A guide to Roth conversions: Deciding what works for you

When it comes to Roth conversions, there are no "one-size-fits-all" answers. Each situation is different — and there is much to consider.

If you have decided to convert, you have probably concluded that you will come out ahead. Only time will tell whether you do come out ahead, and this will depend on:

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- The rate of return on your portfolio — the higher the return, the higher the advantage of tax-free growth.
- The tax rate that you pay on the converted funds — adding a large amount to your income may push you into a higher tax bracket.
- The tax rate that you would pay in the future as you withdraw the required minimum distributions — smaller amounts added to income incrementally would keep distributions taxed in a lower bracket; however, future tax rates may be higher.
- How long you can leave the converted funds untouched — the account needs time to recover from the tax hit on conversion.
- Whether you can pay the tax from savings rather than from the IRA — it is best to use other savings.
- Whether you will need to spend the IRA during your retirement, which would put an end to the tax-free growth in the Roth, or whether you have ample savings elsewhere.
- Assuming you can afford to save the whole converted amount, the age of your beneficiaries — the younger they are, the longer they can leave the Roth to grow tax-free, subject to the requirement that they take the required minimum distributions.

When to pay state income tax

If, after careful analysis, you decide to convert, next comes the "when to pay the state income tax" decision tree. The converted amount will be included in income in the 2010 tax year, which will mean you owe state income tax on it for the year 2010.

- The state income tax is due no later than April 15, 2011, to avoid a late-payment penalty.
- You may want to increase your estimated payments to avoid a late payment of estimated tax penalty.
- You can avoid the late payment of estimated tax penalty by making sure your total withholding and estimated tax payments for the year 2010 equal a safe estimate, which is either 100 percent or 110 percent of your total 2009 tax.
- Even if you can wait until April 15, 2011, to pay the state income tax, you may want to pay the state income tax in 2010 (rather than in 2011), especially if you include the converted amount in income on your 2010 federal return, because you may get more tax savings from the resulting state income tax deduction in 2010 than in 2011.

No state income tax is due if you convert a rollover IRA from a lump-sum distribution from a qualified defined benefit employer plan. Note that 401(k) plans, 403(b) annuities, thrift savings plan or state deferred compensation plans are not defined benefit plans.

When to include the converted amount in income

For federal income tax purposes, you have a choice — you can include the entire amount in income in 2010, or you can include half in income in 2011 and the other half in income in 2012. Let's assume you convert $60,000.

- Including the entire $60,000 amount in income in 2010 may push you into a higher income tax bracket, whereas including $30,000 in 2011 and $30,000 in 2012 may keep you in a lower tax bracket.
- Including half in income in 2011 and the other half in 2012 allows you to defer payment of the income tax.
- Deferring the income to 2011 and 2012 may subject the conversion income to higher tax rates. If the Bush tax cuts expire (and they will expire unless Congress acts), as a rule of thumb everyone's tax rate will increase by 3 percent.
- The income tax for 2011 is due no later than April 15, 2012, and the tax for 2012 by April 15, 2013, but be sure to make safe estimated tax payments for both years.
- For 2010 only, there is no phase-out of itemized deductions, which is another reason to include the conversion income in 2010.

Whether to unconvert

If you change your mind and decide that converting was not such a good idea, you can "unconvert" — just switch the account back to a regular IRA. You have until October 2011 to "unconvert."

- If you include the conversion amount in income in 2010 (which you necessarily will for state tax purposes), if you "unconvert" then you will have to amend your income tax return and get a refund.
- If you include the conversion amount in income — half in 2011 and half in 2012, perhaps decide whether you are going to "unconvert" before any federal payments are made. Worst case, you will owe a penalty for underpayment of estimated tax, which essentially is interest on the late payments.

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