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Effects of Paying the Tax on a Roth Conversion from IRA Funds

The tax on a Roth conversion may be paid either from other funds or from the IRA funds being converted. However, if the taxpayer chooses to pay from the IRA funds, those funds will not be considered part of the rollover. Therefore, they will be subject to early withdrawal penalties if you are under 59½ at the time of the withdrawal.

Payment of the tax from the IRA funds can severely limit the benefit of a conversion to a Roth by eroding the capital that can be invested. For example, in a conversion of a $50,000 IRA to a Roth and paying the tax from the conventional withdrawal, only $29,429 (amount left in the IRA after paying taxes and penalties) actually would get invested in the Roth account. The result, shown below in after-tax dollars, assumes a 6% interest rate and an accumulation period of 25 years.

Years Of Accumulation	Roth (Tax-Free)	Conventional (After Tax)
Rollover Amount	29,429	50,000
5	68,000	74,660
10	91,900	99,920
15	122,980	133,720
20	164,580	178,960
25	220,240	239,460

Time Limits on Holding Converted Roth Accounts

When a Traditional IRA is converted to a Roth account, the converted amount must be held in the Roth IRA for at least five years; otherwise a penalty may apply. Any converted amount withdrawn before the end of the five-year period, to the extent it was included in income due to the conversion, is subject to a 10% early withdrawal penalty even if you have reached age 59½. After the five-year period has been satisfied, the 10% penalty still applies to distributions of earnings if you have not attained the age of 59½ or an exception applies.

Any withdrawal made from a Roth IRA before the five-year holding period ends is treated as being made first from contributions and then from amounts that were included in income due to the conversions.

Impact of Conversions on Other Tax Consequences

When considering whether or not to convert to a Roth IRA, carefully consider how the move will increase your taxable income in the conversion year. The increase could have drastic effects on other tax consequences. For instance, the increase may:

- Limit the Hope and Lifetime Learning Credits allowed for higher education expenses;
- Cause more of your social security income to be taxed;
- Limit your losses on rental real estate; and
- Mean some of your itemized deductions will be phased out.

The income "catch" for Roth conversions can be averted with appropriate tax planning. That's why it's important to consult with your tax advisor before making a final Roth investment decision. Only by looking at your entire tax picture will you really be able to decide whether the Roth option is best for you.

Factors That Favor Your Conversion to a Roth

- Your Traditional IRA has been open for a relatively short time.
- A large part of your Traditional IRA comes from nondeductible contributions.
- Roth accounts don't require distribution at age 70½.
- You have other funds from which to pay the tax on the conversion.

Factors That Don't Favor Your Conversion to a Roth

- You may need to withdraw from the Roth account before meeting the five-year holding period.
- You have a short time until retirement and you expect to make withdrawals soon.
- You expect to be in a lower tax bracket when you withdraw from your IRA.
- You do not have other funds with which to pay the tax on the conversions.

Saver's Credit

The Retirement Savings Contribution Credit, frequently referred to as the Saver's Credit, was established to encourage low- to moderate-income taxpayers to put funds away for their retirement.

Up to $2,000 per taxpayer of contributions to an IRA (traditional or Roth) or other retirement plans, such as a 401(k), may be eligible for a nonrefundable tax credit that ranges from 10% to 50% of the contribution, depending on the taxpayer's income. The maximum credit per person is $1,000.The contribution amount on which the credit is based is reduced if the taxpayer (or spouse if filing jointly) received a taxable retirement plan distribution for the year for which the credit is claimed (including up to the return due date in the following year) or in the prior two years. If the modified AGI exceeds $27,750 (single), $55,500 (married joint) or $41,625 (head of household), no credit is allowed. The amounts indicated are for 2010. Call this office for the rates for other years. An individual who is under age 18, a full-time student, or a dependent of someone else is ineligible. The credit is in addition to any deduction allowed for traditional IRA contributions.

Roth IRA

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Roth IRA

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The Roth IRA Advantage

Traditional IRAs are familiar to most taxpayers, providing a relatively simple method of saving for retirement AND deferring taxes in the process. But one drawback of the Traditional IRA is that once withdrawals from them begin, distributed earnings and contributions that were tax-deductible get taxed. In contrast, a Roth IRA allows no tax deduction of contributions. However, it does allow tax-free accumulation on the account so that at retirement ALL distributions from a Roth IRA are tax-free, both contributions and earnings. Naturally, to get this tax-free treatment, certain conditions must be met.

Predicting IRA Growth

The question always arises as to the future value of an IRA and the retirement income that it will produce. The future value for Rollover IRAs is dependent on whether the IRA will contain only rollover funds or whether additional annual contributions will be made to the IRA. Two tables follow, one including the future value of a rolled over sum and the second illustrating the future value of a $1,000 annual contribution. By using the two tables and an assumed investment rate of return, it's possible to predict the future value of an IRA account, whether it be traditional or Roth.

Lump Sum Accumulation

$1 Rolled Over "X" Years

	INVESTMENT RATE OF RETURN (ANNUALLY)					
YRS	2%	4%	6%	8%	10%	12%
5	1.1041	1.2167	1.3382	1.4693	1.6105	1.7623
10	1.2190	1.4802	1.7908	2.1589	2.5937	3.1058
15	1.3459	1.8009	2.3966	3.1722	4.1772	5.4736
20	1.4859	2.1911	3.2071	4.6610	6.7275	9.6463
25	1.6406	2.6658	4.2919	6.8485	10.8347	17.0001
30	1.8114	3.2434	5.7435	10.0627	17.4494	29.9599
35	1.9999	3.9461	7.6861	14.7853	28.1024	52.7996
40	2.2080	4.8010	10.2857	21.7245	45.2593	93.0510

Example: A rollover contribution of $30,000 left to accumulate for 25 years at 6% will be worth $128,757 ($30,000 x 4.2919) at the end of the period.

