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To Convert or Not To Convert: Advantages and Pitfalls of Roth IRA Conversions

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Annually since 1998, many taxpayers evaluate the tax and non-tax benefits of contributing to a Traditional IRA and a Roth IRA. Starting this year, a new evaluation is being considered by even more. This year for the first time, high-income taxpayers with traditional IRAs have a unique opportunity to convert their Traditional IRAs to Roth IRAs irrespective of level of income. As a result of the Tax Increase Prevention and Reconciliation Act of 2005, or TIPRA, all taxpayers are allowed to convert Traditional IRAs to Roth IRAs beginning in 2010 at a current income tax cost. Prior to 2010, conversions were only allowed for taxpayers earning less than $100,000 a year.

Background

For years, taxpayers have been taking deductions and deferring income tax on contributions to traditional IRAs, 401(k)s and similar plans, such as 403(b) and 457(b) plans. Of course, the benefit of these deductions from income eventually comes with a price: Withdrawals from these accounts are taxed, usually during retirement, as ordinary income, although hopefully at lower tax rates.

The Roth IRA, a specialized retirement account established as an alternative to the traditional IRA, was created through the Taxpayer Relief Act of 1997. Why contribute to a Roth IRA when no tax deduction is allowed for contributions? As long as certain conditions are met, all distributions are tax-free, including investment earnings. The most significant restriction prohibits distributions for a five-year period beginning Jan. 1 of the first tax year an individual establishes the Roth IRA.

Another benefit of the Roth IRA is that there are no mandatory minimum required distributions upon turning 70-and-a-half, as required by traditional IRAs. This affords the opportunity to set aside funds in the Roth account until needed, or until the account is passed income tax-free to heirs at death.

New Conversion Rules

Beginning in 2010, taxpayers with modified adjusted gross income in excess of $100,000 will be permitted to convert a traditional IRA to a Roth IRA. Previously, only individuals with modified adjusted gross incomes of $100,000 or less could initiate the conversion. Upon conversion, the IRA is taxable as if the account were distributed in its entirety to the account holder. Income tax liabilities are among the biggest challenges associated with IRA conversions.

To ease the tax bite, taxpayers have the option to defer or spread the payment of income taxes upon the Roth IRA conversion over two years, specifically 2011 and 2012, or recognize 100 percent of the conversion income in 2010. The tax deferral option is only available for 2010 conversions. Additionally, a taxpayer who has reached the age of mandatory distribution requirements must still take a taxable distribution in the year of conversion.

Although the income limits have been eliminated for conversions, the Roth IRA annual contribution limits will still apply. Contributing to a Roth IRA is restricted to single and joint taxpayers with modified adjusted gross income in excess of $120,000 and $177,000, respectively.

Conversion Considerations

The question of whether to convert to a Roth IRA centers on the assessment of whether it is more advantageous to pay tax now by converting, or to defer the tax by maintaining a traditional IRA or other tax deferred retirement plan. Each course of action has advantages and disadvantages and the final decision will depend upon each individual's unique set of circumstances with additional weight given to factors considered to be most important. It is recommended that you or your clients consult with a qualified tax professional well versed in the intricacies of conversion, as the decision to convert is complex. The following factors are critical when evaluating whether to convert.

Income Tax Rate

The first and most obvious factor to consider is the taxpayer's income tax rate at the time of conversion compared with anticipated tax rates at the time of withdrawal. A conversion may be appropriate if an individual expects their blended federal and state income tax rate to be higher in retirement than their current rate. With the expectation of rising federal tax rates, paying tax on converted amounts at today's relatively low rates to avoid higher taxes later may be worthwhile, particularly if the invested funds are projected to grow significantly.

The recent global economic crisis has also had a dramatic effect on tax revenues at state levels. As a result, many state governments have raised or intend to raise individual income tax rates to make up for budget shortfalls. Fortunately, IRA conversions are not taxable by every state. For example, in Pennsylvania, such conversions including earnings are not taxable. In New Jersey, while the traditional IRA contributions are generally not subject to tax on conversion, the earnings from the traditional IRA are taxable at the time of conversion (unless the taxpayer opts to spread the tax over tax years 2011 and 2012).

Paying Taxes from Conversion

The second key factor and perhaps the single greatest impediment to conversion is whether the taxpayer can pay the tax liability resulting from the conversion from a taxable brokerage or bank account and not from the converted Roth IRA. If IRA funds are used to pay the conversion tax, the balance of the Roth IRA, after taxes, will be less than the pre-conversion amount. This can make it difficult for the Roth IRA to grow to the level the pre-conversion account may have achieved. Additionally, payment of the tax liability from the IRA account minimizes the taxpayer's ability to shift a greater percentage of total assets into a tax-free account, which may be the most significant advantage of conversion.

If conversion funds are used to pay taxes, extreme caution must be exercised to avoid violating the five-year distribution restriction applicable to Roth IRAs. Not only could the 10 percent penalty be triggered for distributions made by individuals under 59-and-a-half, but distributions from the Roth IRA would lose their tax-favored status, and the loss of tax benefits relative to future investments earnings would be significant. It may make sense to convert even though a taxpayer will pay the early distribution penalty when an individual's traditional IRAs consist mainly of nondeductible contributions.

In this situation, even though the taxpayer must pay a 10 percent penalty on the conversion funds used to pay the tax, the overall benefit of the conversion may outweigh the penalty since the sum of the tax and the penalty reflect only a small fraction of the value of the IRAs. As the pitfalls of improper or ill advised transactions from the conversion process could be significant, it is essential to consult with a qualified tax professional when considering conversion.

