

# To Roth or Not

*Revised May 2011*

## **Introduction**

In May of 2006, the tax laws changed to allow any taxpayer (without income limitation) to convert their traditional IRA to a Roth IRA during calendar year 2010 and thereafter. High-income taxpayers now can convert traditional IRAs to Roth IRAs and, accordingly, must decide whether or not to convert and pay the conversion tax. (The opportunity to convert and defer the income to the years 2011 and 2012 (spreading the taxes out over the two-year period) was only for 2010.) Conversions after 2010 are included in income during the tax year of the conversion. Even though conversion to Roth status is available to all taxpayers, income limits continue to deny high-income taxpayers the privilege of directly contributing to Roth IRAs.

## **Why conversion is a good idea –**

1. Roth withdrawals are tax-free after five years of holding and age 59½. Earlier Roth withdrawals are subject to penalty tax at ten percent unless related to death, disability, or a first-time home purchase. Heirs do not owe any income tax on Roth distributions after the original five-year holding period requirement has been met.
2. Roth IRAs have no required distributions for the lifetime of the taxpayer or surviving spouse beneficiary. Distributions are required on the initial life expectancy for heirs other than the spouse.
3. The risk of tax rate change is reduced. By converting, the tax rate is fixed on the amount converted, and there is no risk of future increases nor benefit from any future decreases in tax rates.
4. The amount of income tax on conversion is removed from the death tax base.
5. If an IRA beneficiary is a trust that may accumulate income, conversion avoids the higher compressed trust tax bracket.

## **Tax on Converting the IRA**

The taxpayer is required to pay tax only on the portion of the IRA on which taxes have not been previously paid. In other words, nondeductible contributions included in converted traditional IRAs are not taxed. The taxable income from conversion is the fair market value of the converted amount at the date of conversion minus the taxpayer's nondeductible contributions (basis) includable in the amount converted. All IRA accounts must be aggregated for this purpose.

## **Pension and Profit-Sharing Plans Amounts**

Some taxpayers with minimal traditional IRA accounts have significant qualified plan accounts; that is, profit-sharing, money purchase pension plan and, 401(k) accounts. Effective January 1, 2008, these accounts may be transferred directly to Roth IRAs. Many profit-sharing plans and 401(k) plans allow, or could be amended to allow, in-service distributions. Where in-service distributions are allowable, the accounts could be transferred trustee-to-trustee or distributed (subject to withholding – see question No. 16) and rolled over within 60 days. Accordingly, taxpayers with significant profit-sharing or 401(k) balances whose plans allow or could be amended to allow in-service distributions have the opportunity of converting all or some of their retirement savings to Roth IRAs. Those with significant money purchase pension balances who are age 62 or older might be able to arrange an in-service distribution making the Roth conversion available. In summary, profit-sharing, 401(k) and money purchase pension plans may be considered for possible conversion to Roth status. (See Appendix A)

## **Some Questions on Conversion**

### **1. Who Should Consider Converting?**

1. Those who expect higher tax rates in the future
2. Those expecting above-average asset appreciation in the IRA
3. Young people – they receive a longer period of tax-free compounding and might achieve conversion at lower tax rates.
4. Those who will not consume their IRA funds during retirement as they can leave their IRAs as stretch Roth IRAs to their children or grandchildren
5. Those who will pay death taxes – they will thin their estate by the amount of income tax paid on conversion to Roth. They will leave an asset with the very valuable characteristic of long-term, tax-free compounding, but it will be valued for death tax purposes identically to assets without that characteristic.
6. Those who are leaving IRAs to a trust that might want to accumulate trust income as the compressed trust tax brackets are avoided.

### **2. Who should probably not convert?**

1. Those who expect future distributions to be taxed at a rate significantly lower than their tax rate on conversion.
2. Those who would have to use IRA or other tax-deferred funds to pay the tax (especially if a withdrawal penalty would apply).

**3. Is deferral of the taxable income on a 2010 conversion required or is it an election?**

For conversions in 2010, the taxpayer will recognize the distribution amount ratably in 2011 and 2012 unless the taxpayer elects to recognize all of the income in 2010. Distribution from the converted Roth IRA will cause earlier taxation of the amount distributed.

**4. How will tax rate increases for 2011 and 2012 impact the tax-deferred conversion?**

The 2011 and 2012 tax rates will apply to the 2010 deferral. The deferral is of the taxable income – not of the tax.

**5. When should the conversion occur?**

The earlier the conversion, the greater the Roth benefit of tax-free earnings.