IRA Growth with $1,000 Annual Contribution

For larger contributions, extrapolate the results.
Example: contribute $3,000 annually, simply triple the table results.

	INVESTMENT RATE OF RETURN (ANNUALLY)					
YRS	2%	4%	6%	8%	10%	12%
5	5,204	5,417	5,637	5,867	6,105	6,353
10	10,950	12,006	13,181	14,487	15,938	17,549
15	17,294	20,024	23,276	27,152	31,773	37,280
20	24,298	29,778	36,786	45,762	57,275	72,053
25	32,031	41,646	54,865	73,106	98,347	133,334
30	40,568	56,085	79,058	113,283	164,494	241,333
35	49,995	73,652	111,435	172,317	271,025	431,664
40	60,402	95,026	154,762	259,057	442,593	767,092
45	71,893	121,030	212,744	386,506	718,905	1,358,230
50	84,580	152,667	290,336	573,770	1,163,909	2,400,018

Example: $2,000 annually contributed to an IRA earning 6% per annum would have a value of $109,730 (54,865 x 2) after 25 years. Based on the two examples above, a taxpayer who rolled $30,000 into an IRA and then continued to contribute $2,000 a year to that IRA would have $238,487 in the IRA account at the end of 25 years.

How Much Can You Contribute?

As with a Traditional IRA, to be eligible for a contribution to a Roth IRA, you (or your spouse, if you aren't employed or self-employed) must have taxable compensation like wages, earnings from a self-employed business, or alimony. The IRA contribution annual limit is slowly increasing over the years. In addition, taxpayers age 50 and older are allowed to make "catch-up" contributions, allowing them larger contributions in their later years to fund their approaching retirement needs. The table below illustrates the annual contribution limit applicable to each year by age.

	Contribution Limits	
Year	Under Age 50	Age 50 and Over
Through 2001	2,000	2,000
2002 through 2004	3,000	3,500
2005	4,000	4,500
2006 through 2007	4,000	5,000
2008 through 2010	5,000	6,000
2011 and after	Inflation Adjusted	

The annual limit applies to all of your IRA contributions in a given year. So, you can contribute to a Traditional IRA and a Roth IRA as long as the combined total does not exceed the annual IRA limits and you meet all of the other requirements.

Your income level can limit your Roth contributions. Contributions are gradually reduced (i.e., phased out) for married joint taxpayers with adjusted gross income (AGI) between $167,000 and $177,000. They are reduced for other taxpayers when the AGI is between $105,000 and $120,000. The contributions of married separate taxpayers who lived together at anytime during the year are reduced when the AGI is between $0 and $10,000. The amounts indicated are for 2010. Call this office for the rates for other years.

With Traditional IRAs, contributions cannot be made once you turn age 70½. However, there is no such age limit for making contributions to Roth accounts.

Handling Roth IRA Distributions

Generally, distributions from a Roth IRA (unless due to a conversion from a Traditional IRA) are treated as coming first from contributions (principal) on which you have already paid the tax. Therefore, any distribution to the extent of the principal is tax-free. Distributions of earnings are also tax-free (qualified distributions) if:

They are not made within the five-year tax period beginning with the first tax year in which you contributed to the Roth account, AND

They meet one of the following conditions:

- They are made after you reach age 59½; OR
- They are made after your death; OR
- They are made on account of you becoming disabled; OR
- They are made so that you can pay up to $10,000 in expenses as a first-time homebuyer.

Another big advantage of Roth IRAs over Traditional IRAs is that the former are not subject to the minimum required distribution rules at age 70½. This means that if you don't need to utilize your Roth IRA for retirement, you can leave it untapped for heirs (who would also get deferral on withdrawals, but would be subject to certain required distribution rules that apply to beneficiaries).

Conversions of Traditional IRAs to Roth Accounts

Because of the tax-free nature of Roth accounts, Congress has provided taxable rollover provisions that allow you to convert your Traditional IRAs to Roth accounts. Once you convert, all future earnings in the new Roth account accumulate tax-free. The catch is that the tax on the Traditional IRA must be paid in the year the conversion is made to the Roth. Whether it is beneficial to elect this taxable rollover depends on a number of variables.

After 2009, a Traditional-to-Roth IRA conversion can be made by anyone regardless of filing status or income. Prior to 2010, the conversion option is available to anyone, except married taxpayers filing separately, but only if a taxpayer's AGI is $100,000 or less.

A special rule applies to conversions made in 2010, allowing a taxpayer to elect to pay the conversion tax all in 2010 or include one-half of the conversion income in 2011 and the other half in 2012.

Paying the Tax on Conversion

The taxability of a Traditional IRA to Roth IRA conversion depends on whether the taxpayer made nondeductible contributions to his or her Traditional IRA. If so, the Traditional IRA includes amounts that have already been taxed. These post-tax contributions are not taxed again when converting to the Roth. However, the tax must be paid on any interest the Traditional IRA earned plus on contributions deducted prior to conversion.