



Roth IRA Conversions: Right for You?

To convert or not convert: that is the question for investors previously prevented from converting by the \$100,000 income cap.

Beginning in 2010, investors converting assets from a Traditional IRA to a Roth IRA are no longer limited by a \$100,000 modified adjusted gross income cap. (Incidentally, the law in 2010 will allow married individuals who file a separate tax return to convert – a provision not available in the past.) So now that you *can* convert, the new question becomes *should* you convert. The answer depends on a large number of variables, some of which require some educated guesses about the future of the tax system and your own situation. Because of the complexity of these factors, you should discuss your individual situation with your tax and investment professionals before finalizing your decision.

Pay Now or Pay Later

With a Roth IRA, you pay taxes on income now, invest that income and pay no taxes on your contributions or the earnings when you withdraw them. A Traditional IRA works in reverse: you contribute pre-tax dollars or receive a tax deduction now, and pay taxes on your withdrawals when you take them. Your decision to convert depends in part on your expected tax bracket after retirement. If you believe your tax level will be higher in the future than it is today, it may make sense to pay those taxes now with a conversion. If you expect your tax level will be lower in the future, a conversion may not be in your best interest, as you would pay more taxes by converting today than you when you withdraw those assets from a Traditional IRA in the future.

A second consideration will be the impact of the recent market decline on your portfolio value. For example, if your portfolio value was \$100,000 prior to the decline and is today at \$75,000, it may be advantageous to convert now and pay taxes on the lower portfolio value, rather than waiting until later when your portfolio may have increased from market increases or additional contributions.

Source of Contributions

Your Traditional IRA may have been funded with both nondeductible contributions (you already paid taxes on them) and deductible contributions (you have not paid taxes on them or received an equal tax deduction). If you convert nondeductible IRA contributions, you will pay taxes only on the earnings. If you convert deductible contributions, you will owe taxes on the contributions or earnings – resulting in a significant tax hit at the time of conversion. The law allows you to split the income realized in 2010, half into 2011 and half into 2012. Each half of the income is taxed at that year's rates, along with any other income normally realized for those years. You also have the option of making a special election and report the income in 2010, which may be beneficial if the tax rates are higher in 2011 and 2012.

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Bell Canyon Business Center 30 Hackamore Lane, Suite One Bell Canyon, California 91307-1065 USA
Telephone: 818-999-OPIS (6747) • Facsimile: 818-227-2939 • Email: info@opis.com

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If your Traditional IRA contains both deductible and nondeductible contributions, you will pay taxes based on the percentage mix. For example, if your Traditional IRA contains 40 percent deductible contributions and 60 percent nondeductible, you will pay taxes on 40 percent of the contribution amount you convert. You cannot cherry pick only the nondeductible assets for conversion.

Splitting the Difference

You can make a partial conversion of your Traditional IRA to a Roth IRA. For example, if your nondeductible and deductible contributions have been segregated into separate Traditional IRA accounts, you can choose to convert only the accounts holding nondeductible contributions. Partial conversion may also help you diversify your accounts for tax purposes, particularly if your future tax bracket is unclear. In addition, partial contributions may impact the basis for accounts that are not converted. Again, counsel from your tax and investment professionals is advised.

Paying the Piper

If paying the tax bill on your deductible contributions will require you to take a withdrawal from the account, a conversion may not be in your best interest, especially if you are under age 59½ and subject to the 10 percent early withdrawal penalty. In addition, you will be reducing the amount that can grow tax-free in the Roth IRA.

Because the conversion will be considered a taxable event (i.e., results in you paying taxes at this time), it can impact your income level, moving you into a higher tax bracket or making you subject to the Alternative Minimum Tax. Work closely with your tax professional to ensure your future planning doesn't create unexpected negative consequences in the present.

If circumstances change or there is a mistake in the your assumptions, you may be able to reverse the Roth conversion in a process known as recharacterization, which treats the Roth conversion as if it had never been made. Because of this process, owners of traditional IRAs who make a mistake in a Roth conversion in 2010 may incur less risk in the conversion process. The deadline for recharacterizing a contribution or conversion is the *extended due date* of your tax return for the year of contribution or conversion. This would normally be April 15 following the year of contribution or conversion, or Oct. 15 of this subsequent year if you have filed for and obtained an extension. As noted above, you can file your return on April 15 if you are ready and still take advantage of the six-month additional period to make the recharacterization, but you must be prepared to execute the transfer and file an amended return by Oct. 15.

If eligible, you may want to consider deductible contributions to a Traditional IRA in 2009, which you can make up until April 15, 2010. This may reduce your current taxes and, following a 2010 conversion, you won't pay back the tax savings until 2011 and 2012.

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If you are not eligible for deductible contributions, consider contributions of up to \$5,000 (\$6,000 if you are over 50 years old) to nondeductible IRAs. You can convert these amounts in 2010 to a Roth and pay tax (again in 2011 and 2012) only on any earnings rolled over.

Legacy Planning

Roth IRAs can be particularly advantageous if you expect *not* to tap them in retirement. Because the Internal Revenue Service won't delay its cut forever, you are forced to take distributions from your Traditional IRA starting at age 70½ and you can not make contributions past that age. With a Roth IRA, there is no required minimum distribution age and you can continue making contributions regardless of your age, provided you meet the income requirements for making Roth IRA contributions. This allows your Roth IRA account to continue growing, tax free, until your death. At that time, your heirs will not owe income tax on the assets in the account. Your spouse is not required to take distributions either, but required minimum distribution rules do apply for other heirs.

Your Age

The younger you are, the harder it is to predict tax rates and other factors that may impact your retirement. On the other hand, younger investors typically have longer to allow their Roth IRA assets to compound tax-free. A Roth IRA conversion may not be appropriate if you are near retirement and expect to need the assets in your IRA soon after you retire, as you will have less time for the assets to earn an amount comparable to your tax hit at conversion.

Distributions

For Traditional IRAs, any distributions you take prior to age 59½ are subject to income tax as well as a 10 percent penalty, with some exceptions for disability and higher education expenses. Roth IRA distributions prior to age 59½ are also subject to a 10 percent penalty, but of course not to the regular income tax, and cannot be taken within five years of establishing the Roth IRA. Exceptions to the Roth IRA penalty include disability and distributions for a first-time home purchase that meet IRS requirements.

Your decision to convert or not convert will depend on the many factors of your individual situation today and your beliefs about your situation in the future. Careful analysis should be undertaken before making a conversion from a Traditional IRA to a Roth IRA. Your tax and investment professionals can provide important guidance and analysis. You should feel free to ask these professionals to work together to help you determine if a Roth IRA conversion is in your best interest.

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