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Roth Conversion: When is it the Right Strategy?

Individual taxpayers have a unique opportunity to pay their federal income tax early with a Roth conversion. Although it breaks the most practical rule of tax planning – defer taxes as long as possible – a Roth conversion may create significant tax savings based on a taxpayer's timeline for spending retirement savings and expectation of future tax rates. Tax liability on a 2010 Roth conversion is divided equally between 2011 and 2012. Furthermore, a taxpayer who makes a Roth conversion in 2010 can reverse the tax transaction at any time before the filing deadline for the 2010 federal income tax return without incurring penalties. This Client Alert provides a framework for evaluating the cost of the accelerated income tax liability generated by a Roth conversion against the benefits of longer tax-free growth.

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How the Roth IRA Works

A Roth conversion can be made from a traditional IRA or from a rollover distribution from a qualified retirement plan. Because the retirement funds are transferred to a Roth IRA in either case, an understanding of the Roth IRA rules provides a starting point for the Roth conversion analysis.

Although contributions to a Roth IRA are not deductible, distributions of those contributions (exclusive of earnings) are not subject to federal income tax. Distributions from a Roth IRA of earnings on the contributions are not subject to federal income tax, provided that the Roth IRA is held for five years and the distribution is made after the taxpayer reaches age 59½, dies, becomes disabled or makes a first-time home purchase.[1] Generally, a 10 percent penalty applies to Roth distributions that do not qualify for tax-free treatment.

The Roth Conversion

In a Roth conversion, a taxpayer decides to convert all or part of either a traditional IRA or a rollover distribution from a qualified plan to a Roth IRA. Federal income tax is due on the Roth conversion in similar fashion to an outright distribution of these funds; state and local income taxes may be due as well. If the Roth conversion occurs in 2010, the federal income tax liability is divided between 2011 and 2012 unless the taxpayer elects otherwise. The ability to spread the tax liability over two years is available only for a Roth conversion that occurs in 2010. For example, if a Roth conversion in 2010 generates $100,000 of taxable income, the taxpayer would report $50,000 in taxable income in 2011 and $50,000 in taxable income in 2012 unless the taxpayer elects to report the entire $100,000 in 2010. Unlike the tax rules for 2009 and prior years, income tax limits and filing status limits for Roth conversions have been removed.

1 The distribution rules for a first-time home purchase require that the home be purchased by the taxpayer, spouse, descendant or ancestor who has not owned a home within the two-year period preceding the purchase of a home. There is a $10,000 lifetime limit on the distribution for a first-time home purchase.

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The required minimum distribution rules do not apply to a Roth IRA. Unlike a traditional IRA or retirement plan, there is no need to distribute a portion of the account in each year after a taxpayer reaches age 70½. Accordingly, funds can accumulate longer in the tax shelter of a Roth IRA than in traditional retirement vehicles. Withdrawals of the converted funds are made tax-free from the Roth IRA if the distribution requirements, discussed above, are met. If a taxpayer's initial Roth contribution is due to a Roth conversion, the five-year period for tax-free distributions is the first day of the taxable year in which the conversion occurs.

Factors that Favor the Roth Conversion

Several factors should be considered in determining whether a Roth conversion is appropriate. Because the factors are based on certain assumptions, there is no definitive answer for most taxpayers. Nevertheless, for some taxpayers, a Roth conversion is highly likely to save a significant amount of federal income tax. Here are the primary factors that favor making a Roth conversion:

1. **Future tax rate is expected to be higher than the current tax rate.** If a taxpayer's current income tax rate is low and is expected to be higher when retirement funds are withdrawn, an individual may benefit by having paid taxes on the Roth conversion at the lower tax rate. By way of example, some taxpayers experience periodic drops in income during employment transitions which may be an appropriate time for a Roth conversion. When an individual takes a Roth distribution in the future, taxes that would otherwise be due at the higher rates will be avoided. Unless the taxpayer elects to pay the tax on the Roth conversion in 2010, he or she should focus on income tax rates for 2011 and 2012. Federal income tax rates vary based on levels of income as well as the changes in the tax laws. With a growing deficit and a scheduled increase in the top marginal rate from 35 percent to 39.6 percent, many believe that an increase in tax rates is virtually inevitable.

    The recently enacted Patient Protection and Affordable Care Act adds a surtax of 3.8 percent on investment income to those single taxpayers whose modified adjusted gross income is above $200,000 (the threshold amount for married taxpayers is $250,000 for those filing jointly and $125,000 for those filing separately). The surtax does not apply to distributions from retirement plans, traditional IRAs or Roth IRAs. Nevertheless, the taxable income generated by the retirement plan or traditional IRA distribution will raise certain taxpayers above the threshold amounts and cause their investment income to become subject to the surtax. For those who make a Roth conversion in 2010, modified adjusted gross income in future years is more likely to fall below the surtax threshold.

2. **Ability to pay the income tax on the conversion with funds outside the IRA.** Taking funds prematurely out of a traditional IRA or retirement plan to pay the taxes on the Roth conversion will undermine the long-term tax-free growth in the Roth IRA.