**6. Can I convert a non-deductible IRA?**

Yes, the taxable income is the excess of the FMV at conversion over the basis (Form 8606), subject to a pro-rata rule for partial conversions.

**7. What is the pro-rata rule?**

The pro-rata rule requires that, on conversion, the taxpayer must total the fair market values of all traditional IRAs – both deductible and non-deductible. The taxpayer then divides the total basis by the total fair market value of all of the traditional IRAs to determine the percentage of the converted IRAs allocable to basis recovery. The basis recovery amount is subtracted from the converted fair market value to determine the gain from conversion. For example:

Taxpayer has a \$50,000 fair market value IRA with a basis of \$35,000 and a \$200,000 fair market value IRA with zero basis. If the taxpayer converts both, the income is \$215,000. If only \$50,000 is converted, the taxable income is \$43,000 ( $\$35,000 \div \$250,000 = 14\%$ ;  $\$50,000 \times 14\% = \$7,000$ ;  $\$50,000 - \$7,000 = \$43,000$ ), and the taxpayer has \$28,000 of basis remaining in the \$200,000 traditional IRA.

**8. If the fair market value of my traditional IRA is less than my basis in it, can I deduct a loss on conversion?**

Yes, but only if you convert all of your traditional IRAs. If all of the amounts in your traditional IRAs have been distributed to you, and the total distribution is less than your unrecovered basis (your total non-deductible contributions to your traditional IRAs), you may claim the loss as a miscellaneous itemized deduction subject to the two-percent-of-adjusted-gross-income limit (see page 42, IRS Publication 590)

**9. I have decided to make the Roth conversion in 2011. Can I avoid taxation on my 2011 required minimum distribution?**

No, the required distribution for 2011 cannot be converted to Roth. You must take that distribution, and you may then convert the balance.

**10. I currently have my IRA 50% in fixed income and 50% in equities. If I convert half of my IRA to a Roth, which half (fixed income or equities) should I site in the Roth?**

The half that you expect to have the higher rate of return (the equities) should be in a Roth IRA.

**11. If I convert my IRA to a Roth, can I reverse my conversion?**

Yes, you can recharacterize (or reverse) all or any part of a Roth IRA conversion by moving the funds back to a traditional IRA until October 15 of the year following the conversion. The recharacterization is available even if a timely return has been filed and the tax paid. Reversal is not dependent on an extension (page 30, IRS Publication 590). If the tax has been paid, a full refund with interest is available by filing an amended return.

Recharacterizations are unlimited in number. However, following a recharacterization, a taxpayer must wait at least 30 days or if longer, until the calendar year following the year of conversion to reconvert (second conversion) to Roth.

**12. What pre-tax savings can be converted?**

Traditional IRAs, deductible or non-deductible, and SIMPLE IRAs may be converted. It is possible to convert 401(k)s, 403(b)s, governmental 457 plans, profit-sharing, and money pension plans where the distributions are available under the terms of the plan. A taxpayer who inherits an IRA from a spouse can roll the IRA to the taxpayer's own IRA and then convert to Roth. Similarly, a spouse inheriting a 401(k) plan, etc. can convert. A non-spousal beneficiary inheriting an IRA or qualified plan account cannot convert the inherited IRA or plan account to a Roth IRA.

**13. I think conversion is a good idea for me except that I cannot pay all of the conversion tax without using a penalty-free distribution from my IRA. Is a partial conversion using only funds from non-IRA sources better than using some IRA funds for payment of the conversion tax?**

Yes, even with penalty-free distributions from IRAs (generally over age 59½), use of IRA funds for payment of conversion tax is generally not a good idea. It does not expand the amount of investment under the tax-free umbrella as paying the tax with outside sources does.

When IRA funds are used to pay the tax, reversal of the conversion will not recover all taxes, but only the tax on the amount transferred to the Roth IRA. For example, assume a 40% state and federal marginal tax rate on conversion:

Before Conversion

	<u>Total Resource Involved</u>	
	<u>IRA Funds</u>	<u>Non-IRA Funds</u>
	<u>Used</u>	<u>Used</u>
Cash	0	40,000
Traditional IRA Balance	<u>140,000</u>	<u>100,000</u>
Total Funds Involved	<u>140,000</u>	<u>140,000</u>

After Conversions

Income Taxes Paid		
140,000 x .40 =	56,000	
100,000 x .40 =		40,000
Roth IRA Balance	<u>84,000</u>	<u>100,000</u>
Total Funds Involved	<u>140,000</u>	<u>140,000</u>

After Recharacterization (Reversal)

Cash from Reversal Tax Refund		
84,000 x .40 =	33,600	
100,000 x .40 =		40,000
Traditional IRA	<u>84,000</u>	<u>100,000</u>
Total Taxpayer Funds	117,600	140,000
Net Taxes Paid	<u>22,400</u>	<u>0</u>
Total	<u>140,000</u>	<u>140,000</u>
Assets Removed from Tax Shelter	<u>56,000</u>	<u>0</u>

Generally a partial conversion limited to the amount of conversion tax, which can be paid from non-IRA sources, is the better choice.

