ASSURED RETIREMENT SOLUTIONS

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Roth Conversions Just Got Tougher

As much as we like Roth conversions and encourage individuals to convert, we do realize that Roth conversions aren't for everyone. There have always been many factors to consider before doing a conversion. With the passage of the 2012 tax act on January 2, 2013 and with the healthcare surtaxes taking effect in 2013, there are now more factors to consider.

One of the things clients worry about when doing a conversion is the effect on their income taxes. In 2013, we now have an additional tax bracket, 39.6%; we have the phase-outs of itemized deductions and personal exemptions; and we have the addition of the surtax on net investment income, 3.8%. Not only do we have these new tax considerations, but they all become effective at different levels of income and on different types of income.

We generally advise that the income tax due on the converted amounts should be paid with outside assets and not be taken from the retirement account. Many times that involves the sale of investment assets with the accompanying capital gain taxes. There is now an additional capital gain rate of 20%. The sale of investment assets could also put the client at risk of becoming subject to the 3.8% net investment income surtax. Those are just two more things to consider when contemplating the value of a Roth conversion.

The new law also changed the rules for doing an in-plan Roth rollover (IPRR). The IPRR is an optional feature for employer plans, it is not mandatory. Under the new rules, if an employer plan has a Roth feature, and if the employer plan allows for IPRRs, any employee can do the IPRR. Under the old rules you had to be eligible to take a distribution from the plan in order to do the IPRR. This puts the IPRR in the reach of any employee. The biggest drawback to the IPRR is that there is no recharacterization allowed. Once you do the rollover to the Roth, you are stuck. There is no undo allowed, you will have to pay the tax owed on the conversion.

This is just one more thing to consider when determining whether or not to do a Roth conversion. Should you convert your IRA funds or should you convert your plan funds?

To sum it all up, there are now more items that the conversion could affect on your tax return; you need to be more thoughtful about where your income comes from to mitigate the impact of the investment surtax; you have to decide whether to do the conversion in an employer plan or outside of a plan and you still have to consider factors that have not changed under the 2012 tax law such as the effect of the conversion income on your tax bracket.

If you are older - the effect of the conversion income on Medicare Part B premiums; if you are younger -the effect of the conversion income on financial aid you or a family member is receiving; will your taxes be higher when you retire; what will be your sources of income when you retire; what will be the source of the funds to pay the tax on the conversion.

There is a lot to think about, which is why we suggest having a Roth conversion conversation before deciding to go through with the conversion itself.

The best piece of advice I can give you is that you should work with a financial professional when you are considering doing a Roth conversion.