

Roth IRA conversions: The tax fallout

This year, everyone has the opportunity to convert a traditional IRA to a Roth IRA. The downside is paying the ordinary income tax due on the conversion. Where is that money to come from? Financial planners have generally recommended against invading the Roth IRA for the tax money to avoid compromising this important retirement asset. But not too many taxpayers have tens or hundreds of thousands of dollars lying around in cash, ready to dedicate to this purpose.

The answer for many will be to look to the taxable portfolio. Taxpayers who have carried forward capital losses realized in past years can sell some winners this year without enlarging their tax bill, generating the necessary cash.

Many taxpayers still have unrealized losses to put to this purpose. Selling these positions will raise cash for tax payments while creating a reservoir of tax losses. Those losses can then be used to shelter additional realized capital gains from tax. Unfortunately, only \$3,000 of the net capital loss can be used to reduce the tax cost of the Roth conversion itself.

Example: Robert needs \$100,000 to cover the cost of his Roth IRA conversion. Among his taxable holdings are \$50,000 worth of shares he bought for \$75,000, and another \$50,000 that cost \$25,000. If he sells both holdings, the capital loss will perfectly offset the capital gain, so Robert's net tax bill won't go up. But he will have the \$100,000 in cash needed for the conversion.

Those who are lucky enough to have avoided having losing positions may have to bite the bullet, increasing their tax bill for their capital gains as they raise cash for the Roth conversion. By doing so this year, they may create future savings, avoiding the additional 3.8% health care tax on such gains coming in 2013, as well as the scheduled tax increase already on the books for 2011.

What if the taxpayer wants to continue owning the securities in the taxable portfolio? Can they be reacquired in the Roth IRA instead? There's no problem with having the Roth IRA buy shares sold at a profit, but shares sold at a loss can't be reacquired for 31 or more days without endangering the loss.