Roth IRA Conversions Still Alive

They're Not for Everyone, but They Can Be an Attractive Alternative

BY DOUG WHEAT

If you missed the opportunity to convert your traditional IRA to a Roth IRA in 2010, there is good news: Roth IRA conversions are still alive in 2011.

Roth IRAs are attractive retirement accounts because they hold the promise of tax-free investment gains, no required minimum distributions (except for inherited Roth IRAs), potentially lower estate taxes, and lower income taxes on inherited IRAs, among other benefits. But Roth IRAs are not for everyone, and it important to pay careful attention to how the details of the rules apply to your particular situation.

When you do convert an IRA to a Roth IRA, you have to pay income taxes on the amount you convert. In effect, you are volunteering to pay taxes now in order to receive tax-free growth in the future. A few employers also allow a conversion from a 401(k) to a Roth 401(k), but this new provision is uncommon.

Direct contributions to a Roth IRA may be withdrawn tax-free at any time. Rollover and converted (before age 59 1/2) contributions held in a Roth IRA may be withdrawn tax- and penalty-free after the 'seasoning' period (currently five years). Earnings may be withdrawn tax- and penalty-free after the seasoning period if the condition of age 59 1/2 (or other qualifying condition) is also met. Another plus is that, with a Roth IRA, there is no rule requiring distributions that must begin for holders of traditional IRAs after age 70 1/2. So if you don't need the money, investment gains in your account can continue to compound indefinitely without being eroded by taxes.

Before 2010, you couldn't convert a traditional IRA into a Roth in a year in which your modified adjusted gross income exceeded $100,000. That restriction was eliminated starting in 2010 and resulted in an explosion of interest in Roth IRA conversions. The ability to do Roth IRA conversions for all income levels will continue in 2011 and beyond. The attractiveness of a conversion has not diminished because the recently signed Middle Class Tax Relief Act of 2010 keeps tax rates from rising for everyone in 2011 and 2012.

So if you missed the opportunity to convert to a Roth IRA last year, now you have another chance to review your personal circumstances to determine if a conversion is right for you. Here are a few important questions to consider:

1. How will you pay the tax on the conversion? If the money to pay the tax has to come out of the tax-deferred assets you're transferring (your IRA or 401(k), it will limit the benefit of the conversion. Remember, you need to pay both the federal and state income taxes on the conversion amount.

2. What's your tax rate? How much you pay now and your expected income-tax rates during retirement directly affect the conversion equation. While you might normally expect to be in a lower bracket during retirement, federal, state, and local tax rates may increase in the future.

3. Did you make non-deductible contributions to your traditional IRA? You won't be taxed to convert the non-deductible contributions, but the earnings will be subject to tax on conversion.

4. How old are you and other members of your family? Your age affects how long assets will be able to grow tax-free in a converted Roth IRA — and the longer they grow, the bigger the tax advantage.

5. Do you need the money? If you have young children who are likely to inherit your Roth IRA, they may be able to spread out distributions (required after the account goes to the next generation) over many decades. If so, the compounding effect of the tax-free status can be enormous.

With all of these factors to consider, deciding whether to convert can be complicated. If you do have adequate savings to pay the tax on a conversion, you might want to consider whether your income-tax rate will be going up in the future. With all the uncertainty in tax rates, this is obviously difficult to foresee, but let's look at a couple of situations in which physicians and other highly compensated individuals may

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A physician in the middle or later part of her career may find herself at one of the top tax brackets. If she will need all or most of her retirement savings for her own retirement needs, a Roth conversion may not be an advantage. However, if she has contributed after-tax money to an IRA over the years, or has done the same for a spouse, these accounts can be attractive Roth IRA conversions because the tax will be due only on the earnings, not the contributions. However, the rules for determining tax basis can be tricky, so you need to be careful before you proceed.

A physician with large accumulated savings who retires at age 65 may find himself in a window of opportunity with low taxes, which may provide an attractive opportunity for a partial Roth conversion. This is particularly true if the person does not plan to take Social Security benefits or IRA distributions until they turn 70. In this scenario, it is entirely possible for the person to be temporarily in one of the lowest tax brackets even though they have a significant amount of assets. It may be a golden opportunity for a Roth conversion. As an added bonus, Roth conversions decrease future minimum required distributions from traditional IRAs.

While, for many people, establishing a Roth IRA is a great way to genenerate tax-free retirement income, moving assets from a traditional IRA to a Roth doesn't make sense in every case. And even if the positives out weigh the negatives, it may be best to convert only a portion of your IRA assets in any one given year. It's also important to know that it is possible to undo Roth IRA conversions within a limited window of time.

With the continued low tax rates for 2011, many people may still find it an attractive year to do Roth conversions. ❖

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