IRA Conversion: The Planning Opportunity of the Decade?

Although it may not feel like it, Uncle Sam was pretty generous during the Bush administration. Your income taxes declined if you were in one of the top two brackets, and dividends and long-term capital gains also received more beneficial treatment than they had in the recent past. In addition, a tax law passed in 2006 included a nifty gift for those who save in an IRA. Beginning in 2010, investors of all income levels will be able to convert their traditional IRA assets to Roth assets. (For 2009, your adjusted gross income must be $100,000 or less for you to be able to convert, whether you file your tax return as a single or you’re part of a married couple filing jointly.)

In addition to allowing upper-income investors to convert from a traditional IRA to a Roth, the 2006 tax-law change included another beneficial provision. You’ll still have to pay ordinary income taxes on any deductible contributions and investment earnings when you convert from a traditional IRA to Roth, but if you make the conversion in 2010, you’ll be able to spread the tax hit over the subsequent two years, 2011 and 2012.

Advantages to Conversion

It may be hard to get excited about paying taxes now, as you would if you made the conversion, versus letting the assets sit in your traditional IRA and paying taxes later. Traditionally, the calculus about whether to convert from a traditional IRA to a Roth required you to project whether your income would be higher or lower in retirement than it is now, a question that’s very difficult to answer if you have more than a few years until retirement.

However, I think the odds are excellent that tax rates across the board are currently low relative to where they could be in the future. If you share that view, you’ll want to take advantage of every means you can to pay taxes now rather than waiting until later.

For that reason, I strongly prefer the Roth IRA to a traditional IRA for most savers, and I’m also a fan of the Roth 401(k) for many individuals. The Roth 401(k) works much like a Roth IRA; you contribute aftertax dollars but qualified withdrawals are tax-free. The Roth IRA also gives you more flexibility than you’ll have with a traditional IRA. Notably, you won’t be required to take mandatory distributions from a Roth at age 70 1/2, as is the case with traditional IRA assets. That’s a huge boon if you don’t expect to need your IRA assets during retirement; you can allow those investments to grow and pass on a greater amount to your heirs.

And while it’s never ideal to tap your retirement savings prior to retiring, the Roth is a much better option than a traditional IRA should you need to do so. If you convert to a Roth and five years have elapsed since you made the conversion, you can withdraw the converted amount, plus any additional contributions, prior to age 59 1/2 and you won’t have to pay taxes or penalties.

The other compelling argument for an IRA conversion is that you may take less of a tax hit by converting within the next year or two than you might when the market goes back up. That’s because you’ll pay tax on any deductible contributions and investment earnings when you convert from a traditional IRA to Roth, but if your portfolio has taken a big hit over the past year, the investment-earnings component of your IRA is way down, which in turn reduces the taxes you’ll owe. (If you have a loss in your IRA, it’s possible to claim a loss, but it’s not the same as taking a loss in your taxable accounts. You must withdraw all assets from that IRA type, and IRA losses can’t be used to directly offset ordinary income or capital gains. Instead, IRA losses are part of the miscellaneous itemized deductions you claim on schedule A of your form 1040. These deductions must amount to 2% of your adjusted gross income or they won’t be usable. This article details the ins and outs of taking a tax loss in your IRA.)

Prime Candidates

In general, the younger you are, the more beneficial a conversion will be. That’s because you’ll have more years to recoup the tax hit. That’s not to say a conversion should automatically be off the table if you’re nearing or even in retirement, though. If it’s fairly early in your retirement, longevity runs in your family, and you won’t need to put your hands on your IRA assets for five years or even more, a conversion may well be worth it because you’ll have a good shot at...
careful if it looks like your conversion will push you into a higher tax bracket in the year in which you convert. The risk is that you could disqualify yourself for tax benefits, such as credits and deductions, that you would otherwise be eligible for.

In all of the above situations, though, you should be aware that you needn't convert all of your IRA in one fell swoop. Partial conversions are also permissible. However, you can't pick and choose which IRA assets to convert—for example, you can't convert all of your nondeductible IRAs and leave your deductible IRAs intact, although that would be advantageous. Instead, each dollar you convert will receive exactly the same tax treatment based on your aggregate IRA's breakdown between deductible contributions/investment earnings and nondeductible contributions.

For example, say you have $100,000 in an IRA that's composed of $30,000 in deductible contributions, $10,000 in investment earnings, and $60,000 in nondeductible contributions. In that case, 40% of every amount that you convert would be taxable upon conversion (that 40% encompasses deductible contributions and investment earnings), whereas you wouldn't owe taxes on 60% of your conversion (the percentage of your IRA portfolio represented by nondeductible contributions). Each subsequent conversion that you do would receive the same 40% taxable/60% nontaxable treatment.

Logistics

If you determine you want to move forward with a conversion, it pays to double-check with a financial advisor or tax specialist to make sure you're thinking through all of the variables. And when you do convert, make sure you mind your Ps and Qs. IRS Publication 590 (Individual Retirement Arrangements) includes all of the nitty gritty details. Your investment provider should be able to walk you through the forms you need to fill out for the conversion; some investment providers now allow you to make the conversion using online tools.

Also know that if you convert your IRA from a traditional to a Roth, you needn't change your investments—you're changing the tax treatment of those investments, not the investments themselves. Finally, be mindful of the deadlines related to conversions. Whereas you have until April 15 to make an IRA contribution, the conversion will need to be done by December 31 to count for that tax year.

Christine Benz is Morningstar's director of personal finance.