

Ins and outs of Roth IRA conversion

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Today I'll answer more questions about Roth IRA conversions.

As stated in previous columns, starting in 2010, anyone can convert a regular individual retirement account to a Roth IRA regardless of income or filing status. Before this year, you could not convert if your income was more than \$100,000 or if you did your tax return as married filing separately.

The amount you convert to a Roth in any year is added to your income, usually in the year of conversion. This year only, you have the choice of adding it to your 2010 income or splitting it evenly between 2011 and 2012. For more background, see my past columns at sfgate.com/ZJCX and at sfgate.com/ZJFK.

Q: Bruce asks, "Can a SEP IRA be rolled into a Roth?"

A: Yes. Money that is in a SEP IRA can be taken out and transferred via "taxable rollover" to a Roth IRA, says Natalie Choate, an attorney with Nutter, McClennen & Fish.

Q: Bob W. asks, "Can a person with no 'taxable compensation' income convert from a traditional IRA to a Roth?"

A: Yes. Although you need compensation from a job to contribute to a Roth, you do not need it to convert from a regular IRA to a Roth.

Q: Kit O. writes, "Let's say I have \$90,000 in my SEP IRA to convert this year. Can I convert the whole \$90,000 immediately and take \$30,000 on my 2010 taxes, then split the other \$60,000 between 2011 and 2012? I'm retired and have no other income, so the taxes on \$30,000 three times (2010, 2011, 2012) is less than the taxes on \$45,000 twice (in 2011 & 2012)."

A: Definitely not, Choate says. If you convert \$90,000 from an IRA, SEP IRA or other traditional plan to a Roth IRA in 2010, you only have two choices regarding how to recognize the income from that conversion.

One is to recognize the entire \$90,000 in 2010. The other is to recognize \$45,000 in 2011 and \$45,000 in 2012. You cannot spread the income from a 2010 Roth conversion out over three years. Even if you do separate multiple Roth conversions in 2010, you have to include all the income in 2010 or spread it over 2011 and 2012.

If you really want to spread the income over three years, you have two choices. You could actually convert one-third of the account in 2010, one-third in 2011 and one-third in 2012. Of course if the account increases in value over those years, the resulting income from the conversions will increase.

Or, if a husband and wife are both doing conversions, the wife could spread the income from her conversion forward over 2011 and 2012 and the husband could take all the income from his conversion in 2010, Choate says. That would approximate the effect of spreading it out over three years.

Q: Martin M. asks, "I'm 72 and my wife just turned 70 in January. We are both retired and have no earned income. My wife has her own IRAs from past employment and would like to convert as much as possible to a Roth. We can afford the extra taxes.

"Since most of our present income is from my pension and Social Security and only a small amount from my wife's Social Security, it occurred to me that if we filed separately, her income would be low and therefore the tax on her IRA conversion could be in a lower tax bracket assuming she doesn't convert all of it. Is this a possibility?"

A: This depends on each spouse's income, their deductions and which spouse takes them, the size of the converted IRA and other thorny issues. An individual who chooses married filing separately goes into a higher income tax bracket at roughly half the income level of a married couple filing jointly. Some couples who normally file jointly could lose deductions or exemptions if they choose to file separately.

Robert Keebler, a certified public accountant in Green Bay, Wis., doubts whether this couple would benefit from filing separately. But the only way to know for sure is to run the numbers both ways and see.

"Anyone planning to do this in 2010 should plan ahead to make sure all of the itemized deductions are paid by the spouse who will receive the most benefit from those tax deductions," says Stephen Koster, a tax lawyer in Newton, Mass.

Q: Tom T. asks, "Over the years I made nondeductible contributions of \$50,000 to my traditional IRA. The stocks and funds in the traditional IRA are now worth \$100,000. If I only convert \$50,000 into a Roth IRA, what is the taxable amount? If I convert all \$100,000, what is the taxable amount?"

I also made deductible contributions to other retirement accounts such as a 401(k) and SEP IRA that I do not plan to convert into a Roth IRA. Will converting the traditional IRA account affect my other retirement accounts in term of taxes?"

A: In his traditional IRA, Tom has \$50,000 in after-tax money (his nondeductible contributions) and \$50,000 in pretax money (his earnings). If this was his only IRA and he converted any amount into a Roth, one-half would be tax-free and one-half would be taxed.

However, under the tax code all of your traditional, SEP and Simple IRAs are considered one big IRA. When you take money out of any one, it's deemed to be coming out of all on a pro rata basis, no matter which account you take it from.

Suppose that in addition to his regular IRA, Tom has a total of \$100,000 in his SEP IRA. So all of his IRAs combined are worth \$200,000. But only \$50,000 or one-fourth of this amount is money that has already been taxed.

If he converts \$50,000 to a Roth IRA, one-fourth or \$12,500 would be tax-free and three-fourths would be taxable.

If he converts \$100,000, then one-fourth or \$25,000 would be tax-free and \$75,000 would be taxable.

IRA expert Ed Slott says it's like putting cream in your coffee. "Once you mix it up, every drop is a percentage cream and a percentage coffee. The cream is the nondeductible part. You can't just take it out by itself."

A 401(k) plan is separate from your IRAs. It is not added into this calculation. It's a different cup of coffee.

Net Worth runs Tuesdays, Thursdays and Sundays. E-mail Kathleen Pender at kpender@sfgate.com.

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