The rules for Roth conversions are changing in 2010

Vanguard Investment Counseling & Research

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Executive summary. Beginning January 1, 2010, many more investors will be eligible to convert their traditional IRAs to Roth IRAs, and they will have a special one-time option for dealing with the taxes on the conversion. These favorable rule changes result from the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005. To sum them up:

- The income limit for Roth conversions will disappear. Currently, households with modified adjusted gross income greater than $100,000 are not eligible for a Roth conversion.
- Married couples who file separately will be allowed to make Roth conversions.
- Investors who convert in 2010 will be able to spread any taxable income created by the conversion evenly across 2011 and 2012, unless they elect to recognize all of the income in 2010.[2] This two-year option exists for 2010 conversions only.

There are no changes to the rules governing Roth IRA contributions. See **Figure 2**, on page 5, for a summary of what is new for 2010.

1 The authors wish to thank Hugh Casey and Theresa O'Hara for their technical contributions.

2 Note that the tax rates are scheduled to increase after 2010 under the sunset provision of the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA). Therefore, investors who elect to spread the converted income over 2011 and 2012 may pay higher taxes on the conversion. See **Figure 4**, on page 9, for a tax rate summary.

Although tax experts generally do not recommend accelerating the recognition of income taxes, a Roth conversion may provide benefits for many investors. This paper discusses the major factors that investors should consider when deciding whether to convert. Please note these important points: (1) We use the term "traditional IRA" throughout to include any tax-deferred (non-Roth) IRA or employer-sponsored plan. (2) To simplify the discussion, we assume that traditional IRA accounts consist of pre-tax contributions unless otherwise noted. (3) We discuss only federal tax considerations, and do not address state or local taxes.

Considerations: Traditional IRAs versus Roth IRAs

With a traditional IRA, contributions may be tax-deductible, depending on both the individual's income and whether he or she participates in an employer-sponsored retirement plan, such as a 401(k). Earnings grow tax-deferred until the investor makes withdrawals, which then will be subject to income taxes. In addition, account owners are required to take minimum distributions beginning at age 70½.

On the other hand, with a Roth IRA, investors contribute after-tax dollars—that is, money that has already been taxed (there is no tax deduction for Roth contributions). As a result, the investor will not have to pay tax on the future qualified withdrawals. In addition, Roth IRAs are not subject to required minimum distributions during the owner's lifetime, so these accounts can benefit from additional tax-free growth.

From a mathematical standpoint, the decision of which type of IRA is more beneficial for a particular investor is primarily dependent on the investor's expectation of their future tax rate relative to their current tax rate. The tax rate assumption is important because the after-tax dollars are equivalent whether the investor puts pre-tax dollars in a tax-deferred plan or after-tax dollars in a tax-free plan (assuming identical investment amounts and rates of return).[3] It is generally preferable for an investor who expects to be in a higher tax bracket, or believes that significant tax hikes could be on the horizon, to consider converting to a Roth IRA and paying taxes on the conversion at the current, presumably lower tax rate.

Since the future of tax rates is unknown, investors may want to hedge their bets by investing in both traditional and Roth IRAs. This approach, often referred to as "tax diversification", allows the investor to lock in taxes at current rates on a portion of their portfolio balance, thus alleviating some of the uncertainty about future tax rate changes.

Figure 3, on page 6, compares key characteristics of traditional and Roth IRAs.

3 This assumes that the after-tax contribution amounts are identical for the traditional and Roth IRAs. In reality, an investor can save more on an after-tax basis by investing up to the maximum amount in the Roth.

The implications of tax rate expectations

While several other factors can affect the Roth conversion decision, the major consideration is current versus future income tax expectations and when the *investor anticipates making withdrawals from the traditional IRA*. What follows are some general guidelines:

No tax rate change expected: Investors with this view should consider a Roth conversion. The maximum benefit results if the investor has sufficient assets outside the IRA to pay the conversion tax, and will not incur capital gains in the taxable account to pay the conversion tax. Additionally, investors should determine whether the taxable income created by the conversion could put them in a higher marginal tax bracket for that year. If that is the case, then the investor could consider either making a partial conversion—limiting the converted amount to a level that would keep the same marginal tax bracket—or taking advantage of the one-time option available in 2010 by spreading the converted income across two years (again being careful of staying in the same marginal income tax bracket).

