

## **Roth Conversion FAQ**

### **What is a Roth Conversion?**

A Roth Conversion is an election made by an individual to convert a portion or all of their Tax-Deferred (Traditional) IRA into a Roth IRA.

### **What are the advantages of converting a Tax-Deferred IRA into a Roth IRA?**

Investments in a Roth IRA grow tax-free and are not taxable when distributed at retirement. In essence, an individual pays the tax up-front but does not pay tax on it ever again. In addition, a Roth IRA is not subject to required minimum distributions at age 70 ½ allowing the retiree greater flexibility in their income distribution.

### **Is the Roth Conversion a new rule?**

No. The Roth Conversion has been permitted for a number of years. However, prior to 2010 there were income limits for determining who was eligible to elect a Roth Conversion.

### **What is different about 2010?**

Beginning in 2010, there are no income limits for determining who is eligible to elect a Roth Conversion. This change opens up an opportunity for individuals to elect a Roth Conversion who may have been excluded previously due to their higher income.

### **What are the tax implications of a Roth Conversion?**

The tax-deferred amount that is converted to a Roth IRA is fully taxable and is reported as income. For example, if an individual converts \$50,000 of their Tax-Deferred IRA into a Roth IRA then the \$50,000 is considered additional taxable income.

### **How is the income from a Roth Conversion reported on my tax return?**

The taxable amount of the Roth Conversion is reported on a 1099-R by your account administrator. For example, if an individual converts \$50,000 of their Tax-Deferred IRA into a Roth IRA then the \$50,000 is reported on a 1099-R and sent to the individual to be included on their tax return.

### **What is the special tax-reporting rule for 2010?**

Normally, a Roth Conversion is reportable and taxable for the calendar year it is elected. However, there is a special exception in 2010. For Roth Conversions that take place in 2010 an individual can choose to report 100% of taxable income in 2010 or report 50% in 2011 and 50% in 2012.

For example, if an individual converts \$50,000 of their Tax-Deferred IRA into a Roth IRA on December 20<sup>th</sup>, 2010 the full \$50,000 is considered additional taxable income. However, because the conversion occurred in 2010 the individual can choose to report \$50,000 on their 2010 tax return or else report \$25,000 on their 2011 tax return and \$25,000 on their 2012 tax return.

### **Why would Congress allow an individual the option to split the taxable income in 2011 and 2012?**

While there remains some uncertainty about what the final tax rates will look like in 2011 and 2012, the current favorable marginal tax rates are set to expire at the end of 2010. An individual that elects to split their Roth Conversion income between 2011 and 2012 will likely be paying a higher marginal tax rate on that income.

### **If I elect a Roth Conversion, is the entire IRA subject to the conversion?**

No. Each individual can decide what amounts to convert and which specific accounts to convert.

### **Is a Roth Conversion a good option for everyone?**

Not necessarily. A fundamental consideration is what the marginal tax rates may be for an individual at retirement age compared with their current marginal tax rates. If an individual believes they will be in a lower marginal tax rate at retirement then it may be advantageous to continue to defer paying the tax until retirement.

A Roth Conversion is generally not recommended for an individual who does not have outside resources to pay the tax bill from the Roth Conversion. Paying the tax bill by using funds from within the IRA can result in additional taxes and penalties and usually negates the benefits of the Roth Conversion.

In addition, be aware that a Roth Conversion is reported as taxable income and usually results in a subsequent increase to the taxpayers Adjusted Gross Income (AGI). It is important to consider the ancillary impact of a having a higher AGI such as the bump-up into a higher marginal tax rate, phase-out of certain tax-adjustments and itemized deductions, as well as eligibility for college financial aid.

### **What if I change my mind after electing a Roth Conversion?**

It is possible for an individual to reverse, or "*Recharacterize*", a Roth Conversion after it has occurred. An individual can Recharacterize a Roth Conversion as late as October 15<sup>th</sup> of the year following the Roth Conversion (with a filing extension). The funds revert back to a Tax-Deferred IRA status.

A Recharacterization may be especially favorable if the investments decrease in value following the initial Roth Conversion. For example, if an individual elects a Roth Conversion when the investments are worth \$50,000 then they must report \$50,000 as additional taxable income. However, if the value of the investment falls to \$35,000 then the individual faces the prospect of paying taxes on \$50,000 though the value has dropped to \$35,000. By Recharacterizing the Roth Conversion an individual can undo the Roth IRA and the obligation to pay tax on the \$50,000.

### **For more information:**

[http://www.irs.gov/pub/irs-tege/forum10\\_roth\\_conversions.pdf](http://www.irs.gov/pub/irs-tege/forum10_roth_conversions.pdf)