IRA Conversion Fact Sheet

The best and worst candidates for this maneuver, and details on how it works

Investors of all income levels are now able to convert their traditional IRA assets to Roth IRAs as of the beginning of this year. The opportunity to take tax-free withdrawals on IRA investments certainly holds appeal, but a conversion isn't for everyone. Investors should check with a tax specialist to ensure that they've considered the ramifications--including the potential tax liability--before converting.

About the Author
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Here are some common questions related to IRA conversions, along with the answers.

What's changing in 2010?
Two things. First, income limits on conversions have been lifted, so now anyone can convert from a traditional IRA to a Roth. Second, those who convert in 2010 will be able to spread the taxes associated with the conversion over two years--2011 and 2012.

Is the change permanent or only for 2010?
Income limits are permanently lifted beginning in 2010. However, the special tax treatment (splitting the tax hit over 2011 and 2012) is available only for conversions made in 2010.

What are the benefits of converting?
There are two key benefits. First, Roths offer tax-free withdrawals in retirement, whereas withdrawals from traditional IRAs are taxed as ordinary income. Second, Roths don't require you to take distributions during retirement, so if you don't need the money you can let the assets accumulate for your heirs.

Who is a good candidate for conversion?
In general, younger people are better candidates for conversion than are older investors who are close to retirement or already retired. Those who have the cash on hand to pay the taxes associated with the conversion are also much better candidates for conversion than those who will need to tap the IRA assets to pay the tax. Investors who have a lot of assets in traditional 401(k)s and IRAs may also benefit from a conversion because it will diversify the tax treatment of their in-retirement withdrawals. This article details who might be a prime candidate for conversion and Morningstar's IRA Calculator can help you crunch some numbers.

Who should think twice about converting?
A conversion will tend to be less attractive for older investors who are well into retirement; they won't have the chance to recoup the tax hit. Conversions are also usually a bad idea if tapping the IRA assets is the only way to pay conversion-related taxes. Finally, conversions won't generally make sense for those who haven't saved much for retirement and will therefore be in a lower tax bracket in retirement than they are now. This article discusses who should think twice about converting.

Are the income limits for starting a Roth from scratch going away in 2010, or is conversion the path for investors whose income is over the limit?

The income limits to open a Roth IRA are still in place; individuals with incomes of more than $120,000 who can also contribute to a company retirement plan can't open a Roth; the threshold goes up to $177,000 for married couples filing jointly. However, individuals whose incomes are over those limits can take a backdoor way into a Roth, opening a traditional nondeductible IRA, then converting soon thereafter. They'd owe taxes on any investment earnings at the time of the conversion. This strategy doesn't make sense, however, for those with substantial traditional deductible IRA assets because the taxes associated with the conversion will be based on the breakdown between deductible and nondeductible contributions in the IRA. Check with a tax advisor before opening a "backdoor IRA" because some advisors are concerned that Congress could close this loophole.

Can I roll over a regular 401(k) into a Roth IRA directly?

Yes, assuming you no longer work for the company where you amassed the 401(k). In this case, the rollover functions almost exactly like a conversion; you'll owe taxes on your deductible contributions and investment earnings at the time you convert.

Will I owe taxes because of the conversion?

It depends. If you've made only nondeductible contributions and you don't have any investment earnings in the account, you won't owe taxes upon conversion. If, however, your IRA consists of deductible contributions, rollover assets from a traditional 401(k), and investment earnings--or some combination thereof--you'll owe taxes when you convert.

Should I worry about what the conversion will do to my reportable income (namely, pushing me into a higher tax bracket)?

Yes, and that's one of many reasons to check with a tax advisor before embarking on a conversion. The risk is that in bumping up your income level, you could disqualify yourself for tax credits and deductions that would otherwise be available.

When will the taxes be due?

Normally when an investor converts an IRA, any investment earnings and deductible contributions in the traditional IRA are taxed as income in the year in which the individual converts. For individuals who convert in 2010, however, they can either take the tax hit for the 2010 tax year or split the tax burden across the 2011 and 2012 tax years.

Is there a limit to how much I can convert?

No. But once you're looking at converting large sums, it's especially important to consider the tax implications, both the effect on your tax bracket and whether you have money on hand to pay the conversion-related taxes.

Is the conversion permanent (or can I convert back)?

You can convert back through what's called a recharacterization. A recharacterization enables you to change the character of a Roth IRA to a traditional IRA, and vice versa. This can be an important lever if you convert your IRA and it turns out that the tax burden associated with the conversion is far greater than you had calculated, or if the conversion pushes you into a higher tax bracket and reduces your eligibility for tax credits and deductions. You'll also need to do a recharacterization if you convert your IRA but then determine that you weren't eligible to because of income limits. This article lays out some of the details.

Will I be able to tap principal in the new Roth IRA without penalty?

Yes, assuming five years has elapsed since you made the conversion. If you're over 59 1/2 years old, that waiting period doesn't apply. You can take withdrawals at any time without incurring a penalty.

Do I have to convert all of my accounts, or is a partial conversion possible?

A partial conversion is possible and advisable if converting in a single year creates an extreme tax burden or pushes you into a higher tax bracket. This article details the ins and outs of partial conversions.

If I do a partial conversion, can I convert only nondeductible traditional IRA contributions?

That would be nice, wouldn't it? Regardless of which IRA assets you convert, the assets will all receive the same tax treatment upon conversion, based on the proportion of nondeductible contributions and deductible contributions/investment earnings. This article provides a concrete example of how this works.

After I convert, can I contribute to the new Roth account this year or in the future?

Yes, but only if your income is under the limits for new contributions ($120,000 for individuals who can contribute to a company retirement plan and $177,000 for married couples filing jointly). If your income is above these levels, you'll need to open a traditional, nondeductible IRA and then convert it.

Should I worry about what the conversion will do to my reportable income (namely, pushing me into a higher tax bracket)?

Yes, and that's one of many reasons to check with a tax advisor before embarking on a conversion. The risk is that in bumping up your income level, you could disqualify yourself for tax credits and deductions that would otherwise be available.