

Conversion tax choices

The 2010 calendar year was an important one for the “Roth accounts” —Roth IRAs, Roth 401(k)s, Roth 401(b)s, Roth 457(b)s. It was the year that the income cap came off on conversions of retirement accounts from pre-tax status to after-tax Roth status. We won’t know for some time just how many taxpayers took advantage of this opportunity, but early indications are that a great many did so.

The Roth conversion is reported to the IRS on Form 8606. This form is also where the taxpayer lets the IRS know whether he or she plans to pay the income tax on the conversion for the 2010 tax year, or spread the tax over the next two years, 2011 and 2012. As a rule, unless the taxpayer expects to be facing much higher marginal tax rates in the future, deferral of the tax payment is likely to be more advantageous.

What if the taxpayer did several Roth conversions in 2010? What if both traditional IRAs and 401(k)s were converted? Here are the IRS rules:

- All conversions of traditional IRAs in 2010 must have the same treatment. Either the tax is paid on all of them for 2010, or the tax is deferred on all of them. Picking and choosing are not allowed.

- A similar rule applies to 401(k)s; all in-plan Roth rollovers for 2010 must be treated the same for income-averaging purposes.

- However, an individual who has both 401(k) and IRA conversions may make separate elections for the two types of accounts; they need not be both the same. An individual who has a conversion from a traditional retirement plan to a Roth IRA and an in-plan conversion to a “designated Roth account” (such as a Roth 401(k)) also may make separate elections for the two transactions.

This is an advanced area of tax planning, not really suitable for amateurs. Be sure to seek professional tax advice before making any final decisions on your retirement plans.

(April 2011)

© 2011 M.A. Co. All rights reserved.