



## **Roth conversion – what you need to know**

In 2010 the \$100,000 income threshold lifts for ROTH conversions, but the rules surrounding Roth IRAs are complicated with serious tax and income implications for the unschooled.

First, have you ever wondered why Congress created this random rule allowing high-income individuals to convert to a Roth beginning in 2010? Turns out it was a bit of budget sleight of hand. Congress wanted to keep the cost of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) under \$70 billion during the 10-year budget window in order to prevent a point of order or filibuster that would have required 60 votes to override. So, as a revenue offset, Congress inserted the provision allowing high-income taxpayers to convert to a Roth beginning in 2010. Anticipated tax revenues: \$6.4 billion.

In the long run, this \$6.4 billion windfall will cost the government \$14 billion in future tax revenues in present-value terms, according to an analysis by the Tax Policy Center. So there you have it, your general justification for doing Roth conversions. In the aggregate, Americans will spend \$6.4 billion to save \$14 billion. Fine by me, the government's loss is your gain.

One of the most underappreciated benefits of Roth IRAs is that there are no minimum distribution requirements during the Roth holder's lifetime. People who have not yet reached age 70½ may not fully understand the power of this benefit. But when they start having to pay taxes on income they don't need, they may wish they had converted to a Roth earlier, when the account was smaller and the taxes were lower.

People are living longer today. 70 is the new 50. Baby boomers who plan to work past age 70 will not only want to take RMDs, they may want to keep contributing to an IRA so that when they finally do retire, they'll be set for life. Converting to a Roth IRA eliminates the need to take unwanted taxable distributions and allows the account to grow tax free well into your 70s, 80s, or 90s.

When you factor in the various stealth taxes and means testing that high-income retirees are subject to, the value of tax-free income is even greater than a straight tax-bracket comparison would indicate.

### **The special rules for 2010**

As I noted earlier, anyone may convert a traditional IRA to a Roth beginning in 2010. The \$100,000 income limitation does not apply. As an additional enticement, the income is reported over two years, beginning with the 2011 tax year. So a conversion in 2010 would be required to only report half the income on your 2011 return (paying the taxes by April 15, 2012) and the second half on your 2012 return (paying the taxes by April 15, 2013). The conversion itself would be reported in 2010 using Form 8606, but none of the income is reported for that year unless you opt out of this special rule.

### **Timing the conversion**

The best time to convert to a Roth is when the account is down in value. That's because taxes are based on the value of the account at the time of conversion. I recommend converting early in the year, for two reasons. First, the taxes aren't due for a full 15 months after the conversion—or in the case of the special rule for 2010, 27 months. And second, converting early in the year offers a longer opportunity to undo it if investments perform poorly afterward. The deadline for re-characterizing a Roth conversion is October 15 of the year after the conversion. For example, a conversion done in January 2010 offers 21 months of hindsight—until October 15, 2011. If the account dips in value, you may want to take advantage of the Roth "oops" rule and "un-do" the conversion.

## Partial conversions

It is perfectly acceptable to convert part of the account. People who want to hedge their tax bets in retirement may prefer to hold assets in both traditional and Roth IRAs. A partial conversion reduces the tax hit now and hedges against the possibility that the conversion was a mistake that won't be recognized until it's too late to re-characterize (for example, if you end up being in a much lower tax bracket in retirement). A partial conversion also leaves the door open to converting the remaining amount should the account fall in value or should other circumstances change.

The important thing to know about partial conversions is that if any part of the account is made up of nondeductible contributions, you can't cherry-pick the nontaxable part. Rather, the converted amount must maintain the same ratio of taxable and nontaxable contributions as found in all the person's IRAs in the aggregate, including traditional, SEP, and SIMPLE IRAs. For example, if all IRAs are worth \$100,000, and \$25,000 is made up of after-tax contributions, 25% of any amount converted—regardless of which account it is taken from—will be considered nontaxable.

## Converting a 401(k) or 403(b) to a Roth IRA

Assets in 401(k) and 403(b) plans may now be converted directly to a Roth IRA without stopping for a traditional IRA rollover first. The assets must be available for distribution, which means old 401(k)s from former jobs are the most likely pool of assets to tap. You can arrange an in-service non-hardship withdrawal that may be able to convert 401(k) assets from their present job. The rules for converting 401(k) and 403(b) assets are different than for IRAs. Each account stands on its own for the purpose of determining the nontaxable portion. So if you have multiple 401(k) accounts with several former employers and want to convert just one account, the proportion of taxable to nontaxable money will be whatever it is for that account without regard for the others.

The rule against cherry-picking still applies to that one account, however. So if someone has \$100,000 in a 401(k), and \$20,000 of it is after-tax money, they can't direct only the \$20,000 to a Roth for a nontaxable conversion. If you convert any portion of the account, 80% will be taxable and 20% will be nontaxable. However, there is a way to get around this rule. If you want to convert only the nontaxable portion of a 401(k) in order not to pay taxes on the conversion, here is what you have to do:

1. Request a withdrawal of the entire balance (important).
2. Within 60 days, put an amount equal to the pretax dollars (\$80,000 in the example above) into a traditional IRA.
3. Then put an amount equal to the after-tax dollars (\$20,000 in the example) into a Roth IRA. Make sure all is done within 60 days.

I hope this helps you understand the nuances of ROTH conversions. As retirement planning specialists, we are dedicated to staying on top of the confusing and ever-changing rules for our clients. If you would like more information or to talk with a specialist, just give us a call.

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