**14. Should I have one or multiple Roth IRAs?**

You might consider multiple IRAs – one to hold fixed income investments, one to hold equity investments, and one to hold real estate funds. That would give you the option of recharacterizing the conversion should one of the investment choices decrease in value before October 15 of the year following conversion.

**15. Why is the Roth conversion suggested for those who will pay death taxes?**

The death tax base is decreased by the income taxes paid on the conversion with the resulting death tax savings. The death tax savings has a present value in excess of the future benefits of the income tax deduction for the estate tax on income with respect to a decedent. For example, converting \$100,000 with a 40 percent income tax rate will decrease the taxable estate by \$40,000 saving 45 percent of that, or \$18,000. Without the conversion, the estate tax will be \$18,000 more, and the heir will pay income tax on distributions partially offset by an itemized deduction of \$18,000 spread out over the IRA distribution years, usually with a significantly higher present value cost than the income tax cost of conversion (2011 and 2012 estate tax rates are 35 percent with a scheduled increase to 50 percent in 2013).

**16. For those currently not eligible for a Roth, but with a traditional IRA, profit sharing, 401(k), etc., what is a simple way to convert?**

In 2011, you might open a traditional IRA and contribute the maximum non-deductible contribution for 2011. In effect, the 2011 contribution, but for income and appreciation, will become the equivalent of a 2011 Roth contribution when you convert to Roth. You can roll over your profit-sharing distribution, 401(k) distribution, etc. to the traditional IRA before conversion or to your newly converted Roth IRA after conversion.

You can then convert the traditional IRA into a Roth IRA or IRAs by trustee-to-trustee transfer, by transfer from the traditional to a Roth IRA with the same trustee, or by roll over with an eligible distribution from the traditional IRA that is rolled over into a Roth IRA within 60 days after the distribution. Because distributions are subject to income tax withholdings, they are not generally appropriate for conversions. The better choice is usually direct transfer.

In 2012, before filing your 2011 income tax returns (could be as late as October 15, 2012), and with a better understanding of the 2011 investment performance and tax rates, you can decide to reverse the conversion (recharacterize), or to pay the conversion tax at your 2011 rates.

# ROLLOVER CHART

6/7/2011

		Roll To							
		Roth IRA	IRA (traditional)	SIMPLE IRA	SEP-IRA	457(b) (government)	Qualified Plan <sup>1</sup> (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b) <sup>2</sup> )
<b>Roll From</b>	<b>Roth IRA</b>	YES	NO	NO	NO	NO	NO	NO	NO
	<b>IRA (traditional)</b>	YES <sup>3</sup>	YES	NO	YES	YES <sup>4</sup>	YES	YES	NO
	<b>SIMPLE IRA</b>	YES, <sup>3</sup> after two years	YES, after two years	YES	YES, after two years	YES, <sup>4</sup> after two years	YES, after two years	YES, after two years	NO
	<b>SEP-IRA</b>	YES <sup>3</sup>	YES	NO	YES	YES <sup>4</sup>	YES	YES	NO
	<b>457(b) (government)</b>	YES <sup>3</sup>	YES	NO	YES	YES	YES	YES	YES, <sup>3,5</sup> after 12/31/10
	<b>Qualified Plan<sup>1</sup> (pre-tax)</b>	YES <sup>3</sup>	YES	NO	YES	YES <sup>4</sup>	YES	YES	YES, <sup>3,5</sup> after 9/27/10
	<b>403(b) (pre-tax)</b>	YES <sup>3</sup>	YES	NO	YES	YES <sup>4</sup>	YES	YES	YES, <sup>3,5</sup> after 9/27/10
	<b>Designated Roth Account (401(k), 403(b) or 457(b)<sup>2</sup>)</b>	YES	NO	NO	NO	NO	NO	NO	Yes, if a direct trustee to trustee transfer

<sup>1</sup>Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans

<sup>2</sup>Governmental 457(b) plans, after December 31, 2010

<sup>3</sup>Must include in income

<sup>4</sup>Must have separate accounts

<sup>5</sup>Must be an in-plan rollover

For more information regarding retirement plans and [rollovers](#), visit [Tax Information for Retirement Plans Community](#).