The Ins and Outs of IRA Conversions

IRA conversion mania has been in full swing since income limits on conversions were lifted in 2010. As of that year, savers of all income levels can now convert their IRAs from a traditional to a Roth, and wealthy people are the most likely to benefit from Roth accounts.

As with any major decision with tax implications, it's worth making sure you're thinking through all of the key variables before deciding whether to convert your traditional IRA assets to Roth. Here are some commonly asked questions.

I've taken a look at the taxes I'll pay to convert my traditional IRA assets to a 401(k), and it's not pretty. Can I do a partial conversion?
Yes. Partial conversions are permissible and can be a great strategy, particularly if you've done the math and determined that converting all of your IRA assets will push you into a higher tax bracket for the tax year in which you convert. Partial conversions can also make sense if you don't have the cash on hand to pay the taxes associated with a full conversion. (Whatever you do, don't tap your IRA assets to help pay the taxes: You'll pay a 10% early-withdrawal penalty on any assets you don't roll into the Roth.)

Bear in mind, however, that 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, though that would result in a lower tax hit because you've already paid taxes on those nondeductible contributions. Instead, the Internal Revenue Service considers all of your IRAs as one big pool when calculating your tax burden. Each dollar you convert will receive exactly the same tax treatment based on your aggregate IRA's breakdown between deductible contributions/investment earnings (taxable) and nondeductible contributions (not taxable).

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.

My wife and I don't have any IRA assets because we earn too much to qualify for a Roth IRA. Does this mean I can open a traditional IRA now and then convert to a Roth next year?
Yes. Income limits on new IRA contributions still remain in place; in 2013, single filers earning more than $127,000 and those who are part of a married couple filing jointly that earns more than $188,000 cannot make Roth IRA contributions. However, it's possible for those high-income earners to take a backdoor way into additional Roth contributions by making nondeductible IRA contributions and then converting shortly thereafter. It's possible that Congress may close this loophole down the line, given that it doesn't make sense to leave the income limits in place for initial contributions but not conversions. But for the time being it looks like an opportunity. Just be aware that the presence of other IRA assets could trigger an unwanted tax bill.

What if the government rescinds Roth tax treatment? Is there a possibility my assets will be taxed upon withdrawal?
There has been a lot of debate about this question, and, unfortunately, there are few clear answers. Almost anything is possible when it comes to the tax code, and the long-term trend in tax rates is likely
to be upward. But you can take comfort in a few points. First, the Roth IRA has heretofore been a tax-sheltered vehicle targeted toward middle-income savers—contribution limits have kept out the highest-income earners. Raising taxes on middle-income earners is apt to come with significant negative political repercussions.

And in a worst-case scenario, if the tax treatment for Roth IRAs is rescinded, it would very likely only affect earnings growth on the investments, as Roth IRA contributions have already been taxed. That would be a bitter pill to swallow, of course, but not nearly as bad as paying taxes on the whole amount.

**I have assets sitting in my former employer’s 401(k) plan. Can I earn Roth treatment?**

Thanks to the Pension Protection Act of 2006, shifting those assets into a Roth is much like doing a conversion from a traditional IRA to a Roth. You’ll owe taxes at the time you make the conversion. (Roth 401(k) assets aren’t taxable). And now, individuals at all income levels can roll over from a company retirement plan directly into a Roth; prior to 2010, investors needed to have incomes of less than $100,000 to do a direct rollover into a Roth IRA.

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