

Financial Planning Matters: Roth IRA Conversions

Should I convert my IRA from a traditional IRA to a Roth IRA in 2010?

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Starting in 2010, individuals with any amount of income can switch a traditional IRA to a Roth IRA. Conversions are fully taxable at your regular federal tax rate. For conversions in 2010, taxpayers can spread the tax due over two years. One-half of the tax will be due by April 15th, 2011, on your 2010 tax bill and the remaining one-half will be payable in 2012, on your 2011 tax bill.

There is no simple answer to the question – Should I convert or should I leave my traditional IRA alone?

Whether you convert your IRA from a traditional IRA to a Roth IRA depends on three things:

1. Your belief in what federal tax rates will be when you take money out of your IRA. If congress does nothing in 2010, tax rates will be higher in 2011 than in 2010. Converting your traditional taxable IRA to a Roth IRA in 2010 may make sense, but it may not be a great idea to spread the taxes over into 2011 when tax rates are higher.
2. The source of funds to pay the taxes on the conversion. If you have to take funds out of the traditional IRA to pay the federal income taxes, then it is likely that a conversion does not make sense. If you have funds sitting outside of your IRA in a money market account earning .025%, then the case for conversion becomes stronger.
3. You have a deductible or non-deductible traditional IRA. If you have been making non-deductible IRA contributions, then you may want to strongly consider a conversion to a Roth IRA. You'll pay taxes on the earnings that have accumulated in the IRA, but the non-deductible portion is not taxable. If you made both deductible and non-deductible contributions, then you will need to convert both deductible and non-deductible amounts on a pro-rata basis.

Here is additional information you need to know. Beginning in 2011, the higher federal tax rates that were in effect prior to 2001 will return. The top income tax rate goes back to 39.6 percent (from 35 percent in 2010). The special low 10 percent bracket is eliminated and the lowest tax rate reverts to 15 percent for 2011. If Congress does nothing in 2010, income taxes on all individual tax payers will effectively rise by at least 14 percent for high income earners and up to 50 percent for average income earners. Here's how.

Joint filers with adjusted gross income (AGI is the amount of taxable income after adjustments) of \$40,000 in 2010 will pay taxes at the 10% tax rate, but in 2011 will be in a 15% federal tax rate. At a 10% tax rate they will pay \$4,000 in federal income taxes. At the 15% rate the same \$40,000 of AGI will result in taxes of \$6,000. That's a 50% increase in federal income taxes - \$4,000 in 2010 versus \$6,000 in 2011.

The percentage of tax increase isn't as dramatic for the highest income earners. A married couple with AGI of \$300,000 in 2010 will pay federal income taxes at a 35% rate or \$105,000 in taxes. In 2011, \$300,000 of income will result in \$118,800 of federal income taxes. That's a 14% increase in taxes - \$105,000 in 2010 versus \$118,800 in 2011.

If you believe taxes will go up significantly in the future and you have cash available outside of the IRA to pay the taxes in 2010, then a Roth Conversion may be right for you. Roth Conversions have been available since 1998, but only 3% of traditional taxable IRAs have converted to Roth IRAs. The elimination of the maximum income limitation and the ability to spread the taxes over a 2-year period may be the incentive higher income earners need to make a Roth conversion and pay the taxes.

Be sure to consult a tax professional who will consider multiple scenarios before making a decision for or against a Roth Conversion.