ROTH IRA CONVERSION OPPORTUNITIES (AND TRAPS) IN 2010

Peter L. Reiss

<u>New Law</u>. A recent tax law change has repealed the $100,000.00 income limit on Roth IRA conversions and has also made married taxpayers filing separate returns eligible for Roth IRA conversions. Amounts in "eligible retirement plans" (traditional IRAs and employer-sponsored plans) may now be rolled over into Roth IRAs without regard to income limits that apply to regular contributions.

<u>Important Background</u>. Amounts distributed from traditional IRAs and employer retirement plans are subject to regular income tax in the year they are received. Amounts distributed from Roth IRAs are not taxable provided certain rules (e.g. a 5-year holding period) are met.

<u>Tax Deferral</u>. Generally, the value of previously-untaxed retirement assets (pre-tax contributions and untaxed earnings) rolled into Roth IRAs is included in gross income and subject to tax in the year of the rollover. In 2010, however, unless the taxpayer elects otherwise, one-half of the amount includible in income as the result of a 2010 conversion is subject to tax in 2011 and the remaining half is subject to tax in 2012. If the taxpayer withdraws amounts converted in 2010 to a Roth IRA before 2012, the income inclusion is accelerated. If a taxpayer dies before all amounts from a Roth IRA conversion have been included in income, the remaining amounts will be included in income in the year of death.

<u>The Potential Downside of Deferral</u>. If you elect to have your 2010 Roth IRA conversion taxed in 2010, you may not later change your mind. If you take the automatic deferral, it may end up costing you more tax if income tax rates increase in 2011 and/or 2012, or if you will otherwise be in a higher income tax bracket in 2011 and/or 2012.

<u>Should You Convert</u>? It depends. If your personal tax rate is likely to be lower in the years when you will be taking normal IRA distributions, probably not. Although you will pay regular income tax on distributions from traditional IRAs or retirement plans when you receive them, you will pay more tax now on the conversion if you are in a higher tax bracket now. If you don't have cash on hand (in excess of your near-term cash needs) to pay the tax on the conversion, you should not convert. Paying the income tax on the conversion from the IRA assets should not be an option because this would substantially decrease the amount you can earn tax-free in the remaining Roth IRA funds, and, if you are under age 59-1/2, any funds withdrawn to pay the tax are subject to the 10% premature withdrawal tax, because those funds are not being converted to the Roth IRA. Also, see the caveats at the end of this article.

Pay Attention to Your Near-Term Needs. If your employment situation is precarious or you anticipate having to make substantial expenditures, for example for college tuition, in the near future, it may not make sense to pay extra tax on a Roth IRA conversion now. As in most cases, the tax decision should not be made without considering non-tax factors.

Some Caveats.

1. If you do a conversion, try to do it as a direct trustee-to-trustee rollover. If you receive a distribution check from your current plan administrator to convert to a Roth IRA, you must deposit the funds into the Roth IRA within 60 days. If you miss this deadline, the distribution is taxable, and, if you are under 59-1/2, also subject to a 10% penalty.

2. Your taxable income increases because of the income you must recognize as a result of a conversion. In that case, some of your itemized deductions or personal exemptions may be phased out, or more of your Social Security income may be subject to tax.

3. Be sure to prepare a new beneficiary designation form if you create a new Roth IRA.

4. Do not attempt to roll over (convert) after-tax (non-deductible) prior IRA contributions.

5. You may not convert Required Minimum Distributions (“RMDs”) to Roth IRAs. Be sure to take your 2010 RMD before doing the conversion.

6. Transfers from SIMPLE IRAs are subject to special rules, including a two-year holding period, that apply only to these IRAs, making transfers in the first two years ineligible for conversion benefits and therefore taxable.

As with all transactions of this type, consult with a knowledgeable professional before acting.