



2010 ROTH IRA CONVERSIONS

What are the rules for Roth conversions in 2010 and beyond?

Effective January 1, 2010, the \$100,000 modified adjusted gross income limit on conversions from a traditional IRA (including a SEP-IRA or SIMPLE IRA) to a Roth IRA, as well as the current bar on conversions for married taxpayers filing separate returns, will no longer apply. Any taxpayer, regardless of income, will be able to convert all or part of an existing IRA into a Roth IRA.

When are the converted amounts included in income if a conversion is made in 2010?

For conversions that take place in 2010 only, the converted amount is included in gross income in two equal amounts in 2011 and 2012, unless the taxpayer otherwise elects. The election is made upon filing the 2010 tax return, so the taxpayer who has extended the return can wait until October 15, 2011 to decide whether to include the amount in income for 2010 or defer it to the following years.

When are the converted amounts included in income if a conversion is made in other years?

For all other years, the entire converted amount will be included in income for the year of the conversion.

What is the purpose of a Roth conversion?

In essence, a Roth conversion involves trading today's income tax rates for future income tax rates. If an account holder expects to be in a lower tax bracket during the withdrawal phase, a Roth conversion is not particularly attractive. A relevant but less important consideration is whether the investments held by the existing IRA reflect a depressed market value that is expected to significantly increase in future years.

What are the benefits of a Roth conversion?

First, the earnings portion of distributions from a Roth IRA are not subject to federal income tax or the 10% early distribution penalty provided (i) the distribution is made at least five years after the conversion, and (ii) the account holder is age 59 ½ or the distribution is made because of death, disability, or the purchase of a home by a qualified first-time homebuyer (limited to \$10,000). For retirement planning purposes, this may help a taxpayer remain in a lower tax bracket, avoid increased taxation of Social Security benefits, and maintain more favorable AGI-based deductions. Second, Roth IRAs are not subject to the required minimum distribution rules, thus allowing a retiree to withdraw funds at a more leisurely pace or accumulate additional funds for beneficiaries.

What are the disadvantages of a Roth conversion?

The primary disadvantage is that the amount converted will be subject to ordinary income tax in the year it is converted (unless the 2010-only deferral option applies). Collateral consequences of income inclusion should also be taken into account, including: (i) placing the taxpayer in a higher tax bracket or within the alternative minimum tax (AMT), (ii) increasing the amount of Social Security benefits subject to income tax, (iii) increasing the taxpayer's costs for Medicare Part B benefits, (iv) increasing the 7.5% floor for deduction of medical expenses, (v) reducing the availability of AGI-based deductions, (vi) potentially increasing state taxes, and (vii) potentially reducing the availability of financial aid for college-bound children.

How should the conversion tax be paid?

The taxpayer should use funds outside of the IRA to pay the conversion tax. Although selling other assets to raise the cash necessary for the conversion tax may accelerate capital gains that the taxpayer otherwise would have deferred, a taxpayer with capital losses or loss carryforwards may be able to offset a significant portion of the conversion tax liability. The accountholder should also consider whether the funds used to pay the conversion tax might be better applied elsewhere, particularly if an alternative investment would pass to heirs with a step-up in basis.

Can IRA funds be used to pay the conversion tax?

A taxpayer is permitted to use funds within the converted IRA itself to pay the income tax. However, this will reduce the amount in the Roth IRA that can grow tax-free, will be subject to the 10% penalty if the accountholder is under age 59 ½, and cannot be returned to the IRA in the event of a recharacterization.

How will nondeductible IRA contributions affect the conversion tax?

If the accountholder has *any* IRA that contains nondeductible contributions, *all* of the person's IRAs must be aggregated in determining how much of the converted amount is not subject to income tax (the "pro rata" rule). For example, if Joe has four different IRAs totaling \$450,000 of deductible contributions and \$50,000 of after-tax contributions, 90% of the amount converted from all or any of the IRAs will be subject to tax.

Should the conversion be made to an existing Roth IRA?

No. The conversion should be made to a new, separate Roth IRA that holds only the converted funds. This allows the taxpayer the option of recharacterizing the conversion should asset values significantly decline. The taxpayer may also separate the converted funds into separate Roth IRAs based on asset classes in order to more easily monitor investment performance and recharacterize as necessary.

What are the estate planning advantages of conversion?

A Roth conversion allows the taxpayer's IRA funds to grow tax-free over a longer period of time because distributions are not required until the accountholder's death. The beneficiary upon death will still enjoy the benefits of tax-free growth, which can be exponential if the beneficiary is young. In addition, a conversion will reduce a taxpayer's estate tax liability and may avoid estate tax altogether if the asset level is close to the federal limits. However, the tax bracket of the intended heirs should be taken into account to determine whether the Roth conversion actually increases the total intergenerational tax burden.

Should a Roth conversion be made if the IRA's market value has dropped significantly?

Not necessarily. Most individuals expect to be in a lower tax bracket upon retirement, and so paying a higher rate now on a reduced value may not be better than paying a lower rate later on a greater value. If an IRA's assets decline further following a conversion, the taxpayer should consider recharacterizing the conversion.

What is the most important factor in considering a conversion?

The major wild card in deciding whether to make a Roth conversion – and when to pay the tax on a conversion – is future income tax rates. Given the likelihood of health care reform, anticipated funding problems for Social Security and Medicare, and the increased federal deficit, most analysts expect some level of higher tax rates in the near future. If no Congressional action is taken, current tax brackets will reset to their pre-2001 levels after 2010, resulting in a 4.6% increase in the top tax bracket (35% to 39.6%) and a 3% increase for the next three brackets. As a result, high income taxpayers that believe their tax rates will go up may prefer to pay the entire conversion tax in 2010 rather than spreading it out over the following two years. In addition, some taxpayers may prefer to implement a Roth conversion to remove the uncertainty surrounding future tax rates.

Conversion should be considered if....

- The taxpayer is several years away from retirement.
- The taxpayer believes that her income tax rate will be the same or higher in future years.
- The taxpayer believes that the IRA assets will appreciate significantly in future years.
- The taxpayer is likely to be subject to the estate tax.
- The taxpayer has non-retirement account assets available to pay the tax or losses that can significantly offset the tax liability.
- The taxpayer wishes to diversify the tax consequences of retirement distributions by completing a partial conversion.
- The taxpayer has room to fill up a lower tax bracket with conversion amounts.
- The taxpayer has the ability to make contributions after reaching age 70 ½.
- The taxpayer does not need the IRA funds for retirement.

Conversion may not work to the taxpayer's advantage if....

- The taxpayer is retired and relies on distributions from a traditional IRA to pay living expenses, or has an immediate need for the money.
- The taxpayer is close to retirement and expects to have a lower income tax rate during retirement years.
- The taxpayer does not have available outside funds to pay the conversion tax.
- Inclusion of the conversion amount will significantly increase the accountholder's tax liability for the year beyond the mere inclusion of the converted amounts.
- The taxpayer believes that Congress will change the current tax treatment of Roth IRAs.
- The IRA beneficiary is a tax-exempt entity.

Steps to take now....

- High-income taxpayers should consider making nondeductible IRA contributions in 2009 in preparation for a 2010 Roth conversion.
- High-income taxpayers that plan to make a 2010 conversion should defer deductions to 2010 and accelerate next year's income into 2009 (the reverse of standard year-end planning).
- Consult with a financial advisor to determine whether a Roth conversion fits within the taxpayer's financial objectives and overall estate plan.