Move a traditional IRA into a tax-free Roth IRA

By Kathleen Crawford, EA

The recent economic climate has left everyone on edge. The decrease in value of retirement accounts is unhappy news to most people. Life seems to be passing out lemons for everybody. However, there are ways to make lemonade in these times. There are strategies to make the most of even this situation. This column does not give financial advice or even direct tax advice. Everyone's situation is different. Also, just like the caution in the old Timex watch commercials: "we are professionals, do not try this at home"; you should consider carefully the consequences of any investment action you take and seek professional advice. Now that you have all of the cautions and disclaimers, let's discuss one strategy to make lemonade from your retirement lemons.

The strategy is to move gain from the traditional IRA into a tax-free Roth IRA. For this strategy, one needs to have a traditional IRA account and a Roth IRA account. The best of worlds has the two accounts at the same firm and the firm allowing direct transfer of securities, rather than only transferring cash. For this example, 100 shares of Apple, Inc. stock (AAPL) will be used because I follow it, having a relative who works for Apple, Inc.

In my traditional IRA, I bought 100 shares of AAPL on 6/29/07 for $12200. On 1/13/09, I noticed that the value had decreased to $8700. Darn, but wait... Being a smart tax person, I called my IRA trustee and asked them to move the 100 shares of AAPL to my Roth account as a conversion distribution. Now, as of 6/10/09 my 100 shares are worth $14200.

What happened with this move? First, I had put $12200 of my retirement funds in this stock. It went down to $8700. Though I had lost value, I did not panic because I believed it would recover. I moved the shares to a Roth IRA. A conversion of this sort requires that the income taxes on the distribution of $8700 be paid, in addition to my other 2009 income. There is no penalty because this conversion is allowed even for people younger than 59 1/2. The downside is that a conversion like this cannot be touched for 5 years without penalty, regardless of your age. There are several other considerations, but they are too detailed for this short article. Finally, now that the stock is safely tucked into the Roth IRA, it has recovered quickly and my $8700 of taxed retirement money is worth $14200 with no additional taxes due on the gain...ever. Also remember, that the $14200 is paper value and is not real until I sell it.

Look at this strategy again; I took an income tax deduction of $12200 with the original contribution to the traditional IRA. Because of the value lost, I paid tax on $8700, which was the value on the date of the conversion distribution. Now, with the recovery, I have $14200 in my Roth IRA retirement account, which will be tax-free when I take my regular qualified distributions.

If this did not make sense to you then please remember the Timex caution: “we are professionals, do not try this at home". Consult with your financial advisors for help. If this did make sense to you, then you will also know that I chose wisely. Had my stock been Enron, AIG, Washington Mutual or any of the many other stocks that will never recover, my strategy would not work. The point is not to panic, but to use even this situation to manage your financial future. No one should just sit back and hope for the best.

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