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Roth IRA conversions: 2010's unique opportunity

In 2010, a new tax law will permit high-income tax payers to convert IRAs into Roth IRAs, providing a potentially powerful new tax-planning option that should be considered in your overall financial strategy.

A sound financial strategy encompasses the key elements that contribute to your overall financial health, including tax planning, insurance, portfolio management and investment planning. This strategy should be reviewed on a periodic basis to take into account any changes in market conditions or your own situation. One such change occurs this year: As a result of the Tax Increase Prevention and Reconciliation Act of 2005, high-income taxpayers now have, for the first time, the option to rollover traditional IRA accounts into Roth IRAs.

What is the difference between a traditional IRA and a Roth IRA?

An IRA (Individual Retirement Account) provides an investor with a tax-deferred or tax-free method for retirement savings. While there are many types of IRAs available, the most common are the traditional and Roth IRAs; the main difference between the two is whether your contributions are pre-tax or post-tax and whether you have a minimum distribution requirement. Both tools are used to house stocks, bonds, mutual funds and other assets owned by the account holder and allow these investments to accumulate in a tax-advantaged manner.

Under a traditional IRA, the account is created and the account holder may receive an upfront tax deduction upon contribution. The account holder only pays taxes when funds are withdrawn. The account holder of the traditional IRA is subject to minimum distribution requirements: You can begin withdrawing funds at age 59½ without penalty for early withdrawal but are required to take distributions at age 70½.

With a Roth IRA, you contribute after-tax dollars, but the income and growth are not subject to tax when removed, provided the distribution satisfies a five-year holding period and takes place after age 59½ (with the exception of death, disability or the need to meet first-time homebuyer expenses). The required minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs, which means the account can continue to grow tax-free after age 70½.

Both traditional and Roth IRAs have annual contribution limits; you could contribute up to $5,000 to both vehicles in 2009 (with a $1,000 catch-up contribution allowed for individuals over 50). The Roth IRA has income limits to determine whether you are eligible to contribute, and those limits may not allow any of the $5,000 to be contributed. Although there are no income limits for traditional IRA contributions, if you are participating in another retirement plan, income does determine how much of your contribution is deductible. A Roth contribution is never deductible; it is made with after-tax dollars.

What is changing in 2010?

High-income taxpayers (defined as single people with an adjusted gross income over $120,000 and married people with an adjusted gross income over $176,000) are not currently permitted to establish and contribute to Roth IRAs. Prior to 2010, taxpayers with an adjusted gross income greater than $100,000 were not allowed to convert existing traditional IRAs into Roth IRAs at all. While high-income taxpayers will still not be permitted to make annual contributions to a Roth IRA, starting this year, they will have the option to convert traditional IRAs to Roth IRAs. "Many high-income taxpayers have large IRA balances, particularly if they have established an IRA rollover account to defer taxation of qualified retirement plan distributions. It's just one reason why this is an exciting tax planning opportunity and one that can have a profound impact on financial planning," said Scott Torgan, principal, PricewaterhouseCoopers Personal Financial Services.

Benefits of converting to a Roth IRA

"The Roth IRA is a great asset to leave to children or grandchildren since it has no built-in tax liability associated with it," said Torgan. "The longer you can keep from using the funds in the account, the more powerful this investment tool becomes."

The tax-free accumulation of income in a Roth IRA is particularly attractive for younger taxpayers, as sheltering years of earnings in this manner can lead to enormous compounding. The Roth IRA account holder does have to meet the five-year waiting period in order to make penalty-free withdrawals. Beyond that point, however, the Roth IRA, given its lack of distribution requirements, has additional flexibility for withdrawing funds when compared to a traditional IRA. Since one does not have to begin taking distributions at age 70½ with the Roth IRA, the asset can continue to grow tax-free. For those individuals who have other assets to draw on during retirement, this tax-free compounding is even more attractive.

Another benefit of the Roth IRA conversion is a special incentive in 2010, where you can elect to pay the income tax associated with the conversion over two years, in 2011 and 2012. (Normally, the tax related to a Roth conversion must be paid on the tax return for the year of the conversion.) But the taxpayer needs to be cautious when taking advantage of this short-term tax deferral: If you are subject to higher tax rates in 2011 and 2012, which would be the case as tax rates increase, there will be a direct cost to delaying the tax payment.

