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It's the Law

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To Convert or Not to Convert: Independent Retirement Accounts

When Roth IRA's were introduced in 1997, they provided an alternative to the Traditional IRA for retirement savings. With Traditional IRA's, the amounts contributed to the account are tax deductible in the year of the contribution and income tax is only paid on the distributions from the account after retirement. Contributions to Roth IRA's, on the other hand, are not tax deductible but all income earned on the funds in the account and all distributions taken after retirement are tax free. Roth IRA's also do not have minimum distribution requirements.

The IRS has allowed owners of Traditional IRA's to convert them to Roth IRA's, provided the owner pays the income tax on the amount being converted. Prior to this year, however, the ability to convert was restricted to those individuals whose modified adjusted gross income ("MAGI") was no greater than $100,000. Beginning January 1st, the $100,000 MAGI limitation disappeared and now anyone, regardless of their income level, can convert their Traditional IRA to a Roth. In addition, although the income tax on the converted funds still have to be paid, for conversions made in 2010 the IRS will allow the account owner to pay half of the income tax due on the converted amount in 2011 and the other half in 2012. This ability to spread the tax burden on conversions over a two year period only applies to 2010. Starting next year, the entire tax due will have to be paid in the year the conversion is made.

You may be thinking, what is the benefit of converting a Traditional IRA to a Roth if you have to pay the income tax on the entire amount converted anyway. Well, there is a potential tax savings for individuals who are either 1) currently in a low income tax bracket and expect to be in a higher tax bracket when they retire, or 2) expecting the funds in their IRA to significantly increase in value between now and the time they retire, or 3) expecting tax rates in the United States to rise between now and the time they retire. Those who are certain that scenario 1, 2 or 3 will occur may benefit by converting because the taxes they pay now on the converted amount should be less than what the total taxes due on distributions from a Traditional IRA would be at retirement if they had not converted. In order to take full advantage of this potential savings the converter should have sufficient funds available, outside of the converted amount, to pay the tax due. Since none of us have the ability to predict the future with 100% certainty, there are some risks involved in deciding to convert and it is important to speak to a qualified investment advisor before taking any action.

There is also a possible estate planning opportunity created by the elimination of the $100,000 MAGI limitation on conversions. Since Roth IRA's have no minimum distribution requirement, individuals can convert their Traditional IRA to a Roth, pay the income tax due on the converted amount, and then, instead of taking distributions after retirement, let the saving accumulate over the remainder of their life. Upon the death of the owner of the Roth IRA, the account will pass tax free to the designated beneficiary of the account. The elimination of the $100,000 MAGI restriction has allowed wealthier individuals to take use this estate planning technique.