Spending Needs and Investment Time Horizon

One needs to consider spending needs relative to assets, and whether, when and how much of a taxpayer's Roth IRA funds are likely to be spent. Finally, the investment time horizon relative to the account owners assets, influenced by the life expectancy of the taxpayer, taxpayer's spouse and non-charitable beneficiaries, if applicable, should be taken into account in making the decision. Both of these factors help determine the number of years the Roth IRA funds will accumulate before distributions commence, if ever.

If the retirement account owner ultimately intends to pass the balance of the IRA to heirs beyond his or her lifetime, the duration of the accumulation period must include any payout to the beneficiaries. Although mandatory minimum required distributions are not required for the Roth IRA owners, the beneficiaries of inherited Roth IRAs must take mandatory distributions based on their life expectancy. Additionally, Roth IRA account values are subject to estate tax the same as a traditional IRAs. However, post-death Roth IRA distributions are made to beneficiaries without any income tax-free.

Other Factors

Other factors to consider prior to making the decision to convert include age at conversion, expected pre-tax and after-tax investment rates of return, inflation rate and whether the taxpayer is subject to the alternative minimum tax, either currently or in the future. Additionally, for those taxpayers intending to bequest an asset to a non-spousal beneficiary, Roth IRAs are among the best vehicles to accomplish this objective. Another consideration includes the ability of a surviving spouse to avoid taking required minimum distributions from a traditional IRA as a single taxpayer (at higher marginal tax rates) after the death of a spouse.

Prime Candidates for Conversion

While there are many factors to consider when deciding whether or not to convert, the prime conversion candidates include those taxpayers who:

• Have the ability to pay taxes resulting from the conversion from taxable or non-retirement assets but not the converted IRA. • Do not expect a significant decline in tax rates during retirement. • Are making the conversion at a younger age. • Do not expect to spend meaningfully, or at all, from the IRA in retirement. • Intend to transfer the IRA to non-charitable beneficiaries upon death.

It is important to note that studies have shown, given the right situation, a conversion to a Roth IRA can potentially produce better after-tax results than maintaining a traditional IRA, if future tax rates remain the same or even decrease. This is primarily due to the elimination of the required minimum distribution requirements, the tax-exempt nature of the assets within the Roth IRA compared to taxable or non-retirement assets and the ability to transfer the Roth IRA benefits to heirs.

Partial Conversion

IRA owners may wish to convert only a portion of their existing IRA. Partial conversions may be desirable for those with larger portfolios that would trigger a considerable tax liability upon conversion. This flexibility may also be beneficial to those who are self-employed or whose income varies year to year. In a year when income is down, as many have recently experienced, a partial conversion will help to avoid the larger tax burden which may be associated with a full conversion. Another advantage of a partial conversion is if the taxpayer wants to protect against the risk of making assumptions that later prove to be incorrect, such as assumptions related to tax rates or estate planning issues, they can convert part and retain part as a traditional IRA.

Reversing the Conversion

Imagine a scenario where the stock market declines after conversion. Recent volatility, highlighted by the unprecedented "Flash Crash" of May 6, is a reminder that with opportunity comes risk. After a conversion, a taxpayer may realize that the timing of the conversion was unfortunate. As with most investments in the market, timing of fluctuations is not always predictable.

Fortunately, the IRS allows time for evaluation of a conversion decision by instituting a "do-over" provision called a recharacterization, which allows a taxpayer to convert the Roth IRA back to a traditional IRA. Assume, for example, that subsequent to a 2010 conversion, a taxpayer's account experiences a decline in value of $500,000. Assume further that the taxpayer is in a 33 percent tax bracket. By recharacterizing, or undoing the conversion, the taxpayer will avoid incurring a $165,000 tax liability. For conversions that occur during 2010, a taxpayer has until the due date of the tax return plus extensions, theoretically until Oct. 17, 2011, to recharacterize. The conversion can still be made at a later date based upon the market value of the retirement account at that time, however, taxpayers are limited to one conversion and one recharacterization per tax year.

For those who plan on making the conversion, an IRA can be separated into multiple IRA accounts with various asset classes prior to implementing the conversion. For example, an individual can separate a traditional IRA with a value of $600,000 into six $100,000 IRAs. The six IRAs would be converted to six separate Roth IRAs. This process will prevent the investment results from being commingled and therefore, if the value of one or more of the accounts decreases, the taxpayer may undo or recharacterize the conversion only for the asset classes that have underperformed.

Use Caution When Evaluating Options

Whether to convert retirement funds to a Roth IRA is a sophisticated and difficult decision for higher-income taxpayers. By accelerating taxable income into an earlier year that otherwise might be deferred until retirement, and paying tax sooner rather than later, a taxpayer will deviate from traditional retirement tax planning techniques. However, ignoring an opportunity that may ultimately result in an earlier or more comfortable retirement for some, as well as the potential deferment of tax on retirement income into periods with lower marginal tax rates, should not be ignored.

To enhance the decision making process, we created a proprietary break-even model for our clients that reflects the point in time at which the projected after-tax value of a taxpayer's non-Roth accounts would equal a Roth account. The model is based on various assumptions such as withdraw needs, growth rates, tax rates and even considers partial conversions. Be sure to consult with a qualified tax professional who may have created a model before deciding if taking advantage of the rule change for 2010, and executing a Roth IRA conversion, is right for you or your clients.

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