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Roth IRA Conversions--Planning for New Opportunities

With the lure of tax-free distributions, Roth IRAs have become popular retirement savings vehicles since their introduction in 1998. But if you're a high-income taxpayer, chances are you haven't been able to participate in the Roth revolution. Well, that's about to change.

What are the current rules?

There are currently three ways to fund a Roth IRA--you can contribute directly, you can convert all or part of a traditional IRA to a Roth IRA, or you can roll funds over from an eligible employer retirement plan (more on this third method later).

In general, you can contribute up to $5,000 to an IRA (traditional, Roth, or a combination of both) in 2008 and 2009. If you're age 50 or older, you can contribute up to $6,000 in 2008 and 2009. (Note, though, that your contributions can't exceed your earned income for the year.)

But your ability to contribute directly to a Roth IRA depends on your income level ("modified adjusted gross income," or MAGI), as shown in the chart below:

If your federal filing status is:	Your 2009 Roth IRA contribution is reduced if your MAGI is:	You can't contribute to a Roth IRA for 2009 if your MAGI is:
Single or head of household	More than $105,000 but less than $120,000	$120,000 or more
Married filing jointly or qualifying widow(er)	More than $166,000 but less than $176,000	$176,000 or more
Married filing separately	More than $0 but less than $10,000	$10,000 or more

Regardless of whether you contribute directly to a Roth IRA, if your MAGI is $100,000 or less, and you're single or married filing jointly, you can convert an existing traditional IRA to a Roth IRA. (You'll have to pay income tax on the taxable portion of your traditional IRA at the time of conversion.) But if you're married filing separately, or your MAGI exceeds $100,000, you aren't allowed to convert a traditional IRA to a Roth IRA.

What's changing?

In 2006, President Bush signed the Tax Increase Prevention and Reconciliation Act (TIPRA) into law. TIPRA repeals the $100,000 income limit for conversions, and also allows conversions by taxpayers who are married filing separately. What this means is that, regardless of your filing status or how much you earn, you'll be able to convert a traditional IRA to a Roth IRA. The bad news? This provision of the new law doesn't take effect until 2010.

So why concern yourself with this now?

Even though the new rules don't take effect until 2010, there are steps you can take now if you want to maximize the amount you can convert at that time. If you aren't doing so already, you can simply start making the maximum annual contribution to a traditional IRA, and then convert that traditional IRA to a Roth in 2010.

Your ability to make deductible contributions to a traditional IRA may be limited if you (or your spouse) is covered by an employer retirement plan and your income exceeds certain limits. But any taxpayer, regardless of income level or retirement plan participation, can make nondeductible contributions to a traditional IRA until age 70½. And because nondeductible contributions aren't subject to income tax when you convert your traditional IRA to a Roth IRA, they make sense for taxpayers contemplating a 2010 conversion even if they're eligible to make deductible contributions.

And don't forget that SEP IRAs and SIMPLE IRAs (after two years of participation) can also be converted to Roth IRAs. You may want to consider maximizing your contributions to these IRAs now, and then converting them to Roth IRAs in 2010. (You'll need to set up a new IRA to receive any additional SEP or SIMPLE contributions after you convert.)

But there's a taxing problem

If you've made only nondeductible contributions to your traditional IRA, then only the earnings, and not your own contributions, will be subject to tax at the time you convert the IRA to a Roth. But if you've made both deductible and nondeductible IRA contributions to your traditional IRA, and you don't plan on converting the entire amount, things can get complicated.

That's because under IRS rules, you can't just convert the nondeductible contributions to a Roth and avoid paying tax at conversion. Instead, the amount you convert is deemed to consist of a pro-rata portion of the taxable and nontaxable dollars in the IRA.

For example, assume that in 2010 your traditional IRA contains $350,000 of taxable (deductible) contributions, $100,000 of taxable earnings, and $50,000 of nontaxable (nondeductible) contributions. You can't convert only the $50,000 nondeductible (nontaxable) contributions to a Roth. Instead, you'll need to prorate the taxable and nontaxable portions of the account. So in the example above, 90% ($450,000/ $500,000) of each distribution from the IRA in 2010 (including any conversion) will be taxable, and 10% will be nontaxable.

You can't escape this result by using separate IRAs. The IRS makes you aggregate all your traditional IRAs (including SEPs and SIMPLEs) when calculating the taxes due whenever you take a distribution from (or convert) any of the IRAs.

But for every glitch, there's a potential workaround. In this case, one way to avoid the prorating requirement, and to ensure you convert only nontaxable dollars, is to first roll over all of your taxable IRA money (that is, your deductible contributions and earnings) to an employer retirement plan like a 401(k) (assuming you have access to an employer plan that accepts rollovers). This will leave only the nontaxable money in your traditional IRA, which you can then convert to a Roth IRA tax free. (You can leave the taxable IRA money in the employer plan, or roll it back over to an IRA at a later date.)

But even if you have to pay tax at conversion, TIPRA contains more good news--if you make a conversion in 2010, you'll be able to report half the income from the conversion on your 2011 tax return and the other half on your 2012 return.

For example, if your only traditional IRA contains $250,000 of taxable dollars (your deductible contributions and earnings) and $175,000 of nontaxable dollars (your nondeductible contributions), and you convert the entire amount to a Roth IRA in 2010, you'll report half of the income ($125,000) in 2011, and the other half ($125,000) in 2012.

And speaking of employer retirement plans...

Before 2008, you couldn't roll funds over from a 401(k) or other eligible employer plan directly to a Roth IRA unless the dollars came from a Roth 401(k) account or a Roth 403(b) account. In order to get a distribution of non-Roth dollars from your employer plan into a Roth IRA you needed to first roll the funds over to a traditional IRA and then (if you met the income limits and other requirements) convert the traditional IRA to a Roth IRA. And, as described earlier, you needed to aggregate all your traditional IRAs to determine how much income tax you owed when you converted the traditional IRA.

The Pension Protection Act of 2006 streamlined this process. Now, you can simply roll over a distribution of non-Roth dollars from a 401(k) or other eligible plan directly (or indirectly in a 60-day rollover) to a Roth IRA. You'll still need to meet the $100,000 income limit for 2008 and 2009. And you'll still need to pay income tax on any taxable dollars rolled over.

One benefit of this new procedure is that you can avoid the proration rule, since you're not converting a traditional IRA to a Roth IRA. This can be helpful if you have nontaxable money in the employer plan and your goal is to minimize the taxes you'll pay when you convert.

For example, assume you receive a $100,000 distribution from your 401(k) plan, and $40,000 is nontaxable because you've made after-tax contributions. You can roll the $60,000 over tax free to a traditional IRA, and then roll the after-tax balance ($40,000) over to a Roth IRA. Since only after-tax dollars are contributed to the Roth IRA, this rollover is also tax free. (Both your plan's terms and the order in which you make the rollovers may be important, so be sure to consult a qualified professional.)

Is a Roth conversion right for you?

The answer to this question depends on many factors, including your income tax rate, the length of time you can leave the funds in the Roth IRA without taking withdrawals, your state's tax laws, and how you'll pay the income taxes due at the time of the conversion. And don't forget--if you make a Roth conversion and it turns out not to be advantageous, IRS rules allow you to "undo" the conversion (within certain time limits).

A financial professional can help you decide whether a Roth conversion is right for you, and help you plan for this exciting new retirement savings opportunity.