

Roth Conversions: Roll Over or Stand Pat?

Charles Buck CFP® and Jon King

Prior to this year, IRS rules prevented you from converting or “rolling over” any portion of your IRA accounts into a Roth IRA account if your modified adjusted gross income for tax (MAGI) was over \$100,000. This restriction prevented rollovers for many Americans. Starting in 2010, and in every year thereafter, there is a new rule. You can now roll over any portion of your IRA accounts into a Roth account. The MAGI restriction has been permanently lifted.

Remember, the money you contributed to your IRA accounts has never been taxed (unless you made some nondeductible contributions). This also applies to IRA accounts that were rolled over from previous employer’s 401K plans. The basic advantage of an IRA is that contributions are generally tax deductible, and you will not pay tax on the earnings in the account each year. In exchange for this deferral of taxes over many years, money eventually withdrawn from a traditional IRA will all be counted as taxable income and taxed at ordinary income rates in the year of withdrawal. IRS rules require you to start making required minimum distributions (RMDs) after you attain age 70 ½.

Roth IRAs work just the opposite. You do not get a current tax deduction for the funds contributed to a Roth. However, provided you follow the rules (generally, you should have a Roth account at least five years before taking withdrawals and be over age 59 ½) the earnings on the Roth account will never be taxed. There are no RMD requirements for Roth accounts. You have the flexibility to make tax free withdrawals whenever you need them.

If you elect to roll over some of your IRA funds into a Roth, the previously untaxed money becomes taxable income in the year of the rollover, and this will increase your current tax bill. In effect, you are exchanging the cost of paying the additional tax now for the potential of avoiding an even bigger tax bill later when you finally withdraw money from the Roth. There is even a special rule to encourage Americans to roll their IRAs into Roths in 2010. You can elect to spread the additional taxable income created by a 2010 rollover evenly over the following two years – 2011 and 2012. If you chose this option remember the current tax law expires at the end of the year; if Congress does not renew them, your bracket will be higher in 2011. Also all 2010 conversions have to be declared either in 2010 or split between 2011 and 2012.

So the opportunity is now available, but the decision is confusing. When would you benefit from rollover and when are you better off standing pat?

The basic decision rule is actually fairly easy. Most rollovers will be motivated by a desire to save taxes. Here are the guidelines:

- If your marginal tax rate (the tax rate applying to your last dollar of taxable income) is the same percentage in retirement as it is now, the

present value of the future tax savings is going to be the same as the increased tax cost of rolling over and you should be indifferent.

- If you expect your marginal tax rate to be higher than it is now in retirement you will probably benefit from a rollover.
- If you expect your marginal tax rate to be lower in retirement you are better off not rolling over.

The rule may be simple, but the application is tricky. It requires you to project what your tax rate will be many years in the future. This not only depends on politics – many believe tax rates applying to the “well off” are destined to increase. It also depends on your own unique situation. For example, even if tax rates increase across the board, your taxable income may be lower in retirement than it is now, and you could fall into a lower tax bracket. That’s not always the case. Some people will have substantial RMD requirements and income from taxable investments in retirement.

There are other considerations:

- Rolling an IRA into a Roth is more beneficial if the funds used to pay the additional taxes do not have to come from a retirement account, so you need to consider how you will pay the additional tax bill. If you use money from non retirement accounts the eventual tax advantage of the Roth becomes bigger. Ten thousand dollars in a Roth account is “bigger” after tax than \$10,000 in an IRA, because the tax has already been paid.
- Using funds from a retirement account to pay the additional tax bill counts as a “withdrawal” and will generate even more tax on the withdrawn amount plus the potential for a 10% early withdrawal penalty.
- The IRS requires you to add up all your IRA accounts (including any SEP or SIMPLE IRAs) and consider any amount rolled over to be drawn proportionate from all the accounts, regardless of which account you take the funds from. This prevents you from only rolling over funds that were contributed without a tax deduction.
- Rolling an IRA into a Roth can even be used as an estate planning tool. If your projected estate is large and you are likely to be subject to the estate tax, then rolling over an IRA into a Roth will reduce the size of your estate by the tax you pay now. Your heirs will then inherit a Roth rather than a traditional IRA. They will have to make RMDs on the inherited Roth over their own lives, but there will not be any associated tax to pay.
- If you roll over a large amount in any one year the recognition of increased taxable income from the rollover can push you into a higher tax bracket.

- You do not have to roll over everything in 2010. You can roll any portion in any future year. There may be an advantage in timing rollovers to correspond to low tax years (for example right after retiring, but before RMDs start). Typical conversion techniques convert enough at the end of the year to move to the top of your marginal income bracket.

Even if you do not have a large traditional IRA to convert, the same logic applies to current year IRA contributions in deciding whether to fund a Traditional or Roth IRA.

All in all, it can be a great opportunity to save some taxes, but you should not assume it is always the best thing to do. Your own unique situation should be analyzed very carefully before making a final decision. Think through the pros and cons. If there is no clear advantage, it is probably best to do nothing.