



February 2010

2010 MAY BE THE YEAR FOR A ROTH CONVERSION

Effective 1/1/10, the rules governing eligibility for converting a traditional IRA or rollover from a qualified employer plan to a Roth IRA have changed. The \$100,000 adjusted gross income (AGI) cap that prevented many people from converting to a Roth and limitations preventing taxpayers who filed as married filing separately have been repealed.

Not only that, but individuals who convert in 2010 have the option to either pay taxes on all of the conversion income in 2010 or to defer and spread recognition from the conversion over tax years 2011 and 2012 by reporting 50% of the conversion income in each of those years. A 2010 conversion could reduce the marginal tax rate on what would have been an otherwise single-year larger distribution. Note that the 10% penalty on early or excess distributions does not apply.

There are several reasons why a conversion should be considered as a retirement income and estate planning strategy. If a taxpayer expects to be in a lower tax bracket, then the traditional IRA may be preferable but for those taxpayers who anticipate maintaining their current standard of living and marginal tax rate, the Roth IRA avoids the tax upon withdrawal at ordinary rates and the required minimum distribution that traditional IRAs require. Also, Roth distributions are not included in the calculation of modified AGI for Social Security purposes which is important in supplementing retirement income without taxing Social Security benefits. Other reasons to consider include the fact that Roth IRAs pass income tax-free from parent to child. The tax-free status of the Roth can extend far into the future if a surviving spouse names a young grandchild or great-grandchild as the beneficiary. Gifting rules and beneficiary designations need to be considered.

A Roth conversion will mean that you will have to pay federal and state income taxes on all tax-deferred money included in the conversion. Also, you cannot withdraw the assets for five years after conversion or until age 59 ½ without paying a 10% penalty.

Roth conversions are also reversible. A taxpayer can reverse or "re-characterize" a traditional-to-Roth conversion within six months of the original due date (without extensions) of his tax return. A taxpayer may want to consider a re-characterization if the value of the Roth declines after conversion, making the tax bill more relative to that value.

One strategy to consider getting into a Roth may be as follows: While there are no income limits on making nondeductible IRA contributions, there are limits on making Roth contributions (Individuals with AGI for 2010 of \$120,000 or more can't contribute. For joint filers, that limit is \$177,000.) A taxpayer could fund a traditional IRA with a non-deductible contribution and then convert those assets to a Roth. The IRS has instituted a pro-rata rule that requires you to consider the assets in all IRA accounts (except Roths and inherited IRAs), including rollover IRAs from past employment, to calculate the tax on the conversion. Tax is owed proportionately on the amount that wasn't previously taxed.