

Roth IRA conversions: should you pay tax now or later?



As of January 1, 2010, you can convert your traditional IRA to a Roth IRA regardless of your income or tax-filing status.

If you're thinking of taking advantage of this change, keep the following in mind before deciding when to recognize any conversion income.

more people are eligible

First, let's review how the rules have changed.

Previously, only investors with an adjusted gross income of \$100,000 or less were able to convert a traditional IRA to a Roth; married couples who file separately were unable to convert to a Roth IRA at all.

The upshot of the income-restriction elimination, says Joel Dickson of Vanguard's Quantitative Equity Group: "A lot of people who weren't eligible to make a Roth IRA conversion are able to do so in 2010."

the special tax option for 2010 conversions

Investors who convert from a traditional to a Roth IRA in 2010 will also have the option to spread any resulting taxable income evenly across 2011 and 2012 unless they choose to recognize all of the income in 2010. (The 2-year tax option exists for conversions during 2010 only.)

However, keep in mind that your tax liability on the income may differ depending on when you decide to recognize it. Because the conversion amount increases your total taxable income, it potentially could reduce the deductions or credits available to you in a given year. If the income is significant, it could potentially push you into a new tax bracket and you'd wind up paying a higher rate on at least some of the amount.

future rates are uncertain

You should also consider that, under the current tax code, tax rates are scheduled to increase after 2010. Therefore, if you elect to spread taxable income across 2011 and 2012, you may actually owe more tax than if you recognize the income in 2010.

"It's not clear that it would be a big advantage to spread your taxes into years where you might actually face higher rates," said Mr. Dickson.

If you convert to a Roth IRA in 2010, you'll at least have some time to make up your mind about how to handle any resulting tax bill; the deadline for making a decision about the 2-year option is your tax-filing deadline—April 15, 2011. (However, keep in mind that you may have to pay estimated tax to avoid an underpayment penalty.)

Notes

- All investments are subject to risk.
- If you take withdrawals from an IRA before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax on withdrawals; however a conversion is not subject to the penalty.
- Roth IRA earnings are taxable and may be subject to a penalty if you withdraw funds within 5 years and are under age 59½. In addition, the converted amount may be subject to penalty if taxable on conversion and withdrawn within 5 years and an exception does not apply.
- State and local tax laws vary and should be considered when deciding when to pay tax.
- We recommend you consult a tax or financial advisor about your individual situation.