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It Was a Good Idea at the Time!

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You've been looking at your IRA situation and are feeling tempted to convert to a Roth IRA from your traditional IRA. It's the advantages that lure you, like the fact that any amount of money withdrawn from a Roth would be tax free. (This is because any money originally contributed has already been taxed.) With your traditional IRA, however, you contributed money before it was taxed. So, up to certain limits, your contribution is not included in your income and not taxed as ordinary income. This is why when you start withdrawing money from a traditional IRA, ordinary income taxes will be paid on all withdraws. But for a Roth, as long as you own it for 5 years ***and*** you are at least 59 ½ years old, all money withdrawn will be tax free, and you are not subject to required minimum distributions (RMD). These are the benefits of a Roth IRA—tax free withdraws and no RMDs. In contrast, with a traditional IRA, withdraws must begin by April 1st the year after you turn 70 ½ years old. The reason for this, of course, is that Uncle Sam finally wants his share, since the entire account has been tax deferred for all those years. Also, if you fail to take your RMD, or didn't take enough, you could be taxed 50% on the shortfall. But for a Roth IRA, you have already paid taxes on the amount contributed, so Uncle Sam has already been paid; therefore, there are no RMDs for a Roth IRA (unless it's inherited). The main disadvantage, of course, is that you have to pay ordinary income taxes on the amount you convert. Therefore, it is recommended that you do not use money from your traditional IRA to pay taxes on the conversion. Assuming you are younger than 59 ½ years old, you might be required to pay taxes and a 10% penalty for early withdraws on any amount not converted; plus that money is ineligible for tax-free growth.

With this in mind, let's say you are 45 years old, have money in a taxable account to cover the taxes, and you like the advantages of a Roth IRA. You decide, then, to convert your traditional IRA to a Roth IRA. On October 30, 2007 your account was worth $100,000; so you calculate that it will average approximately 8% for the next 20 years. However, when you file your income tax return on April 15, 2008, you have to pay $22,000 in taxes on the conversion. Ouch! But rest assured, it will be well worth the conversion, and the taxes, when you turn 65 years old and begin withdrawing money tax free.

Now let's say something happened between last October and the present that you didn't see coming. You had invested heavily in financial stocks, insurance stocks, and commodities and your $100,000 account is worth a mere $35,000. Based on this new value, the taxes you just paid were at an effective tax rate of 63% ($22,000/$35,000), another very unwelcomed reality. Now you are really pulling your hair out. You have lost $65,000 in your portfolio and paid $22,000 in taxes, for a total loss of $87,000, and asking yourself why you did this in the first place. Well, take a deep breath. There is a way out. You can actually do a conversion of your converted Roth IRA back to a traditional IRA. In tax lingo, it's called *recharacterization.* Switching your Roth IRA back to a traditional IRA could get you back the $22,000 you paid in taxes. The money you lost on your investments is gone--unless they eventually rise in value again--but at least you recoup your tax money. But be proactive. If you converted your Roth IRA in 2007 and filed your tax return by April 15of this year, there's not much time to do a recharacterization. You only have until October 15, 2008. You will need to do an amended tax return (Form 1040x) and report the recharacterization on Form 8606. However, if you converted your traditional IRA in 2008 and haven't yet filed your tax return, you still have plenty of time to recharacterize (October 15, 2009). But speak to your financial advisor before you do this. There are some things about this you need to know.