3. **Retirement funds are not needed at age 70½.** Because the required minimum distribution rules do not apply to Roth IRA, savings can remain in the tax-sheltered Roth IRA throughout the taxpayer's lifetime and the lifetime of the designated

beneficiary. The longer funds can remain in a tax-sheltered vehicle, the greater the overall tax savings. Taxpayers who do not expect to begin to spend their retirement funds at age 70½ are more likely to benefit from a Roth conversion.

4. **Tax diversification is appealing.** Many individuals will have taxable income in retirement from pensions, interest and dividends. Qualifying distributions from a Roth IRA provide tax-free income. A Roth conversion allows a taxpayer to diversify income tax exposure in retirement by pre-paying the income tax now. Some taxpayers also value the greater certainty of the ultimate amount of retirement funds in a Roth vehicle because the savings are withdrawn free of federal income tax.

Lurking Risks of the Roth Conversion

1. **Market losses.** When a taxpayer pre-pays the income tax on a Roth conversion, it is expected, of course, that the amount of the distribution from the Roth IRA will exceed the amount of the conversion upon which taxes were pre-paid. As markets decline, the earnings on the Roth conversion erode in full or in part, which undermines the tax advantage. Although markets tend to recover over time, a Roth distribution just prior to an economic downturn is not as valuable for tax and financial purposes.

2. **Unexpected withdrawals.** The benefits of long-term earnings growth in the Roth IRA have been discussed above. Withdrawals of earnings that are made within the first five years of the Roth IRA are taxable, and they are subject to an additional 10 percent penalty if made before age 59½, disability, death or a first-time home purchase.

3. **Social Security and Medicare.** Although Social Security benefits are tax-free for most Americans, from 50 to 85 percent of these benefits become taxable at higher income levels. Income from a Roth conversion is counted in determining whether Social Security benefits are taxable and in establishing the rate of Medicare premiums. Conversely, because qualifying Roth IRA distributions are not taxable, the distributions do not count as income in determining the taxability of Social Security benefits or the rate of Medicare premiums. It may be advisable to make a Roth conversion before it will have an adverse impact on Social Security benefits and Medicare premiums.

4. **Declining tax rates.** Should tax rates fall for a taxpayer during a time when the Roth distributions are made, the taxpayer will not achieve the same tax advantage as expected. If rates at the time of a distribution are lower than rates at the time of conversion, income tax will have been paid both earlier and at a higher rate than necessary.

5. **Charitable IRA beneficiary.** Charitable organizations that are exempt from federal income tax will receive a greater contribution from a taxable benefit. Pre-paying the income tax with a Roth conversion is not appropriate if the ultimate party to whom the distribution is made would have no tax liability.

Other Considerations

For taxpayers who have a change of heart or circumstances, a Roth IRA conversion can be reversed in what is called a “re-characterization.” The re-characterization must be done by the due date of the income tax return for the year of conversion (with extension, October 15, 2011 for a 2010 conversion). The re-characterization is useful if there is significant market decline after the Roth conversion. Taxpayers also can re-convert to a Roth IRA at a later time. As with all tax rules, there are specific procedures and timelines to follow, but the process is manageable.

Income taxes are determined by the value of the account at the time of the Roth conversion. For this reason, taxpayers may wish to take advantage of market declines in order to lower the tax liability at conversion. State income taxes are relevant as well. A taxpayer who plans to retire in a state with no income tax should take into account the state taxes paid on a Roth conversion in his or her current domicile.

Traditional IRAs can be converted to Roth IRAs without regard to age or other types of distribution rules that are found in qualified retirement plans. However, a Roth IRA conversion can only be accomplished from a qualified retirement plan if the taxpayer is eligible for a distribution from the plan. Many qualified retirement plans do not permit distributions before separation from service. Furthermore, any amount withheld from a retirement plan for taxes is treated as a distribution, and may result in a 10 percent early withdrawal penalty.

Next Steps

Many financial websites offer on-line calculators where taxpayers can enter certain financial information and assumptions to determine whether a Roth conversion makes sense. There are many factors to consider, and it is best to model several different scenarios to paint a complete picture of the expected results. The cautious taxpayer will try a couple of on-line calculators to take advantage of the different perspectives of the various financial institutions. If the on-line tools indicate that a Roth conversion would create tax savings, personal financial analysis and legal advice can assist in making a final decision.

Summary

The power of the Roth IRA lies in the tax-free accumulation of earnings over long periods of time. A Roth conversion is a useful tool in tax planning, particularly in 2010. Not only have the income restrictions been lifted so that all taxpayers qualify, but the tax liability for a 2010 conversion is spread between 2011 and 2012. Taxpayers also have the opportunity to re-characterize their 2010 Roth conversion back to its traditional retirement form by the due date of the 2010 federal income tax return.

In the analysis of a Roth conversion, certain assumptions must be made with respect to future tax rates, market growth and cash-flow needs. The Roth conversion is more favorable for those who use financial resources outside the retirement account to pay the tax. The longer the time in which the funds can percolate tax-free in the Roth IRA, the greater the likelihood that the conversion will be the right choice. Some may find it appealing to lock in current tax rates for themselves or their heirs. Because of the complexities of these considerations and assumptions, it is best to confer with professional advisors and model several scenarios before making a decision.