

Is a Roth IRA Conversion Right for You?

2010 brings a new opportunity for higher-income taxpayers

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You've filed — or at least extended — your 2009 income tax return, so it's time to start thinking about 2010 and beyond. If you're a higher-income taxpayer, one new opportunity is the Roth IRA conversion. But is it right for you?

The Roth IRA is a smart way to save for retirement — or to build wealth for heirs — because qualified withdrawals (including withdrawals of earnings) are tax free. But most higher-income taxpayers have been ineligible to benefit from this savings vehicle.

Income-based phaseouts reduce, and in many cases eliminate, the ability of higher-income individuals to contribute to a Roth IRA. And, until recently, taxpayers were ineligible to convert a traditional IRA to a Roth IRA if their modified adjusted gross incomes (MAGIs) were greater than \$100,000.

Beginning this year, anyone, regardless of income, can convert a traditional IRA into a Roth IRA. Before you start making conversion plans, it's important to consider both the potential benefits and the income tax implications.

Traditional vs. Roth

Both a traditional and a Roth IRA allow you to build wealth on a tax-advantaged basis but impose a 10% early withdrawal penalty (with certain exceptions) on distributions before age 59½. The 2010 maximum contribution limit is also identical for both IRAs: the lesser of \$5,000 or 100% of earned income for the year, reduced by any contributions to other IRAs. And if you're age 50 or older, you may also be able to make a "catch-up" contribution of up to \$1,000.

But that's where the similarities end. Contributions to a traditional IRA may be tax deductible and earnings grow on a tax-deferred basis, but withdrawals are subject to ordinary income taxes (unless they were not tax deductible when they were made). Contributions to a Roth IRA, on the other hand, aren't deductible but qualified withdrawals are tax free.

The MAGI limits for contributing also vary. For traditional IRAs, the ability to *deduct* contributions is phased out at relatively low MAGIs for taxpayers who participate in an employer-sponsored plan, such as a 401(k), or whose spouses participate in such a plan.

Taxpayers with MAGIs exceeding the limits can still contribute to traditional IRAs, but they can't deduct their contributions. Although account assets grow tax deferred, 100% of the earnings distributed are taxable. So even though Roth IRA contributions aren't deductible either, Roth IRAs are more attractive because earnings are tax free (assuming only qualified withdrawals are made).

Plus, the way the distributions are treated differs. With a Roth IRA, distributions are presumed to be contributions first, then earnings.

The MAGI limits for Roth IRAs are generally higher than those for traditional IRAs, but taxpayers with MAGIs exceeding the limits aren't allowed to contribute at all. So if your MAGI exceeds the limits, converting a traditional IRA to a Roth IRA may be your only opportunity to reap a Roth IRA's benefits.

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Estate planning benefits

Another important difference between traditional and Roth IRAs is that you must take required minimum distributions (RMDs) from traditional IRAs beginning after age 70½ — regardless of whether you need the funds. With a Roth IRA, you can leave the funds untouched for as long as you wish, the advantage being that you can allow the funds to continue to grow tax free. Further, you aren't permitted to make contributions to a traditional IRA starting in the year you reach age 70½, whereas there is no age limit on Roth IRA contributions.

A Roth IRA has another estate planning advantage over a traditional IRA: When you pass your Roth IRA to your loved ones, distributions to them are income-tax free. With a traditional IRA, on the other hand, beneficiaries have to pay income taxes on all distributions, so income taxes can greatly reduce their inheritance. Plus, because you're paying the taxes associated with a Roth IRA, you're essentially making a tax-free gift to your family.

A Roth IRA's ability to grow tax free is especially powerful when the beneficiary is relatively young. Although the beneficiary will have to take RMDs on inheriting the IRA, the RMDs will be lower than if the beneficiary were older, and there potentially will be a long period for assets remaining in the account to continue to grow tax free.