Traditional vs. Roth IRA comparison

Traditional IRA

- Method for housing stocks, bonds, mutual funds and other assets owned by the account holder for retirement savings
- Funds within the account grow tax free
- Minimum distribution requirements start at 59½ and are mandatory at 70½
- No income restrictions for contribution amounts
- Contribute pre-tax money, taxes are paid when funds are withdrawn

Roth IRA

- Method for housing stocks, bonds, mutual funds and other assets owned by the account holder for retirement savings
- Funds within the account grow tax free
- No minimum distribution requirements
- Income limits affect contribution amounts
- Contribute after-tax money, no taxes on funds when withdrawn

What should I consider when converting to a Roth IRA?

The process of converting from a traditional IRA to a Roth IRA is fairly straightforward—much like the process for an IRA rollover—but the manner in which the account(s) is set up can impact the overall effectiveness of the Roth IRA.

Because you must pay income tax on the taxable portion of an IRA upon conversion, the first step is to determine how you will pay these taxes. You can pay them upfront or take advantage of the opportunity to pay in installments. Although this can be a significant tax cost, remember: Once the IRA becomes a Roth IRA, all income and future appreciation have the potential to grow tax-free. Given recent market declines in retirement accounts, a conversion to a Roth IRA early in 2010 may be much less costly than it would have been in the past when IRA values were higher.

"Another consideration is the rising tax rate," said Torgan. "In 2010, the top federal tax rate will be 35 percent. However, the rate is going

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up in 2011 to 39.6 percent and may even go higher. Therefore, it may be prudent to pay the taxes now, rather than later."

Another tax consideration is the state income tax rate where the account holder lives. If you live in a high-tax rate state and are planning to move to one with a low tax rate, you need to consider the state tax laws and income tax rate to determine if moving would be beneficial.

"Ideally you want the funds you'll use to pay the taxes on your Roth IRA conversion to come from another source, rather than creating a distribution from your IRA," said Torgan. "As it is in your best interest to keep as much value in your Roth IRA as possible, effective planning for the tax-conversion cost is a planning step that should not be overlooked."

As part of this process, consider the beneficiary designation, and update it, if necessary. To extend the tax-deferred compounding, it may be wise to make your spouse the beneficiary and have your spouse designate your children as the ultimate beneficiaries. In this case, the Roth IRA remains part of your taxable estate, but any income tax is avoided.

You also have the option to revert to the traditional IRA (or "recharacterize" your conversion) up until the due date, plus extensions, of the return for the tax year when the conversion was done (i.e., through April 15 or October 15 of the year following the conversion). "For example, let's say you convert to a Roth IRA on January, 1, 2010 by transferring $1 million in assets from your traditional IRA to the new Roth IRA. In early April of the following yearbefore you file your return—the value of the asset goes down to $900,000. You can elect to undo the Roth before paying your conversion taxes, thereby avoiding the tax on the $100,000," said Torgan.

When converting your traditional IRA to a Roth IRA, you may also want to consider setting up multiple Roth IRA accounts and separating them into different asset classes. For example, you might create one Roth IRA for bonds, one for emerging market equities and one for US equities. The benefit of this strategy is that if one asset class performs poorly, you can "recharacterize" so you are not paying tax on an asset that has decreased in value subsequent to the conversion. If all of the asset classes were commingled, you would not be able to isolate and remove the depressed asset class, and the entire account would be treated as one asset. This approach enables you to take advantage of the different rates of growth within the various asset classes.

"As always, it is important to step back and make sure this is the right option for your specific needs, consistent with your own financial plan," said Torgan. "Paying the taxes upfront is counter to how we typically approach savings, and if you convert to a Roth IRA with the intention of withdrawing the funds in the short-term, this is probably not the best investment tool for you." Because the circumstances surrounding each individual's decision to convert to a Roth IRA will vary, working with a financial advisor can be helpful in navigating the variables of the conversion.

Want to know more about Roth IRA conversions? Please contact:

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