

ROTH IRA CONVERSIONS

At the beginning of this year, the \$100,000 modified adjusted gross income (MAGI) limit was dropped for converting traditional IRAs to Roth IRAs. A primary benefit of the Roth is that since it is funded with after-tax money, it can grow tax-free like traditional IRAs and future discretionary withdrawals are also tax-free. This has created the opportunity to assess if a full or partial conversion makes sense for you.

If your traditional IRA has dropped in value and you expect to be subject to higher federal income tax rates in future years, now is a good time to evaluate converting all or part of your traditional IRA into a Roth IRA. Here's why. If you convert, it will trigger a current tax hit on the amount you convert. But with your traditional IRA balance at a potentially lower value due to the recent market decline (and possibly your overall income too), the tax hit will be less. After the conversion, your new Roth IRA balance can grow free of federal and state income taxes. Eventually you can take tax-free withdrawals after age 59½, with no required minimum distributions at age 70½, when your marginal tax rate may be higher (perhaps much higher) than it is right now.

Roth Conversion Basics

Prior to 2010, a \$100,000 MAGI limit prevented conversions. For 2010, the \$100,000 restriction has been eliminated, which will allow all individuals to take advantage of the Roth conversion strategy no matter how high their income.

A Roth conversion is treated as a taxable distribution from your traditional IRA because you are deemed to have received a taxable payout from your traditional IRA, with the money then going into the new Roth account. So, a conversion will generally trigger a current federal income tax bill (and maybe a state income tax bill, too). But the following positive factors may outweigh the current tax hit:

- ◆ The conversion tax hit today may be reduced if the value of your traditional IRA is not back to its peak market value.
- ◆ While 2010 is the actual year that you will be able to convert, the income may be deferred until 2011 and 2012. Expecting a vast majority of converters to take advantage of this, the IRS has set up a special provision on how the tax will be paid. The IRS is granting the option to claim the conversion amount ratably over tax years 2011 and 2012. Keep in mind this is only for 2010 Roth IRA conversions. Also keep in mind, if you elect to pay the tax over the two year period, the tax rate is determined for that year only. For example, in 2011 you will pay the tax based on your tax bracket just for that year. If your income were to increase significantly in 2012, then you will be paying more in taxes that year for the conversion. Therefore, when planning the conversion, remember that a conversion to a Roth IRA could bump you up into a higher tax bracket since the conversion amount is taxable. In these cases, a partial conversion may be a better option.
- ◆ Today's tax rates might be the lowest you'll see for the rest of your life. If so, converting would allow you to completely avoid any higher future federal income tax rates on the entire post-conversion increase in the value of your Roth account.

You Can Reverse an Ill-Advised Roth Conversion

Another positive aspect about the Roth conversion strategy is you can change your mind well after the fact. Believe it or not, you have until October 15 of the year following the conversion year to recharacterize (unwind) your converted account (or accounts). For example, say you convert two traditional IRAs into Roth accounts in early 2010. Later the next year, the values of the converted accounts drop due to market conditions. In this scenario, you would pay 2010 income tax on value that later disappeared. Bad idea! Thankfully, however, you have until October 15, 2011 to recharacterize the two converted accounts back to traditional IRA status. It's as if the ill-advised conversions never happened. Therefore, you would not owe any 2010 income tax on the unwound conversions.

Other Benefits of a Roth IRA

- ◆ There are no RMDs (required minimum distributions) from Roth IRAs starting at age 70½, unlike traditional IRAs. Thus, retirees have complete flexibility to manage their cash flows, and in some cases, taxes. If RMDs are sizeable, these forced IRA distributions can potentially bump an individual up into the next marginal tax bracket.
- ◆ Contributions to a Roth IRA can be made after the participant reaches age 70½. Therefore, a Roth IRA can allow a worker extending his/her career to continue to build tax-favored retirement savings.
- ◆ For taxable estates, Roth IRAs can be more attractive vehicles than traditional IRAs for heirs. While future estate tax laws are being debated, Roth IRA assets generally are included in an estate under current post-2010 estate tax rules. However, heirs may not owe income taxes on withdrawals from the inherited Roth IRA account.

Precautions

- ◆ If Congress changes tax rules in the future, Roth IRAs may lose some of their tax benefits.
- ◆ An amount distributed from a traditional IRA to meet RMD rules does not qualify for conversion into a Roth IRA.
- ◆ One important question to answer is “How to pay for the taxes?” In order to not deplete the retirement account, it is generally advisable to pay the tax with money outside of your IRA.
- ◆ If you are currently not paying income taxes on 85% of your social security benefits due to your income level, keep in mind that the conversion would increase your taxable income and potentially cause a higher percentage of your social security benefits to be taxable in the conversion years.
- ◆ Contributions to Roth IRAs phase out when the participant reaches certain adjusted gross income levels.
- ◆ If you convert a Roth IRA under 59½, the account must be open 5 years before withdrawals can be made or you face withdrawal penalties. Regardless of when you convert a Roth IRA, once you reach the age of 59½, you may make penalty-free withdrawals. Each Roth IRA that is opened has its own 5 year time frame.
- ◆ Medicare Part B participants need to be aware of potentially higher premiums from a Roth Conversion. Premiums for Part B are tied to income and converting a Roth IRA would increase the income over a certain time period.

Conclusion

If you believe that you have low current tax cost for converting, plus the chance to avoid higher future tax rates on income and gains that will accumulate in your Roth account as the economy recovers, then evaluating a Roth conversion would be prudent. As always, you should consult your tax advisor regarding the tax implications of a Roth IRA conversion.

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