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Roth 2010: Should You Convert?

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Beginning in 2010, a new rule change allows people with an Individual Retirement Account (IRA) to reduce their tax burden at retirement by converting a traditional IRA into a Roth IRA. Before deciding if such a conversion would benefit you, there are a few important things to consider.

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Traditional IRAs versus Roth IRAs. What are the differences between the two accounts? A traditional IRA allows individuals with wage income to set aside pretax dollars in savings which are taxed when they are withdrawn during retirement:

- Contributions made to a traditional IRA are limited to $5,000 annually ($6,000 for individuals age 50 and over).
- The tax deductibility of traditional IRA contributions is phased out at higher income levels for those who are covered by an employer-sponsored retirement plan.
- Individuals can no longer contribute to traditional IRAs once they reach age 70-and-one-half years, and they must begin making minimum withdrawals.

On the other hand, Roth IRAs require after-tax deposits and allow tax-free withdrawals:

- While anybody can convert to a Roth IRA, single filers whose modified adjusted gross income is $120,000 or more cannot make contributions to a Roth IRA (for married couples filing jointly, the cap is $176,000).
- The maximum contribution limit for the Roth IRA is the same as the traditional IRA — $5,000 in 2009 ($6,000 for individuals age 50 and over).
- However, contributions can be made to a Roth IRA even after age 70-and-a-half, and the accounts are not subject to minimum mandatory withdrawals during the retirement years.

Converting to a Roth IRA. Conversion means paying taxes on the traditional IRA amount (either using some of the IRA funds or other funds) and depositing the balance in a Roth account. Previously, an individual could convert a traditional IRA to a Roth IRA only if his household income was less than $100,000. Also, a married person who filed a separate tax return was prohibited from converting a traditional IRA to a Roth IRA — no matter how much or how little he or she made.

Beginning January 1, 2010, the $100,000 income limit for Roth conversions will be permanently eliminated, as well as the restriction on spouses who file separate tax returns. This means that individuals holding traditional IRA accounts can covert them to Roth accounts with no restrictions.

What Would a Roth IRA Conversion Cost?

($25,000 IRA balance, with no additional contributions)

Current Marginal Tax Rate	Money Withdrawn from Account to Pay Taxes (includes 10 percent penalty before age 59 ½)	Balance Converted to Roth	Years Required to Restore Original Account Balance	
			(4 percent real rate of return)	(2 percent real rate of return)
15%	$6,250	$18,750	7.4 years	14.75 years
25%	$8,750	$16,250	11 years	21.75 years
28%	$9,500	$15,500	12.25 years	24 years
33%	$10,750	$14,250	14.25 years	28.75 years

Source: Authors' calculations.

Who Would Benefit from a Roth IRA Conversion? Ostensibly, the benefit of conversion is that the taxes are paid today at a known rate, instead of in the future at an unknown and possibly higher rate. But deciding whether to convert a traditional IRA to a Roth IRA depends largely on the ability to pay the taxes that are due when the conversion takes place. For 2010 conversions, individuals have two years to pay the income tax due. A Roth IRA conversion is ideal for anyone who:

- Can pay the taxes using money from nonretirement funds.
- Expects that their federal income tax rate when they retire will be much higher than it is today — because their income will be higher and the burden of government will be higher.
- Faces little to no federal income tax burden today — so that a conversion would cost very little to complete.

Taxes on a Roth Conversion. Suppose you convert a traditional IRA to a Roth but take a distribution from the traditional IRA account in order to pay the taxes. Is it worth it? That depends on your current marginal tax rate, income level and how many years you are from retirement. Consider that a distribution from the IRA to pay taxes on the conversion is subject to a 10 percent penalty in addition to federal income taxes if you have not reached 59-and-one-half years.

With these considerations in mind, the table shows the cost of converting $25,000 from a traditional IRA to a Roth IRA and using money from the account to pay the taxes.

Assuming that no further contributions are made to the converted Roth account:

- If you are in a lower tax bracket (15 percent), you will be able to restore your original account balance in 7 to 15 years, depending on your account's inflation-adjusted rate of return.
- But if you are in a higher marginal tax bracket you will need many more years to build up your balance; in the case of an individual in the 33 percent bracket, it could take anywhere from 14 to 28 years, depending on the account's inflation-adjusted rate of return!

On the positive side, the taxes on a 2010 conversion can be paid over two years (2011 and 2012).

Conclusion. Whether you convert to a Roth IRA or not depends on your preferences for paying taxes, as well as your expected income (during work and retirement). However, the new rules for Roth IRA conversion in 2010 will at least give people more choices regarding their retirement savings.

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