Tax rate increase expected: Investors in the highest marginal tax bracket should consider a Roth conversion. All others who expect higher taxes should also consider converting, but should assess how the additional taxable income would affect their marginal income tax bracket. As discussed above, if the marginal bracket is a concern, then the investor can consider making a partial conversion.

Tax rate decrease expected: An investor with this view should maintain the traditional IRA. A conversion would accelerate taxes at the current, presumably higher rate, resulting in lower future portfolio balances.

The examples in **Figure 1**, on page 4, help to illustrate the tax considerations. We look at three hypothetical scenarios: One with no tax rate change, one with a tax rate increase, and one with a tax rate decrease. In each case, we assume that the investor currently is in the 25% marginal tax bracket, has $100,000 in a traditional IRA, and has $25,000 in a taxable account (the amount sufficient to pay the tax due on the Roth conversion). Furthermore, for each scenario, we consider three options:

- Option 1: No conversion; the investor maintains the traditional IRA and the taxable account.
- Option 2: The investor converts to a Roth and uses the taxable account to pay the conversion tax; therefore only the Roth IRA remains.
- Option 3: The investor converts to a Roth and uses the IRA assets to pay the conversion tax. Thus, the initial Roth balance is reduced by the tax amount, and the taxable account remains.

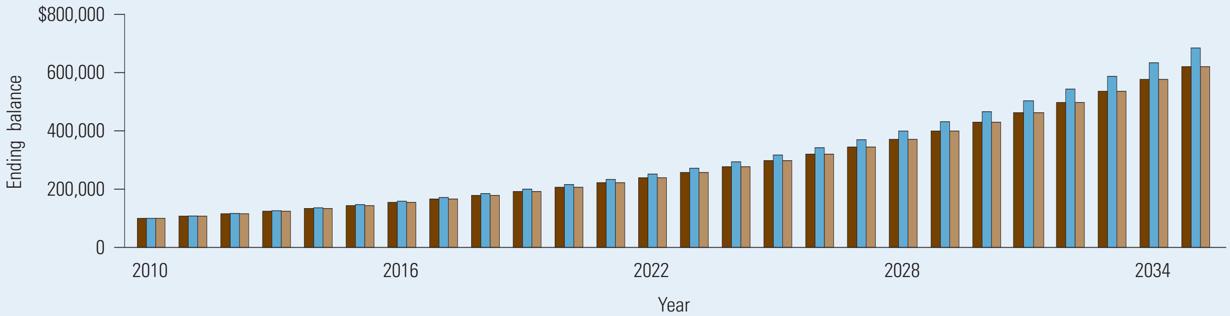
In Figure 1a, which assumes constant tax rates, you can see that Option 2—converting the traditional IRA to a Roth, with conversion taxes paid from the taxable account—results in the highest ending after-tax balance. Under Option 2, the entire $100,000 receives tax-free growth; under the other two options, only $75,000 receives tax-advantaged treatment with $25,000 in the taxable account subject to income and/or capital gains taxes annually. The extent of the difference between Option 2 and the others depends on the tax-efficiency of the non-IRA investment as well as any capital gains tax that will be incurred upon liquidation.

In the case of a tax-rate increase (Figure 1b), the difference in ending asset balances is even greater because with Option 2, the investor is locking in the current lower tax rate while preserving the full retirement balance for future growth. With the other two options, either the investor's entire IRA balance ends up subject to the higher rate, or the Roth account is opened with a lower balance.

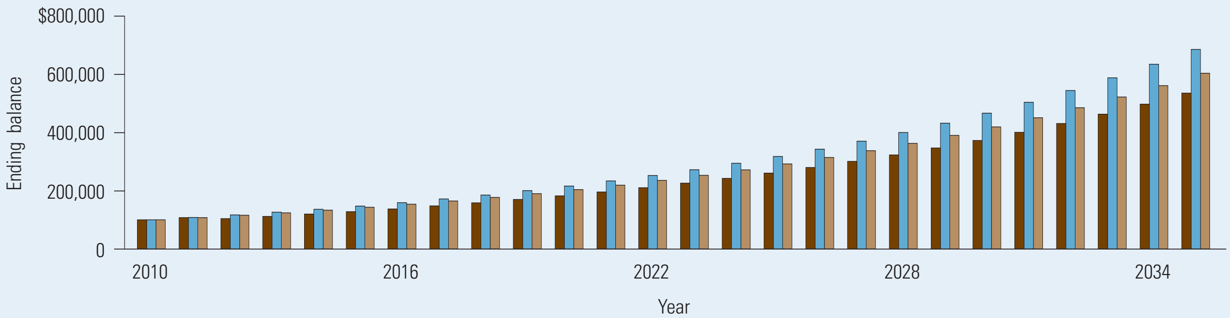
Conversely, if future tax rates are lower (Figure 1c), with Option 1, the investor comes out ahead by maintaining the traditional IRA and deferring taxes. This is because a Roth conversion would lock in taxes on the retirement assets at the higher current rate.

