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THE TAX-CONSCIOUS ADVISER

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Taxpayers act with enough incentive

Roth conversions came in at $64.8 billion in 2010, above an expected $26.5 billion

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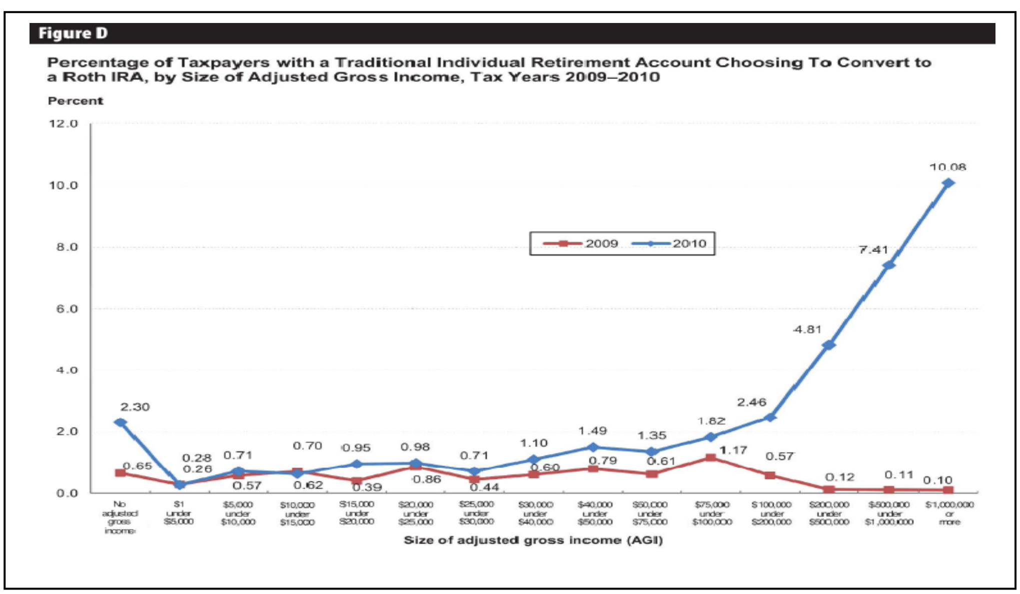
The verdict is in. The government can get people to voluntarily pay taxes earlier than they have to. It seems that if the incentives are high enough, taxpayers will act.

The year 2010 was the first in which those who made more than $100,000 annually could have converted their existing regular individual retirement accounts into Roth IRAs. Converting to a Roth created an immediate tax liability to savers, so the government further sweetened the pot by allowing the tax to be spread out over two years.

Congress' Joint Committee on Taxation had predicted a spike in revenue from conversions, but nothing near what happened.

The committee expected $26.5 billion in conversions in 2010. In fact, conversions came in at $64.8 billion. That amount represents nearly 10 times as much as the $6.8 billion in conversions the year before.



Internal Revenue Service statistics also show that 1 in 10 taxpayers earning $1 million or more annually in 2010 converted to a Roth.

The average conversion amount for all 869,400 taxpayers who converted was $74,534. The average amount converted by those earning more than $1 million was $454,850.

These people represented 22% of the 2010 conversions.

It seems that the not-so-obvious benefits from an inheritance standpoint didn't go unnoticed either: $6.2 billion was converted by those over 75, and 9,200 of these taxpayers were over 80. Oddest still were the 14,801 savers with no income who converted $2.4 billion into Roths.

I discussed in my last column why Roth conversions should be done as early as possible in the year.

Another facet of optimizing retirement savings comes in when retirement accounts are funded. Although putting the money in to compound away from taxes as early as possible is the right move, The Vanguard Group Inc. has found that just 10% of their clients do that. Vanguard found that 41% of their retirement accounts wait until the following year to put money into their retirement plans, losing a full year of tax-free growth that they could have had by acting earlier.

Conversions were much larger than what was expected, and the government raised a lot more money than it planned to.

Because the government pulled in much more than it expected in the short run, some commentators are concerned by what this might mean to balancing the budget over the longer term.

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