Roth IRA Conversions

Overview: The purpose of this article is to discuss the 2010 law changes related to Roth IRA conversions and to assist in determining whether a conversion is advisable for you. Included is a "Checklist" to help determine when a conversion makes sense. Finally, three online conversion calculators are cited to help project the financial benefit of a conversion. Please call or email if you would like to discuss your specific situation.

Roth IRA accounts were first established in 1997 and Roth 401(k) accounts became available in 2006. Roth IRAs are very different from other types of retirement accounts. Contributions are made with after-tax dollars (versus tax-deductible contributions that are made to traditional IRA and 401(k) plans). The huge benefit of Roth IRAs is that eligible distributions are tax-free.[1]

2010 Law Change: Prior to 2010, taxpayers with modified adjusted gross income of more than $100,000 were not eligible to convert their traditional IRA assets to a Roth IRA. Effective January 1, 2010, there is no longer an earnings limit so all IRA holders are now eligible to convert.

Conversions Are Taxable Events: If an investor converts their traditional IRA, the amount of the conversion (less IRA cost basis) must be recognized as income. For those IRA accounts that have only been funded with nondeductible contributions, this means that the only income recognized is the amount of the growth of the account.[2] In addition, for 2010 only, there is flexibility in the law regarding income recognition. The taxpayer may recognize all the income in 2010 or spread the income over the next two years.

Roth IRA Contributions: There are two ways to fund Roth IRAs. One is with a conversion of assets from a traditional IRA or 401(k). The other is to make a non-deductible Roth IRA contribution. Only low to middle-income taxpayers with sufficient earned income qualify for this second method. For years 2009 and 2010, taxpayers under age 50 with at least $5,000 of earned income (i.e. wages and self-employment income) can contribute up to $5,000 per year (taxpayers over age 50 can contribute up to $6,000 per year). Eligibility is phased out for single taxpayers with adjusted gross income (AGI) between $105,000 and $120,000 (and $166,000 to $176,000 for married taxpayers). No contributions can be made for taxpayers with AGI above these limits.

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[1] In order to be eligible for a tax-free withdrawal of growth from a Roth account, five years must elapse from the time of the Roth IRA owner's first Roth IRA contribution and the IRA owner must generally be at least age 59 ½. After-tax contributions to a Roth IRA may be withdrawn at any time, free of any income taxes or penalties.

[2] If a taxpayer has more than one traditional IRA, they'll have to factor all of their own (not a spouse's) traditional IRAs and SEP IRAs into the calculation—even if they are only converting one of them—to determine how much of the conversion amount will be taxable.

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Advantages of a Roth IRA Conversion

A Hedge Against Future Tax Increases: With personal income tax rates at near-historical lows, many taxpayers will be in a higher tax bracket in future years. 2010 may provide an excellent opportunity for high-income taxpayers to recognize IRA income before tax rates are increased.

Reduce Taxable Income in Retirement: Unlike with traditional IRAs and 401(k)s, Roth IRAs are not subject to required minimum distributions (RMDs) when a taxpayer reaches age 70 ½. Not having to take RMDs may increase the amount of social security income that is tax-free or reduce the Medicare surtax that high-income taxpayers are subject to.

A Lifetime (plus) of Tax-Free Growth: For more affluent taxpayers who are expecting to leave a financial legacy, Roth IRAs can be an outstanding estate planning vehicle. There are no minimum distributions requirements during the lives of the original Roth IRA owner and his or her spouse. In addition, *the non-spouse beneficiaries can spread the tax-free withdrawals from the Roth IRA over their life times.* **In combination, this allows a Roth IRA the potential to realize many decades of tax-free growth.**

When a Conversion Does Not Make Sense

The following are circumstances in which a conversion will be less beneficial:

1. **Money to Pay Income Tax Not in After-Tax Account**: If you are younger than 59 ½ and your only option is to use part of your traditional IRA assets to pay the tax, you'll pay a 10% early-distribution penalty (plus 2 ½% for CA residents) on any assets you don't roll directly into the Roth. To avoid this, sufficient cash should be available outside of retirement accounts to pay the tax resulting from the conversion.

2. **You Expect to Be in a Significantly Lower Tax Bracket In Retirement:** In this case, it probably doesn't make sense to convert.