Figure 1. After-tax ending balances based on different tax rate expectations

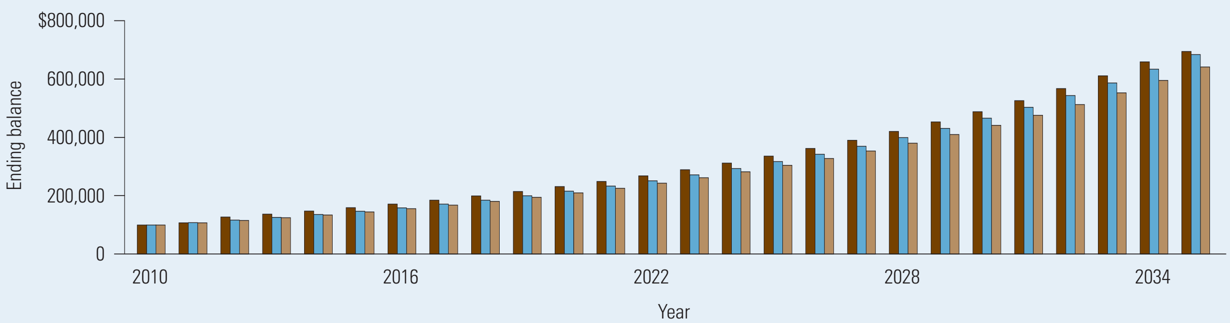
1a. No tax rate change



1b. Tax rate increase



1c. Tax rate decrease



Option 1: Maintain the traditional IRA
Option 2: Convert to a Roth; use taxable account to pay conversion tax
Option 3: Convert to a Roth; use IRA assets to pay conversion tax

Source: Vanguard.

Note: This hypothetical illustration does not represent the return on any particular investment. Balances shown in the charts combine the IRA and taxable assets.

Assumptions

Taxes:

- 2010 tax rate is 25%; 2011 increased tax rate is 35%; 2011 decreased tax rate is 15%.
- Earnings in the taxable account are taxed annually at the income tax rate.
- No capital gains tax is incurred upon liquidation of the taxable account.

Investment return: 8% annually for both taxable and IRA accounts.

IRA starting balance: $100,000.

Taxable account starting balance: $25,000.

Figure 2. Roth IRA rules: Current and 2010

	Current rules	Rules as of January 2010
Contributing to a Roth IRA	Individuals with modified adjusted gross income (MAGI) below $120,000 or married couples with MAGI below $176,000 are eligible to contribute, assuming that they have earned income at least equal to their contribution.	No change to the current rules.
Converting to a Roth IRA	An individual can convert a traditional IRA or employer plan to a Roth IRA if his or her MAGI is $100,000 or less. Married couples who file separately cannot convert (unless they have lived apart for more than one year).	The income limit disappears. Any taxable income created by the conversion can be either: —Divided evenly between the 2011 and 2012 tax years. —Or recognized in 2010. Married couples who file separately are allowed to convert.

More considerations for Roth conversions

Once investors have examined their tax rate expectations, there are a number of other factors to consider before deciding to convert to a Roth IRA. Some of these have already been discussed, but here they are described in more detail, along with additional factors to review.

Availability of cash to pay the conversion tax. The question of whether the investor has non-IRA assets to pay the conversion tax is an essential one. This is because using the IRA assets to pay taxes would greatly reduce the potential benefit of the conversion (as seen in Option 3). The amount of after-tax equivalent wealth that receives a tax benefit is higher for a dollar in a Roth account than for a dollar in a traditional IRA account. Substituting $1 in a traditional IRA account for $1 in a Roth IRA account increases overall tax-sheltered savings.[4] Assuming that sufficient non-IRA assets are available, then cash reserves are typically the best source of funds to pay the conversion tax. Tapping other types of holdings—stock or bond funds, for example—could result in transaction costs or capital gains taxes that may offset the benefit of the Roth conversion.

