

Roth Conversions Frequently Asked Questions

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Here is a short list of the high points of Roth conversions to assist you in determining whether a Roth conversion makes sense for you. I have used a Question & Answer format to break down the salient points. Please note that the conversions can get more complicated depending on your circumstances so please contact me for further details.

1. Why would you consider a Roth conversion?

Answer: IRA's are usually funded with before tax-dollars. When you withdraw funds at retirement, you are taxed on the contribution and the earnings. With a Roth, you are taxed only on the contribution. The underlying consideration is whether you wish to pay tax up-front or on the back end. You may also wish to consider estate planning opportunities (see 7(d) below).

2. Who can convert?

Answer: Anyone - no age, no income limit (formerly \$100,000) and no requirement of taxable income (i.e. retired persons can convert)

3. What can you convert?

Answer: IRA's (both deductible and non-deductible), SEP & SIMPLE IRA's, 401(k), 403(a), 403(b), 457(b) and certain other "tax-qualified retirement plans".

4. What are the tax consequences of conversion?

Answer: The amount converted (or a percentage thereof as explained below) is taxable income. The taxable income can be claimed in 2010 or it can be claimed 1/2 in 2011 and 1/2 in 2012. The decision as to which year to claim will depend on your situation - for example, with Congress contemplating higher rates on the top bracket you may wish to use 2010 as the year to claim the income.

5. What percentage of amounts converted are taxable income?

Answer: The percentage that is taxable depends on the source of the converted funds. If you are doing a conversion of an IRA that was funded completely with before-tax dollars, then 100% of the amount converted is taxable income (converted amounts include original contributions AND earnings).

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If the source is mixed with funding from before and after tax dollars, then a pro rata formula is used. The pro rata formula requires you to aggregate all your IRA's for purposes of calculating taxable income, even if you are converting one IRA that was completely funded with after-tax dollars and not converting another IRA that has after-tax dollars.

6. What is the best strategy for conversions?

Answer: You should consider opening separate Roth accounts for each “investment type” because of operation of the “undo” rule. Under the undo rule, an amount converted to a Roth in 2010 could be converted back to an IRA anytime up to October, 2011. For example, if you create 2 new Roth accounts at conversion and one of those accounts goes down in value, you can undo that conversion and not pay the tax on the values that no longer exists.

7. When do Roth conversions make sense?

Answer:

- a. When you are a young taxpayer - long opportunity for tax-free growth of earnings
- b. When your current tax rate is low and you can pay the conversion tax from personal funds outside the retirement accounts
- c. When you expect tax rates to be higher in the future
- d. Estate planning- regular IRA's require you to start withdrawing at age 70 1/2 ; Roth's have no such requirement and can be passed to a spouse who also does not have to withdraw. Thus, you can pass the entire Roth on to your beneficiaries free of future income taxes
- e. When your portfolio is currently depressed but you expect it to recover in future years... if you can afford the tax now on the lower depressed value, you avoid the tax on the amount of the increase in value.

8. What are the rules for withdrawing tax and penalty-free from a Roth?

Answer:

Source of Roth Distribution	Age: <59 1/2	Age: >59 1/2
Contributions	Tax & penalty free	Tax & penalty free
Converted Amounts	Tax free; 10% penalty unless held for 5 years	Tax & penalty free
Earnings	Taxes as ordinary income plus 10% penalty	Tax free and penalty free if account held 5 years; otherwise taxed but penalty free

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