3. **You Can't Leave the Assets in the Roth Account for At Least 5 Years:** I have read many articles that you need at least five years for the assets to grow tax-free in the Roth for the conversion to make sense. Personally, I feel you should probably have at least ten years tax-free compounding or doing a conversion is less compelling. The exception is if you have an exceptionally low income year, a conversion can allow you to take advantage of being in a low tax bracket.

4. **You Expect to Liquidate Most or All of Your Assets in Retirement:** A Roth conversion is most compelling for those who will have the luxury of not needing their Roth assets and plan to leave them as an inheritance. Conversely, for those who feel they may be financially strapped in retirement, generally I don't think it makes sense to do a conversion and accelerate the payment of tax.

Suggestions & Recommendations

Do a Partial Conversion: Partial conversions are permissible and can be a great strategy, particularly if converting all of your IRA assets will push you into a higher tax bracket for the tax year in which you convert. Partial conversions can also make sense if you don't have the cash on hand to pay the taxes associated with a full conversion.

Make Non-Deductible IRA Contributions: Taxpayers under age 50 with at least $5,000 of earned income can contribute up to $5,000 per year to an IRA (those over 50 can contribute $6,000 per year). Depending on the taxpayer(s) level of income, the contribution may be non-deductible if the taxpayer or their spouse is covered by a pension at work. A non-deductible IRA contribution adds to the taxpayer's cost basis in their IRA. The cost basis will reduce the amount which is taxable if the IRA is converted (although see footnote #2 on page one if the spouse has other IRA assets). ***For spouses who have little or no IRA assets, a non-deductible IRA contribution is very compelling (since little or no taxable income will result if the assets are converted shortly after the contribution).***

Checklist to Determine Whether a Conversion Would Be Beneficial

	Beneficial	Not Beneficial
Is the money available to pay the tax resulting from the conversion?	Yes	No
How many years do you have until you retire?	10 or more	Fewer than 10
Do you expect to tap; your IRA assets for living expenses in retirement?	No	Yes
Will your estate be subject to estate tax?	Yes	No
Do you have beneficiaries who could spread their Roth IRA withdrawals over their lifetimes?	Yes	No
Is your income lower now than it normally is?	Yes	No
Do you expect your income to be comparable or higher in retirement to what it is now?	Yes	No
Is the bulk of your retirement portfolio invested in a traditional (non-Roth) 401(k)?	Yes	No
Have you made nondeductible IRA contributions?	Yes	No
Has your IRA account suffered significant losses over the past several years?	Yes	No

Results:

- If most of your answers fell under the "Beneficial" column, then a Roth IRA conversion is probably a good option for you.
- If most of your answers fell under the "Not Beneficial" column, then a Roth IRA conversion is probably not a good idea for you.

Roth Conversion Calculators

I have reviewed a number of Roth Conversion calculators. The following are my favorites:

MAM website:
http://www.mamportfolios.com/calc.aspx?spid=97621&calcname=RothTransfer

…alternatively this calculator can be accessed at www.mamportfolios.com, click on "Research & Tools" and then "Financial Calculators", scroll down the page and click on "Roth IRA Conversion" (fourth from the bottom of the list of calculators).

BankRate.com:
http://www.bankrate.com/calculators/retirement/convert-ira-roth-calculator.aspx

CalcXML:
http://www.calcxml.com/do/qua04

Warning: Most Roth Conversion calculators require assumptions that have a significant impact on the results (ex. future tax rates, annual rates of return). Depending on how accurate these assumptions end up being, the results of the calculations can be misleading. Furthermore, many of the online calculators make assumptions to simplify their calculations. For instance, all of the ones I reviewed assume there will be Roth IRA withdrawals during the owner's lifetime. It is impossible to project the future (how long you are going to live, your tax rates in retirement, future tax law changes that impact Roth IRAs, etc). Therefore, at best, Roth Conversion calculators are a useful tool to help determine whether a conversion makes sense for you. Be careful, though, not to put much credence into the numbers they project!

Additional Resources

- **Charles Schwab & Co Roth Conversion video: Is it Right for You?**
  http://w.on24.com/r.htm?e=187692&s=1&k=5AAFA7957BA4F90EC6CF985FE387E817
- IRS Publication 590: www.irs.gov/pub/irs-pdf/p590.pdf
- Fairmark's Guide to IRA Conversions: www.fairmark.com/rothira/advant.htm

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Date of Last Update: 1/14/10

/word/tax/tax update letter/Roth IRA conversions