Impact of the conversion on the investor's marginal income tax rate. Another important consideration is how a Roth conversion would affect the investor's current tax situation. Because the amount of the pre-tax assets being converted will be added to the investor's adjusted gross income, the conversion could push the investor into a higher marginal tax bracket. Investors in this situation may want to consider converting only part of the traditional IRA balance, estimating how much additional income could be recognized before moving into a higher tax bracket. (Keep in mind that only the portion of the income that falls into the higher marginal income tax bracket will be taxed at the higher rate, not all of the investor's income). **Figure 4**, on page 9, provides an outline of income tax rates under the current tax code, including the 2009 taxable income thresholds.

4 Additionally, if the investor is under age 59½ and uses IRA funds to pay the conversion tax, the withdrawn proceeds will be subject to penalties.

Figure 3. Characteristics of traditional and Roth IRAs

	Traditional IRA	Roth IRA
Tax advantage	Tax-deferred earnings.	Tax-free earnings.
Eligibility*	• Investors must have earned income equal to or greater than their contribution. • Investors must be under age 70½. • There is no limit on income, but contributions may not be tax-deductible.	• Investors must have earned income equal to or greater than their contribution. • Investors modified adjusted gross income must fall within the limits prescribed by the IRS.
Maximum contribution allowed by law	• $5,000 for tax year 2009 ($6,000 if age 50 or older).	• $5,000 for tax year 2009 ($6,000 if age 50 or older). • The maximum Roth contribution depends on the investors income.
Tax deductibility	• If the investor (and spouse, if married) were not covered for any part of the year by an employer plan, they can deduct their total contributions up to the lesser of $5,000 ($6,000 if age 50 or older) or 100% of compensation.	• Contributions are nondeductible.
Taxes on withdrawals	• Ordinary income tax on earnings and deductible contributions. • No federal tax on nondeductible contributions. • State tax may apply.	• Distributions from contributions are federally tax-free. • Distributions from earnings are federally tax-free if over age 59½ and have owned the Roth IRA for at least five years. If under 59½, distributions are tax-free if the investor owned the Roth IRA for at least five years and the distribution is due to death or disability or for a first-time home purchase (with a $10,000 lifetime maximum for the latter). • State tax may apply.
Penalty for early withdrawal**	• 10% federal penalty tax on withdrawals before age 59½ unless an exception applies.	• Distributions from contributions are penalty-free. • 10% federal penalty tax on withdrawals of earnings before age 59½ unless an exception applies.
Required minimum distributions	• After age 70½. • Exception: A new federal law allows investors to skip their RMD for 2009.	• None.
Contribution deadline	• April 15 of the following year for any given tax year.	• April 15 of the following year for any given tax year.

*If married and filing a joint income tax return, the nonworking spouse may also contribute to an IRA. The total contribution for both spouses cannot exceed the income of the working spouse for the contribution year.

**Distributions received before reaching age 59½ may not be subject to the 10% federal penalty tax if the distribution is for a first-time home purchase (lifetime maximum of $10,000), post-secondary education expenses, substantially equal periodic payments taken under IRS guidelines, certain medical expenses exceeding 7.5% of adjusted gross income, an IRS levy on the IRA, health insurance premiums (after receiving at least 12 consecutive weeks of unemployment compensation), or disability or death.

Tax year when taxable income is reported. Taxpayers who convert in 2010 will be able to spread the conversion income evenly across 2011 and 2012, unless they choose to recognize all of the income in 2010. The two-year option exists for 2010 conversions only. In deciding when to recognize the income, investors should consider two major factors: (1) It is the conversion income that would be evenly spread between 2011 and 2012, not the tax liability. In other words, the total amount of tax owed on the income may differ depending on when it is recognized. Because the conversion amount increases total taxable income, it potentially could reduce the deductions or credits available to the investor in a given year. (2) Under the current tax code, tax rates are scheduled to increase after 2010. Therefore, investors who elect to spread the taxable income over 2011 and 2012 may pay higher taxes on the conversion if current tax provisions remain unchanged. (Figure 4 shows relevant details.) Keep in mind that investors who convert in 2010 will not have to make a decision about the two-year option until April 15, 2011, so this might provide additional flexibility during 2010 tax preparation.

