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Higher taxes would make Roth IRA conversion worth look

$100,000 income limit due to expire in 2010, letting anyone convert

By Dennis Roginski
SPECIAL TO THE JOURNAL OF BUSINESS

David Gergen, senior political analyst and former adviser to Presidents Nixon, Ford, Reagan, and Clinton, has predicted higher taxes, saying, "There's going to be upward pressure on corporate taxes. There's going to be upward pressure on capital-gains taxes and possibly on dividend taxes, because there's a lot to pay for."

Dennis Roginski

With the amount of money the federal government is spending, do you think higher taxes are coming? Do you agree with how President Obama is dealing with the economic crisis? No matter what political views you have, the possibility taxes could be going up might make this a good time to convert a traditional individual retirement account (IRA) to a Roth IRA.

Even if you have been laid off, have changed jobs, or are retired, your retirement plan from your former job, such as your 401(k) or your 403(b) account, could qualify for a Roth IRA conversion. If you're still employed and are allowed to take a distribution from your 401(k) or 403(b) plan, those funds might be eligible for a Roth IRA conversion. Check to see if your plan allows in-service distributions.

The tax implications of a traditional IRA are such that if you withdraw money from one, you'd need to pay taxes at your ordinary income-tax rate. Plus, once you turn 70 ½ years old, you're required to start withdrawing money (this is called required minimum distributions, or RMDs) from a traditional IRA and will lose the opportunity to allow those funds to continue to grow tax deferred. In many situations, most RMDs cannot be reinvested back into an IRA; the amount withdrawn, minus what you pay in taxes, usually would be reinvested into a taxable account, and any earnings would be taxed at your ordinary income-tax rate.

If you think higher taxes are coming, there is an alternative: converting your traditional IRA to a Roth IRA, while tax rates still are low relative to what they might be in the future. One of the advantages of a Roth IRA is that you can make withdrawals from it tax free as long as you've had the account for at least five years and are at least 59 ½ years old. Also, unlike with traditional IRAs, you aren't required to make withdrawals from a Roth IRA when you turn 70 ½ years old, and since withdrawals aren't required, you could continue your legacy by leaving your Roth IRA to your children or grandchildren.

This year might be a good time to convert just because tax rates could rise later, but you might realize more benefit if you wait until 2010 to do so. Prior to 2010, a taxpayer's modified adjusted gross income (MAGI)—basically, all income with a few adjustments—has had to be less than $100,000 for the taxpayer to qualify for a Roth IRA conversion. In 2010, there no longer will be a limit on MAGI, so anyone can convert regardless of their income level.

Also, you would be able to pay your taxes on the conversion over the tax years 2011 and 2012. This is a great benefit, because the first tax payment wouldn't be due until the 2011 due date, which normally would be April 15, 2012. The final payment wouldn't be due until April 15, 2013. For example, if you convert a $100,000 traditional IRA to a Roth IRA in 2010 and are in the 20 percent tax bracket that year, you will owe $20,000 in taxes. The first payment of $10,000 wouldn't be due until April 15, 2012, and the balance of $10,000 wouldn't be due until that date the following year. Split payments and a significant delay on the first payment—more than 27 months from Jan. 1, 2010—are good incentives for a conversion.

> You might realize more benefits by waiting until next year, when adjusted gross income limits go away.

It's best that you don't use money from your traditional IRA to pay your tax bill. Removing money from your IRA to pay taxes will reduce the amount in your newly formed Roth IRA, thus leaving you less money to grow tax free. In the example above, instead of $100,000 in your Roth IRA, only $80,000 would still invested and available to grow if you used part of the money from your traditional IRA to pay your tax obligation. Also, if you're younger than 59 ½ years old, you could be subject to the 10 percent early-withdrawal penalty on the $20,000.

You believe taxes will be higher in the future, and you want to convert to the Roth IRA, but what if the $20,000 tax bill is more than you can pay? In such a case, it's not necessary to convert your entire $100,000 in one year. You can convert $25,000 in one year, $25,000 in the next, and so on. This strategy would allow you to spread out your tax bill.

Are you nervous about the stock market, and do you think it will be years before we see growth in the economy? Are you fearful that stocks might take another plunge? If this were to happen, why should you pay $20,000 in taxes on a conversion only to watch your Roth IRA drop in value to $60,000, making your effective tax rate 33 percent ($20,000 divided by $60,000).

Here is a strategy: Convert your traditional IRA into multiple Roth IRAs based on asset classes. For instance, if you have a portfolio of $40,000 in stocks, $40,000 in fixed income, and $20,000 in U.S. Treasuries, you can convert your traditional IRA into three separate Roth IRAs—one for stocks, one for a fixed-income investment, and one for U.S. Treasuries.

Now, let's assume the stock market does take a plunge. Simply stated, you can reconvert, or take back, your Roth IRA conversion. This means that if your Roth IRA for stocks drops in value from $40,000 to, say, $20,000, you can go back to the traditional IRA from the Roth IRA and get a refund on the taxes you paid on the equity portion of the conversion. These strategies aren't as complex as they sound, but it's important, before you do a conversion, to talk to a financial adviser who understands them and knows the IRS regulations for conversions.

IRS laws are complicated. A simple mistake can be very costly and normally is irrevocable. Still, a Roth IRA conversion might be the right strategy for you.

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