This matching contribution costs you zero out-of-pocket.

Mistake #2: You do not invest carefully.

As with investments outside your plan, you should avoid too heavy a concentration on one particular offering. Other errors include over-diversification, such as scattering dollars in every possible mutual fund or other investment option. Try to find the proper balance. A logical approach is to allocate assets based on your current age, your expected retirement age, the amount you are contributing each year and your tolerance for risk. Of course, there are no absolute guarantees.

Mistake #3: You "rob" your plan early on.

A 401(k) plan is meant to be a savings vehicle for retirement. However, participants often can't resist taking out distributions, especially if they are changing jobs. As a general rule, a distribution made prior to age 59 1/2 is subject to a 10% penalty tax, in addition to the regular income tax that is owed. **Note:** If you switch jobs and roll over funds from your 401(k) to an IRA or another qualified plan, the rollover is exempt from current income tax if it is completed in a timely fashion.

Mistake #4: You borrow money from your plan.

Along the same lines, you should be discouraged from taking a loan from your 401(k). Even though you will effectively be paying yourself back, it will be more difficult to meet your objectives for retirement. You won't have access to the funds you could have earned if the principal had remained intact. Borrowing may be necessary in an emergency, but it should be viewed as a last resort in most cases.

Mistake #5: You don't seek assistance.

Recent developments may encourage 401(k) participants to obtain advice, within certain parameters. There is no need to do it all on your own. With professional guidance, you can sidestep the common pitfalls outlined above.

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