

ROTH AND TRADITIONAL IRA TAXATION



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SHOULD YOU CONVERT TO THE ROTH IRA?

The decision to convert from a conventional IRA to the Roth IRA is one that depends on your particular circumstances. The Roth IRA follows most of the rules governing conventional IRAs and other deductible pension plans, however, it has a twist in that you pay the tax up front and your future appreciation is exempt from federal income tax.

It should be noted that the Roth IRA is subject to the usual restrictions on withdrawing money before retirement but it is important to note, in addition, that money withdrawn from a Roth account within five years is subject to a 10% penalty.

There are several items that need to be taken into consideration when making the decision to convert from a conventional IRA to a Roth IRA. If the marginal tax rate for an individual, when making a contribution, is higher than the rate that will be applied to the distributions (the typical scenario for most individuals) then conventional IRAs and other deductible pensions offer a more tax-advantaged investment environment than a Roth IRA. That is, deductible pensions generally provide more after-tax benefit per dollar invested.

But tax efficiency is not the whole story. An investment return of 10% may provide more benefit per dollar than does an 8% return, but you may end up with more dollars on a

larger investment earning 8% than on a smaller one earning 10%.

The Roth IRA allows a larger tax-advantaged investment than a conventional IRA: \$2,000 after taxes to a Roth account is larger than \$2,000 pretax to a conventional IRA. This extra savings may make contributing to a Roth IRA attractive for some taxpayers. Converting a deductible pension to a Roth IRA has the potential of substantially increasing tax-advantaged investment. This can increase wealth and save estate tax.

Converting can also be attractive because you end up sheltering more money in a Roth account. Conversion requires that you take a distribution from the conventional IRA and pay income tax on this distribution. You then make a Roth contribution equal to the pretax value of the distribution from your conventional IRA.

On the other hand, converting usually means paying more tax than if you were to withdraw the money during retirement. Thus, converting is more beneficial if done when other taxable income is low and if done gradually rather than all at once. This strategy minimizes the adverse effects of graduated tax rates at the time of conversion from a conventional IRA to a Roth IRA.

The dilemma is that the possibility of extra tax is in favor of conventional IRAs and deductible pensions while the potential for extra savings in a tax-advantaged environment favors conversion to the Roth

IRA. Because of this trade-off, the benefits of conversion are case-specific. Assuming benefits are favorable in your circumstance, you should assess additional issues before deciding to convert.

Future changes could affect the benefits of a Roth conversion. Because the Roth IRA is new and regulations have not been issued, the rules are unclear and vulnerable to change. While the tax-exempt status of Roth IRAs probably won't be repealed, the appreciation of a Roth account, for instance, may become subject to the alternate minimum tax or it might be considered when determining the taxability of Social Security benefits.

The Legal Office is here for you! Please call us at 377-4114.

This pamphlet gives basic information about taxation of IRAs as it relates to military personnel stationed in Alaska. It is not intended to take the place of legal advice from a Judge Advocate. There may be important exceptions in some states to the information presented here. Please contact the 354th Fighter Wing Legal Office for questions and further information.