Income tax considerations

When converting to a Roth IRA, the full amount of the conversion from your traditional IRA is treated as a taxable, but penalty free, distribution (unless they were not tax deductible when they were made). This means that the account balance on the date of conversion will be included in your taxable income for the year.

But if you make the conversion in 2010, you have an option of deferring half the taxable income to 2011 and the other half to 2012. Not only can deferring tax be beneficial, but splitting the income between two years might prevent you from being pushed into a higher tax bracket. Of course, you also need to keep in mind that tax rates are scheduled to go up in 2011 if Congress doesn't take action.

Determining whether converting to a Roth IRA makes sense depends on your specific situation. For example, if you believe you'll be paying taxes at a *higher* rate during retirement because you'll be in a higher tax bracket or tax rates will increase, then converting to a Roth IRA likely is a smart move. A conversion also may make sense if you can fund your retirement from other resources and leave the Roth IRA balance to grow tax free for your heirs.

However, for the maximum benefit, you must be able to pay the tax on the conversion with funds from *outside* the IRA. If you use a portion of the IRA funds to pay the tax and you're under age 59½, that portion will be considered an early withdrawal and be subject to the 10% early withdrawal penalty.

Now also may be a good time to convert to a Roth IRA if your IRA investments have been devalued because of the weak economy. Your tax hit will be minimized and you can avoid tax on any future appreciation.

But if you believe you'll be paying taxes at a *lower* rate during retirement, you may want to leave your funds in your traditional IRA. Why? Your tax liability may be lower if you pay taxes later.

Conversion FAQs

Here are a few frequently asked questions regarding converting to a Roth IRA:

After I convert my traditional IRA to a Roth IRA, am I eligible to make contributions to the Roth IRA? Only if your MAGI doesn't exceed the applicable limits. If you're retired, also keep in mind that you must have some *earned* income, because contributions can't exceed 100% of earned income. The other normal Roth contribution rules also apply.

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Can I convert other retirement savings vehicles into a Roth IRA? If your plan permits, you can roll over funds from your 401(k), 403(b), or 457 plan to a traditional IRA and then convert it to a Roth IRA. If done properly, you'll owe no taxes on the rollover to the traditional IRA, but you *will* owe tax on the conversion of the traditional IRA to the Roth IRA.

Bear in mind that, generally, you can make the rollover to the traditional IRA only after separating from the employer sponsoring the plan, such as by changing jobs to a new employer or retiring. There are certain exceptions in the law, however, that allow employers to permit you to make the rollover when you turn age 59½ — and, in some cases, even earlier. Even though most employers allow such rollovers, not all do.

You may also convert your Simplified Employee Pension (SEP) IRA or your Savings Incentive Match Plan for Employees (SIMPLE) IRA. When converting a SIMPLE IRA to a Roth IRA, be aware of early distribution penalties for accounts that are less than two years old.

Can I convert a Roth 401(k) or Roth 403(b) plan to a Roth IRA? You may be able to roll it over into a Roth IRA. And doing so may be advantageous because Roth 401(k)s and Roth 403(b)s have RMDs; thus, without the rollover you'll miss the opportunity to allow those funds to continue to grow tax free.

There are no income limits on rollovers from a Roth 401(k) or Roth 403(b) to a Roth IRA. As with rollovers of other employer-sponsored plans, except in certain limited circumstances, you can make the rollover only after separating from the employer sponsoring the plan.

Can I convert my inherited IRA? It depends on whom you inherit it from. If you inherit the IRA from your spouse, you can roll the funds into your traditional IRA and then convert it to a Roth IRA. But if you inherit the IRA from anyone other than your spouse, you're not eligible to convert it to a Roth.

Converting isn't right for all

Roth IRAs have many tax-saving advantages over traditional IRAs. But just because everyone can now convert their traditional IRAs to Roth IRAs doesn't mean everyone should do so. Before you take any action, please let us help you assess your retirement and estate planning needs and determine if converting to a Roth IRA is right for you.

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