

Converting to Roth IRAs: What We Know and What We Don't

by Charles E. Falk, January 2010

2010 must be here. I am getting lots of inquiries about converting traditional IRAs to Roth IRAs. The more questions that people ask the more it is apparent that the decision to convert is really a crap shoot. At the heart of the decision are the assumptions that are made on what the future holds. If your crystal ball is cloudy the decision is difficult.

What We Know: Sometimes it is good to recount what we know about converting traditional IRAs to Roth IRAs. Here is what we know:

- Distributions from traditional IRAs are taxed at ordinary income tax rates to the extent that those distributions represent pre-tax income. Most IRAs have substantial pre-tax income that has arisen from contributions, rollovers from qualified pension and profit sharing plans and earnings on those amounts. Distributions from Roth IRAs are income tax free so long as the distribution was made after the 5 year period beginning with the 1st taxable year in which the taxpayer or his spouse made a contribution to the Roth IRA. Roth IRAs are not subject to the minimum distribution rules.
- Converting a traditional IRA to a Roth IRA requires the recognition of the non-taxed amount of the distribution in gross income.
- Beginning on January 1, 2010, any traditional IRA can be converted to a Roth IRA without regard to the \$100,000 adjusted gross income limitation that existed before 2010 or without regard to whether the person seeking to convert the traditional IRA is married and filing a separate return. Under the \$100,000 limitation, a Taxpayer could not convert a traditional IRA if the taxpayer's adjusted gross income for the year exceeded \$100,000. The elimination of the \$100,000 limitation is important because (i) the \$100,000 limitation was never indexed for inflation, so it has become more restrictive over time, (2) it didn't distinguish between single and joint filers, thereby creating a "marriage tax penalty."
- An amount must be "distributable" from the traditional IRA in order to be rolled over. In-service distributions are generally prohibited from qualified retirement plans. However, to the extent that an amount from an old 401(k) or other qualified plan is "distributable" such amounts can be converted to a Roth IRA.
- Unless the taxpayer elects otherwise, the income resulting from a conversion in 2010 is included 50% in 2011 and 50% in 2012 (this "spread" is only available for conversions made in 2010). If the taxpayer makes an election, the income is included in 2010. The amount included in a taxpayer's gross income is the amount converted less any tax basis that the taxpayer has (after tax income) that is considered part of the distribution.
- A taxpayer must plan where the payment of any tax resulting from the conversion of the traditional IRA is going to come from. Will the taxpayer have to sell other assets, etc.? Does the taxpayer plan to use some of the proceeds of the traditional IRA to pay the taxes? If the sale of other assets is contemplated, the capital gains resulting from the sale may be offset by capital loss carryforwards that the taxpayer has. Also weighing on this decision is the implicit cost of having to sell other assets and foregoing the growth of those assets. If the taxpayer plans to pay the taxes from the proceeds of the traditional IRA (not rolling over this amount), those amounts are taxable and, if the taxpayer has not attained the age of 59.5 years, those amounts are subject to the additional 10% penalty on early distributions.

- While it is not required that all IRAs that a taxpayer has be rolled over to a Roth IRA, and in fact a taxpayer may choose to rollover only part of a traditional IRA, if the account holder of the traditional IRA has other IRAs that have nondeductible contributions, those other IRAs must be aggregated in determining how much of the converted account is not subject to income tax. Distributions from the account(s) that are converted apply the exclusion ratio.

Example: Assume that the taxpayer has an IRA funded with deductible contributions that is now worth \$70,000 and a separate IRA funded with nondeductible contributions of \$20,000 that is worth \$30,000. The total IRA value, therefore, is \$100,000 and the nondeductible ratio is 20 percent ($\$20,000 \div \$100,000$). If the taxpayer converts \$10,000 from the IRA with nondeductible contributions, this ratio will be applied to this distribution and \$2,000 ($\$10,000 \times 20\%$) of the distribution will be tax-free.

- A conversion in 2010 can be undone by the due date, including extensions, for the 2010 return. This means April 15, 2011 or later.
- An increase in gross income due to a conversion can potentially affect other inclusions and deductions such as how much social security is taxed, the floor on medical deductions and the amount allowed as itemized deductions. Further, state income taxes may significantly increase due to the conversion.
- The converted funds are generally locked up for 5 years before distributions are permitted, so liquidity needs should be taken into consideration when deciding whether or not to convert to a Roth IRA.

What we Don't Know: The most difficult aspect of any conversion decision is what the future holds. There are four distinct financial variables that must be considered:

1. What is the Before Tax Return on Savings during the accumulation phase;
2. What is the Before Tax Return on Savings during the distribution phase;
3. The Taxpayer's income tax bracket during the accumulation phase;
4. The Taxpayer's income tax bracket during the distribution phase.

When evaluating whether to convert, a taxpayer must be a soothsayer when it comes to future tax brackets, expected rates of return and the purchasing power of the dollar. The following examples give some guidance.

Example: Taxpayer A is thinking of converting a traditional IRA to a Roth IRA in 2010. He has a \$500,000 IRA balance made up of entirely deductible contributions. He is 55 years old, expects to begin to take distributions when he is 70 years of age for a period of 15 years. His current tax bracket is 35% and his current rate of growth and his expected rate of growth is 5%. He expects to be in the 30% tax bracket during the distribution phase and expects the rate of growth to be 5%. He will pay the taxes on the conversion from private funds. Should he convert? Surprisingly, if A converts his traditional IRA, his monthly after tax distribution will be \$8,345 while if he does not convert, the monthly after tax distribution is \$8,341. Thus, not much of a difference.

Example: By tweaking the above example the results are much different. If you assume that the rate of growth during the accumulation phase to be 10% and the tax brackets during the accumulation and distribution phase to be the same, 35%, the traditional IRA if not converted will generate a monthly income of \$18,863 while the Roth IRA will generate a monthly income of \$22,883. Thus, a much more significant difference.

Another factor that must be carefully weighed is whether the law regarding the tax free aspect of Roth distributions will change. Given the projected budget deficits, Congress could make distributions from Roth IRAs taxable or partially taxable. One only has to look to the taxation of social security benefits as an example of how the law can change.

The conclusion is clear, converting must be carefully weighed. However, if you convert during 2010, you have until you file your 2010 tax return in 2011 to change your mind.

Caution: The above is for discussion purposes only. All taxpayers have different considerations. No action should be taken without the advice and guidance of a competent professional advisor.