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E-Newsletter Article

Roth IRA Conversions – New Opportunities for 2010 and Thereafter

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Roth IRAs have become a very popular retirement planning vehicle for many individuals. Their popularity is primarily caused by the two major advantages that Roth IRAs have over traditional IRAs. First, they allow participants to take tax free distributions after reaching 59 ½ years of age. Although Roth IRAs are funded with “after-tax” dollars, the lure of tax-free growth for life is very appealing to many. Second, unlike traditional IRAs, Roth IRAs are not subject to required minimum distribution rules applicable to traditional IRAs. This provides significant flexibility in determining how and when distributions will be made later in life.

The downside to Roth IRAs is that many taxpayers haven’t been able to take advantage of them due to relatively low contribution and conversion phase-outs based on the taxpayer’s adjusted gross income. While the contribution phase-outs are still in place, beginning in 2010 the income limitation on conversions is no longer in effect.

Ways to Fund a Roth IRA

There are three ways to fund a Roth IRA:

- 1) Contributions – Maximum \$5,000 in 2010 (\$6,000 if you’re age 50 or older).
- 2) Conversion of a traditional IRA to a Roth.
- 3) A rollover from an eligible employer retirement plan.

If your federal filing status is:	Your 2010 Roth IRA contribution is reduced if your MAGI is:	You can't contribute to a Roth IRA for 2010 if your MAGI is:
Single or head of household	More than \$105,000 but less than \$120,000	\$120,000 or more
Married filing jointly or qualifying widow(er)	More than \$167,000 but less than \$177,000	\$177,000 or more
Married filing separately	More than \$0 but less than \$10,000	\$10,000 or more

As noted above, your ability to make contributions to a Roth IRA is limited by your modified adjusted gross income (MAGI) as shown in the chart above.

Changes in 2010

Before the 2010 law changes, you weren't allowed to convert a traditional IRA to a Roth if your MAGI exceeded \$100,000 (regardless of filing status) or you were married and filing separate federal income tax returns. Also rollovers from employer retirement plans were not allowed under any circumstances. In 2006 President Bush signed the Tax Increase Prevention and Reconciliation Act (TIPRA) which removed the \$100,000 MAGI restriction beginning in 2010 making the Roth conversion available to all taxpayers (there's one exception – generally you can't convert an inherited traditional IRA to a Roth. Special rules apply to spouse beneficiaries).

The removal of the MAGI restriction also extends to rollovers of SEP and Simple IRA's (in the case of a Simple IRA you'll need to participate in the plan for two years prior to converting) as well as employer retirement plans (i.e. 401(k) plans, profit sharing plans, and money purchase plans).

Tax on Conversions

For tax purposes, the conversion is treated as a distribution to you. The 10% early distribution penalty is not applicable even if you're under age 59 ½.

If you've made nondeductible (after tax) contributions to a traditional IRA then only the earnings portion of the conversion is taxable. Things get more complicated when you've made both deductible and nondeductible contributions. In this case, the conversion is deemed to consist of a pro-rata portion taxable and non-taxable dollars in the IRA.

Also, the IRS requires you to aggregate all of your IRA's when calculating the taxable portion of the conversion.

Special Rule For 2010 Conversions

If you convert in 2010 TIPRA provides you with an additional benefit – the option to pay the tax in 2011 and 2012. For the 2010 tax year you may report half the conversion on your 2011 tax return and half on your 2012 return. Alternatively you can elect to report the entire conversion on your 2010 return. The option you select depends on what your 2010 tax rate is versus what you believe your rates will be in 2011 and 2012.

Reversing a Conversion

In the event you decide that the conversion isn't what you want, you can elect to "undo" the conversion up to the due date of that year's return (including extensions). This may be appropriate if, for example, the value of the account declines dramatically after conversion. You then can't reconvert the amount to a Roth until the later of: 1) the beginning of the tax year or 2) the end of the 30 day period beginning on the day of the conversion.

Deciding Whether to Convert

The decision to convert is based on many factors, including current and future tax rates, the time the funds will remain in the Roth prior to distributions and how you plan to pay for the taxes due from the conversion.

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A financial professional can help you decide whether a Roth conversion is right for you as well as the suitability of the election to defer the taxes on a 2010 election.

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