Pro-rata rule. Investors with traditional IRAs that include both pre-tax and after-tax balances cannot elect to convert only the after-tax assets to a Roth. This is because of the IRS "pro-rata rule," which requires that each distribution from an IRA contain the same proportions of taxable and nontaxable assets that exist in the account. For investors with more than one traditional IRA account, the distributions must reflect the proportions in those accounts taken in aggregate. The pro-rata rule only applies to investors who are contemplating a partial conversion.

Roth conversion five-year holding period. If the account owner withdraws converted money within five years of the conversion, distributions are generally subject to a 10% early withdrawal penalty on the converted amount (unless an exception applies). A separate five-year period applies to each conversion. There are exceptions such as reaching age 59½, death, and disability, to name a few.

Required minimum distributions. As mentioned earlier, traditional IRAs and tax-deferred employer-sponsored plans are subject to required minimum distributions (RMDs) beginning when the investor reaches age 70½. If an investor anticipates using the RMDs to meet spending needs, then it may not make as much sense to convert to a Roth unless the investor anticipates being in a higher future tax bracket. On the other hand, if an investor does not need the RMDs for spending (and thus has a longer time horizon for the account), then it may make sense to convert to a Roth and benefit from tax-free growth. A few things to keep in mind:

- A partial conversion will reduce future RMDs.
- Investors over the age of 70½ must satisfy any RMD before or at the time of conversion. The IRS does not allow RMDs to be converted, and doing so may subject the IRA owner to additional taxes and penalties.
- For investors who are receiving Social Security benefits, Roth distributions do not factor into the calculation of whether benefits are taxable. While the income from the conversion would impact the calculation for the year when the income is recognized, future distributions will not.

Other strategic factors to keep in mind

Beyond the considerations already discussed, other factors can influence the Roth conversion decision. Because they are specific to each individual's situation, we discuss general guidelines.

High income earners who do not qualify to make Roth IRA contributions. The elimination of the income limit for Roth conversions provides a new opportunity for these investors. Currently, they can make use of a loophole that allows investors to contribute to a nondeductible traditional IRA each year and then immediately convert to a Roth IRA.

Estate planning. For investors who consider wealth transfer a priority and have assets that would be subject to estate taxes, a Roth conversion may provide additional benefits. The value of either type of IRA would be included in the estate; however, if an investor elects to convert, the estate (and associated estate tax liability) would be reduced by the amount of the income taxes paid on the conversion. In effect, the investor would be prepaying taxes at income tax rates, which are currently much lower than estate tax rates. Further, the beneficiaries would not have to pay income taxes on the Roth distributions. On the other hand, for investors who are charitably inclined, converting a traditional IRA to a Roth IRA may not maximize the value of the transfer since assets that pass to a charity are not subject to income taxes. Clearly, the estate-planning considerations can be complex, so investors concerned about wealth transfer should consult with a tax professional before converting.

Recharacterizations and reconversions. Investors should be aware that they can elect to reverse a Roth conversion by moving the converted assets back to the original account type; this is known as a recharacterization. This recharacterized amount will be adjusted for any gain or loss incurred while invested in the Roth IRA, but will otherwise be treated as never having been converted. The deadline to recharacterize a Roth IRA conversion is the tax filing deadline for the year of conversion, plus any extension.[5]

An investor may want to consider a recharacterization in several situations. Two typical ones: (1) The investor does not have sufficient nonretirement assets to pay the tax on the conversion. (2) A market downturn reduces the converted account balance, so the investor may want to recharacterize in order to avoid paying taxes on the original, higher balance. Once an investor recharacterizes a Roth conversion, he or she may subsequently "reconvert" the traditional IRA back to a Roth. However, there are time constraints, so the process must meet both of the following conditions:

- The new conversion cannot be in the same year as the original conversion.
- The new conversion cannot be made within the 30-day period beginning on the date of the completed recharacterization.

Tax reporting for recharacterizations can be complicated, so an investor should review this strategy with a qualified tax advisor to ensure proper reporting.

5 This means that the deadline to recharacterize a 2010 Roth conversion will be April 15, 2011 (or October 15, 2011, if the investor requests a tax-filing extension). As of mid September 2009, this deadline had not been extended for investors taking advantage of the tax deferral option for 2010 conversions. See IRS Publication 590 and IRS Form 8606 for more details.

