Steven M. Ellard, CPA
Guiding clients toward financial success.

Roth IRA
conversions

For many individuals, a Roth IRA is preferable to a traditional IRA. A look at the basic rules explains why.

The basics

Traditional IRA

With a traditional IRA, contributions may be wholly or partially tax-deductible. (If you or your spouse has a retirement plan at work and your income exceeds certain limits, your contributions may not be deductible.) Withdrawals taken in retirement are taxed as ordinary income; early withdrawals are subject to both tax and a 10% penalty. Once you reach age 70½, you must begin taking withdrawals each year or face a 50% penalty on the amount you should have taken but did not.

Roth IRA

In contrast, contributions to a Roth IRA are never tax-deductible, but qualified distributions are exempt from federal income tax. Generally, a qualified distribution is one taken after you've reached age 59½ from a Roth IRA that has been in existence at least five years. Another important difference in a Roth IRA is that no distributions are required beginning at age 70½.

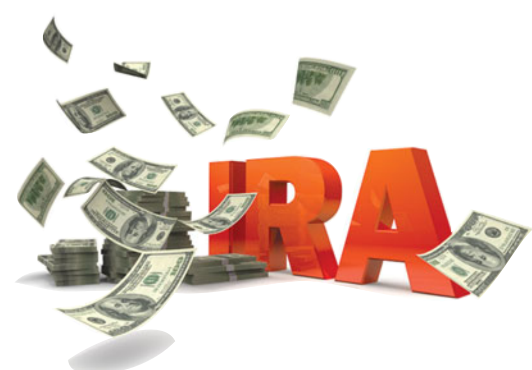
Qualifying for a Roth

The problem with Roth IRAs is that you cannot establish one if your income exceeds certain thresholds that are adjusted each year for inflation. Nor, up until now, could you convert a traditional IRA to a Roth IRA if your adjusted gross income was over $100,000. This double elimination kept many taxpayers from being able to choose a Roth for their retirement savings.

Converting a traditional IRA to a Roth IRA is considered a taxable event.

The current rules

Tax legislation passed in 2006 changed the rule on Roth conversions and ended the $100,000 income limitation, effective January 1, 2010. The rule change also eliminates the prohibition against converting to a Roth for married taxpayers who file separately; they will now qualify to do a Roth conversion. In effect, any taxpayer at any income level and with any filing status is able to convert all or part of a traditional IRA to a Roth IRA.



Note that the income limits for making regular contributions to a Roth IRA have not been eliminated. If your income exceeds these limits, you cannot contribute to a Roth. Your only way to participate is through converting a traditional IRA to a Roth IRA.

Is converting a good idea?

Should you consider converting to a Roth? If it made sense before the current rules went into effect and you were unable to convert to a Roth only because of the $100,000 income limitation, the answer is probably yes. Switching gives you access to the benefits of Roth accounts including tax- and penalty-free distributions once you're 59½ and have met the five-year holding requirement.

In addition, Roths offer estate planning advantages. You're not required to withdraw specified amounts from a Roth each year once you reach age 70½. The same is true for spouses who inherit an account. Other heirs must take distributions, but the account balance can typically be withdrawn over a number of years.

Other factors

The tax bill

If you want to convert a traditional IRA to a Roth, there's a price to pay. Converted amounts attributable to tax-deductible contributions, plus all of the earnings, are subject to income tax at ordinary income rates.

If you expect your tax bracket to be significantly lower at retirement, or you do not have funds outside the IRA to pay the tax bill, you might want to remain with the traditional IRA.

Your age

The greater the number of years until retirement, the better the conversion looks. Younger taxpayers who have a significant amount of time before reaching retirement age may find that generating tax-free income over a long period of time will more than recoup the dollars that were lost to taxes on the conversion.

There are numerous tax, estate, and financial considerations that might come into play. For an analysis of a Roth conversion in your situation, please call our office.

Older taxpayers, especially those in a higher tax bracket, will be able to avoid the taxes associated with annual required distributions from their traditional IRAs and could find that the overall tax impact is significantly less going forward – not to mention the ability to pass tax-free income to their heirs.

Partial conversions

You do not have to convert all of your traditional IRA funds if you choose to do a Roth conversion. You can convert as much as you like and you can convert some each year if that seems advisable.

Changing your mind

If you convert a regular IRA to a Roth IRA and decide it was not a good idea, you can switch back to a regular IRA. You have until October 15 of the year following the conversion to switch back without a penalty. The IRS calls reversing the transaction a "recharacterization." A recharacterized conversion is treated as though it had not occurred. If done properly, there will be no tax due on the original conversion to a Roth.

Do an analysis

Despite the many advantages, a Roth IRA conversion requires careful consideration. Your age and health status, projected rates of return, the tax rates that could apply, and state tax implications could affect the outcome.

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