Higher income taxpayers may benefit from Roth IRA conversion

Beginning in 2010, any taxpayer can convert a traditional individual retirement account (IRA) to a Roth IRA. Currently, higher income taxpayers – those with modified adjusted gross incomes greater than $100,000 – are not eligible.

For federal tax purposes, with a 2010 conversion, you can choose to spread the resulting taxable income evenly over 2011 and 2012 and thereby defer the related taxes, a one-year bonus factor, according to E.G. Schramka, CPA, J.D., ABV, PFS, a principal at SVA Certified Public Accountants.

Now is an especially good time for Roth conversions because the account values of many traditional IRAs are still depressed. While this is an excellent opportunity, 2010 is still weeks away. There may be steps you can take now to get ready, according to Schramka.

Why convert to a Roth?

Taxpayers who convert a traditional IRA into a Roth IRA can enjoy a number of tax advantages. Unlike withdrawals from traditional IRAs, qualifying Roth withdrawals are free of federal income taxes and usually state income taxes too. Generally, qualifying withdrawals involve those taken after you've had at least one Roth account open for more than five years and you reach age 59 1/2.

Roth account owners who reach age 70 1/2 don't have to take the required minimum distributions that must be withdrawn from traditional IRAs. So you can leave a Roth balance untouched for as long as you live. This makes a Roth an ideal asset to leave to heirs if you don't need the money yourself.

Converting now might make sense

Can you afford to live without taking distributions from the IRA after retirement? Will your top income tax rate be higher in future years than it is now? Is your life expectancy greater than 15 to 20 years? Will your estate have to pay estate taxes at your death? Do you have any carryovers like net operating losses or charitable contributions? If you answered "yes" to any of these questions, you're a potential candidate for converting your traditional IRA into a Roth.

Converting will trigger a current income tax bill because you're deemed to receive the converted amount in a taxable distribution from the traditional IRA. But if your traditional IRA balance is low (and possibly your overall income too), the conversion tax hit will be less.

The relatively low current tax cost for converting, combined with the chance to avoid higher future taxes on additional wealth that accumulates in your Roth account as the economy recovers, make this an ideal time to convert.

Roth Conversion Basics

If you have several traditional IRAs, you can convert some accounts and leave others alone. Similarly, you can convert only a proportion of the balances in one or more IRAs.

If you've made some nondeductible traditional IRA contributions over the years, and then convert some of your traditional IRA balances to Roth status, the deemed distribution that takes place when you convert will be partly taxable and partly tax-free. Your SVA tax adviser can handle the calculations.

The extra taxable income triggered by a conversion is added to your salary, self-employment earnings, investment income, and so forth. So if you convert a large-balance IRA, it could bump you into a higher tax bracket and make you ineligible for some tax breaks, such as the child and education tax credits and passive loss deductions from investment real estate.

To avoid this, consider converting a large traditional IRA balance (or balances) in stages over at least two years. For instance, if your 2009 modified adjusted gross income (MAGI) won't exceed $100,000, you could convert half of your traditional IRA balances this year and the other half next year (regardless of your 2010 income).

This multi-year approach can prevent the extra conversion income from pushing you into higher tax brackets and negating AGI-sensitive tax breaks. If a multi-year strategy sounds good, start this year (if possible) because the 2009 federal income tax rates are probably as good as they are going to get. That will probably still be true next year. But after 2010, all bets are off. Rates for higher-income individuals may go up, which could make the multi-year conversion strategy inadvisable. (Hopefully, you'll know your 2011 tax situation by the end of next year and will have time to plan your Roth conversion moves accordingly.)

Reverse Ill-Fated Conversions

Another great feature about Roth conversions is you can change your mind. You have until Oct. 15 of the year following the conversion year to "recharacterize" the converted account back to traditional IRA status. This amounts to reversing the earlier conversion.

Example: You decide to convert two traditional IRAs into Roth accounts in 2010 when there is no income restriction. In 2011, the values of the converted accounts decrease due to poor investment performance. You would have to pay tax on value that later disappeared. Thankfully, you have until Oct. 15, 2011, to recharacterize the converted accounts back to traditional IRAs. Afterward, it's as if the conversions never happened. So you won't owe income tax on the 2010 conversions reversed in 2011.

Preparing for 2010

So what can a higher-income person do on the Roth conversion front between now and 2010?

1. You might be able to take steps to shift taxable income from this year into next year if that's necessary to get your 2009 MAGI below $100,000. That way, you can use the multi-year strategy to convert some IRA balances into Roth accounts this year and some more next year when the income limit won't apply.

2. Start collecting the cash you'll need to pay your Roth conversion tax bill. In general, you don't want to pay the tax with money taken out of the traditional IRA that you're converting because that would mean less tax-free income accumulating in the Roth. Also, if you withdraw money from a traditional IRA before age 59 1/2 to pay the conversion tax bill, you'll generally owe the 10 percent premature withdrawal penalty tax. Bottom line: The conversion tax hit should usually be paid only with "outside money" rather than traditional IRA withdrawals. (Again, with a 2010 conversion, you'll have the option of spreading the resulting taxable income over two years and deferring the related federal taxes.)

3. Split up a large-balance traditional IRA that you intend to convert into several smaller traditional IRAs. That way, you can convert them into separate Roth accounts and follow different investment strategies for each. Then, if one of the new Roth accounts drops in value, you can avoid an inflated conversion tax bill by reversing the conversion for that account (as explained above) and leave the better-performing Roth accounts alone.

Conclusion

While a Roth conversion may be a good idea for you, there are several variables to consider. Consult with your SVA adviser as soon as possible about your situation.

SVA Wealth Management, Inc.
Registered Investment Adviser
www.svawealth.com