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To Convert or Not to Convert: That is the IRA Question

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Until now you may not have given a Roth conversion for your IRA (or other retirement accounts) much thought. After all, if your modified adjusted gross income was greater than $100,000 you were not even eligible. In 2010 that will change, however, as the income limit for Roth conversions is eliminated. Then anyone can convert and everyone should consider whether a Roth conversion is right for them. This article will consider some of the key the differences between traditional IRAs and Roth IRAs and examine the issues involved with conversion.

All things being equal, money in a Roth IRA is preferable. Why?

- **Distributions from IRAs are taxable.** People often make the mistake of ignoring taxes, thinking that if they have $500,000 in an IRA, they have $500,000 to spend. But after taxes they really have closer to $325,000 (depending on their tax rate). Distributions from Roth IRAs are not taxable (as long as those withdrawing are over 59 ½ and hold the Roth for five years). Those with $500,000 in a Roth IRA really have $500,000!

- **Money in IRA accounts is subject to minimum required distributions (MRDs).** MRDs are mandated IRA withdrawals starting at age 70 ½ and are taxable as income. Further, failure to take an MRD triggers a 50% penalty on the MRD amount. Money in Roth IRAs is not subject to MRDs or penalties.

- **Heirs will not owe income tax on any distributions they take from an inherited Roth IRA,** though non-spouse beneficiaries will need to take Roth IRA distributions based on their life expectancy.

Those are the benefits. Now let's consider the downside to Roth conversions. The consequences of converting seem simple enough: You will owe taxes (as income) on the taxable amount you convert. Unfortunately the simplicity ends there.

Complication #1: Determining the taxable amount is not always straightforward. All IRAs must be considered together to determine the taxable amount of a conversion. If all the IRAs are completely from pre-tax sources (i.e. deductible IRA contributions or rollovers from retirement plans) then the answer is simple – the entire amount of the conversion is taxed as income. If, however, an investor made non-deductible contributions to an IRA it gets complicated. Non-deductible contributions become the basis in an IRA. The taxable amount of a conversion is limited to the percent of non-basis value versus total value of IRAs. Perhaps an example will work best.

> Mr. Investor has an IRA valued at $25,000 and an IRA rollover valued at $100,000. The IRA has a basis of $20,000 due to non-deductible contributions. If Mr. Investor converts only his IRA how much income must he recognize for tax purposes? It would be incorrect to determine that only $5,000 is taxable, which is the difference between the value and the basis in the IRA. Unfortunately, Mr. Investor must calculate what percentage the basis in his IRA is across

all his IRAs. In this case the basis is $20,000 out of total IRA assets of $125,000, or 16%. Therefore 16% of the $25,000 conversion amount is not taxable ($4,000). The remaining $21,000 is taxed as income.

Complication #2: In 2010 investors will be able to defer the declaration of income from a Roth conversion to tax years 2011 and 2012, recognizing half the income each year. While deferring taxes is usually desirable, there may be reasons to declare the income and pay the taxes in 2010 (i.e. if 2010 income will be low compared to 2011 and 2012). Note that the IRS will spread the income between 2011 and 2012 unless the investor opts out.

The general rule of thumb when it comes to the conversion decision seems simple enough. You should convert now if you can answer yes to both of the following questions:

1. Will you be able to pay the tax consequences of the conversion from non-IRA money?
2. Will you be in a higher tax bracket in retirement?

Taking money from your IRA to pay taxes from the conversion defeats the purpose of the conversion – to keep as much money as possible growing tax deferred. It will also trigger taxes, since the withdrawn amount to pay for taxes is considered a distribution, and possibly a penalty (if you are under 59 ½).

Most people assume they will be in a lower tax bracket when they retire. Perhaps. To the extent that you are a successful saver and investor over the course of your working career, you may have a substantial portfolio throwing off income and a large IRA from which MRDs must be taken. Then there is the question of the government. Today the conventional wisdom is that tax rates will go higher due to the tremendous amount of debt that has been created in the past year, not to mention Democratic control of the executive and legislative branches of government.

Due to the uncertainties regarding your future tax bracket, many believe it makes sense to diversify your tax risk, much in the same way you would diversify an investment portfolio. You should have some money in both traditional and Roth IRAs.

Assuming you do decide to convert some or all of your IRAs to a Roth IRA, the questions then become how much and when? These are not one-time decisions. You can convert all or part of your IRAs to a Roth any year you want starting in 2010. Be aware that the amount you convert could affect your tax bracket. Chances are you'll want to limit your conversion to an amount that will not raise your tax bracket (consult with your tax advisor).

There are a few situations when doing a conversion may be the clear winning decision:

1. **You have little or no income but expect that to change in the future.** Your tax bracket may never be lower. For example, in 2009 a married couple filing a joint return can have up to $67,900 of income and still be in the 15% marginal tax rate. Unfortunately due to the economy and high unemployment there are likely to be many people in this situation. Doing a Roth conversion under these circumstances is making the proverbial lemonade out of lemons.

2. **You have an IRA with substantial basis, thus making the taxable amount of the conversion low.** As stated above, however, the effectiveness of this strategy could be lessened by the presence of other IRAs with little or no basis (see above example). There are a few strategies here that could help:

    a. Do not rollover your 401(k) into an IRA until after a conversion. 401(k) accounts are not considered relative to the determination of taxable amount.
    b. If you already have an IRA rollover, consider rolling it into your company 401(k) (if your company plans allows it) thus removing that money from the taxable amount calculation.

3. **To the extent that you have estate tax issues a Roth conversion could save significant money** for two reasons:

    a. Income taxes are generally less than estate taxes, and
    b. Paying taxes now will reduce the size of your estate.

One final thought: You can convert without fear of making the wrong decision. Perhaps you realize that you were in a higher tax bracket than you thought. Perhaps the value of your Roth IRA declined, causing you to pay more taxes than necessary. Whatever the reason, you are allowed to recharacterize the Roth IRA back to your traditional IRA without consequences. In fact, if you convert in 2010 you have until the due date of your tax return to recharacterize (April 15, 2011, or October 15, 2011 if you file an extension). You must, however, wait 30 days and until the next calendar year to convert again.