Figure 4. Income tax rates: Pre- and post-JGTRRA and TIPRA

Marginal income tax rates	2002	2003–2007	2008–2010*	2011*
Thresholds based on 2009 taxable income**				
Single: Over $372,950 Married filing jointly: Over $372,950	38.6%	35%	35%	39.6%
Single: $171,551–$372,950 Married filing jointly: $208,851–$372,950	35%	33%	33%	36%
Single: $82,251–$171,550 Married filing jointly: $137,051– $208,850	30%	28%	28%	31%
Single: $33,951–$82,250 Married filing jointly: $67,901–$137,050	27%	25%	25%	28%
Single: $8,351–$33,950 Married filing jointly: $16,701–$67,900	15%	15%	15%	15%
Single: $0–$8,350 Married filing jointly: $0–$16,700	10%	10%	10%	No 10% bracket
Capital Gains Tax Rates				
Long-term capital gains (10% and 15% tax brackets)	10%	5%	0%	10%
Long-term capital gains (All other brackets)	20%	15%	15%	20%
Short-term capital gains	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income
Dividend Tax Rates				
10% and 15% tax brackets	Taxed as ordinary income	5%	0%	Taxed as ordinary income
All other brackets	Taxed as ordinary income	15%	15%	Taxed as ordinary income

*For 2010 and 2011, the table reflects what is outlined in the current tax code.

**We are providing the 2009 taxable income thresholds as a reference to help investors gauge how the additional taxable income created by a conversion may affect their marginal tax bracket. These thresholds are updated by the IRS annually.

Note: JGTRRA is the Jobs and Growth Tax Relief Reconciliation Act of 2003. TIPRA is the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005.

Conclusion

The changes coming in 2010 offer new retirement planning opportunities to high-income earners who previously were unable to invest in Roth IRAs. At the same time, these changes introduce new planning challenges. Most notably, the Roth conversion decision depends to a great extent upon tax rate expectations at the time of withdrawal—and the future tax environment is currently unclear. Absent further legislative changes, tax rates above the 15% bracket are scheduled to revert to pre-2002 levels in 2011, potentially exposing many investors to higher tax rates.

Although tax experts generally do not recommend accelerating the recognition of income taxes, a Roth conversion may provide significant benefits for many investors. As always, investors should consider consulting a tax-planning professional about their unique circumstances before making a final decision.

Important dates for Roth conversions in 2010

January 1, 2010: Eligibility requirements are lifted for Roth conversions, allowing anyone to convert non-Roth IRA and eligible employer plan assets into a Roth IRA. Taxpayers who convert to a Roth IRA in 2010 may divide the resulting conversion income between tax years 2011 and 2012 for the purpose of paying the taxes owed, or they may report all of the income for the 2010 tax year.

December 31, 2010: This is the last day to initiate a Roth conversion distribution to be reported for the 2010 tax year. For conversions made after this date, there is no option to spread the income over subsequent years for tax purposes. Instead, taxes on conversion income will be owed for the year of the conversion.

January 31, 2011: IRS Form 1099-R, reporting any distributions from an IRA (including conversion distributions) in the year 2010, must be made available to the taxpayer by this date.

April 15, 2011: Income tax returns for tax year 2010, or extension requests, must be filed by this date. If neither is filed, then this is also the deadline to recharacterize any Roth conversion made in 2010 back into a traditional IRA.

May 31, 2011: IRS Form 5498, reporting any contributions to an IRA (including conversions into a Roth IRA) in the year 2010, must be made available to the taxpayer by this date.

October 15, 2011: If the taxpayer's 2010 tax return (or extension request) was filed on or before April 15, 2011, then this is the deadline to recharacterize any Roth conversions made in 2010 into a traditional IRA. If the taxpayer has already filed a 2010 tax return, the return may need to be amended. See IRS Form 8606 or a tax advisor for more information.

April 16, 2012: Income tax returns for tax year 2011 (or extension requests) must be filed by this date. If the taxpayer performed a conversion in 2010 and chose to defer the income to subsequent years, then he or she must report 50% of the conversion income as part of adjusted gross income (AGI) on this return. (April 15, 2012, falls on a Sunday. We are assuming that the IRS will move the tax filing deadline to the next business day, as they have done previously in such cases).

April 15, 2013: Income tax returns for tax year 2012 (or extension requests) must be filed by this date. If the taxpayer performed a conversion in 2010 and chose to defer the income to subsequent years, then he or she must report the other 50% of the conversion income as part of AGI on this return.

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