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Congress wouldn't tax Roth IRAs, would it?

It is a burning question for thousands of taxpayers now deciding whether to pay taxes to convert their regular individual retirement accounts to Roth accounts. All taxpayers are eligible to make the switch, because this year the income limit of $100,000 was permanently repealed. Many have done so already: Fidelity Investments says that as of May 31, the firm had handled 87,000 Roth conversions this year, about four times the number for the same period last year.

But dozens of less-convinced readers have asked Tax Report about Congress's intentions, and well-known IRA expert Ed Slott says he hears it from consumers and advisers every time he makes a speech: "'If I pay tax to convert my IRA,' they ask, 'how do I know Congress won't turn around and take away the benefits?'"

Calculating the Odds

These wary citizens are trying to calculate the odds of making a move they will regret, since lawmakers are wrestling with debt and deficits of epic proportions. President Obama has repeatedly called for higher taxes on top earners, and lawmakers have broken new tax ground several times this year already. A 3.8% Medicare tax on high earners' investment income has passed already, and heftier taxes on Subchapter S firms and the "carried interest" of investment partnerships appear imminent.

So are higher taxes on Roth accounts also on the way?

Without a crystal ball, it is impossible to answer the question definitively. But the short answer appears to be: "No, Congress won't tax Roth conversions, at least not soon." And the prospect of longer-term changes isn't deterring experts who are converting their own accounts.

First, let's review some basics. With a regular IRA, contributions usually come from pretax money, but withdrawals are taxable. The opposite is true for Roth IRAs: Contributions come from after-tax money, but withdrawals can be tax-free.

According to experts, the upshot is that if you think your personal tax rate will be higher in the future than it is now—or perhaps even the same—converting a regular IRA to a Roth account can make sense.

Roth accounts have other signal benefits as well: Unlike with regular IRAs, there aren't mandatory distributions for the owner, and Roth income doesn't help to raise Medicare premiums or taxes on Social Security. Roth withdrawals also aren't subject to the new 3.8% Medicare tax on investment income earned by the wealthy that will take effect in 2013, and they don't raise the likelihood that other income will be subject to the new tax.

Estate Planning

Roth IRAs also help with estate planning. Converting a regular IRA to a Roth reduces the size of a taxable estate, and Roth assets inherited by heirs can often compound tax-free for decades with only minimal annual withdrawals.

Great, right? The drawback is that turning a regular IRA into a Roth account means paying full income taxes on the conversion. Although overall tax rates are probably lower now than they will be next year and beyond for higher-income taxpayers, paying taxes before they are due goes against human nature, especially for those who fear a congressional double-cross.

Given the desperate need for revenue, this isn't a totally idle fear. And unfortunately there is a precedent when it comes to taxing those who have saved what lawmakers think of as "excessive." From 1987 to 1997 they imposed a 15% excise tax on annual retirement-plan distributions over $150,000. The tax applied even if other rules forced the account holder to withdraw more than $150,000, and it could hit retirement assets in estates as well.

A Hated Tax

This particular tax was so hated that it is hard to imagine its return. Michael Graetz of Columbia University, a former top tax official at the Treasury Department, also thinks it is unlikely that lawmakers would enact a wholesale levy on Roth assets. "That would be like taxing salary twice," he says. "Congress has never done this, and there's no reason to expect it will."

But he agrees that there are other, more-indirect ways lawmakers could erode the benefits of a Roth conversion at some future date—especially for very wealthy taxpayers who seem (to them) to be taking advantage of the system. They could try to tinker with income definitions for Medicare or Social Security, or perhaps require distributions for Roth owners. They might even tax an account's earnings if either the earnings or the account is above a certain threshold—although these would be such big changes in retirement policy that they don't seem likely, Prof. Graetz says.

What about a value-added tax, unlikely as one may be? A VAT is similar to a sales tax, so it would probably affect both regular and Roth accounts the way state sales taxes affect IRA withdrawals now—as a separate levy.

Of course, what actually happens depends on imponderables like the mood and composition of Congress. Prof. Graetz and others say that in the short run, lawmakers are probably hungriest for the revenue the flood of conversions is bringing in. Recently a spokesman for the House Ways and Means Committee said that members have no plans to tax Roth IRAs.

The bottom line: Roth benefits can be real, while cutbacks mightn't come for years if at all; meanwhile, tax rates are rising for those at the top. Wary taxpayers who stand to benefit from a conversion but don't want to be vulnerable to changes might want to do a series of partial conversions instead of one large one. These are allowed, and advisers often recommend them as a way of avoiding bracket leap on a conversion.

Aware of all the risks, Prof. Graetz himself feels comfortable making a partial Roth conversion this year, and he says many of his colleagues in the tax world are doing the same. They are in good company: Warren Buffett's billionaire partner Charlie Munger told attendees at this year's Berkshire Hathaway meeting that he is converting an old IRA to a Roth. The 86-year-old, who is still going strong, later said he plans to leave the account to his heirs, which include eight children and 16 grandchildren: "I think it just makes sense."

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