

# Everyone Should Be Aware of Opportunities to Convert to Roth IRAs in 2010

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Beginning in 2010, any individual can convert assets from a traditional individual retirement account (IRA) or other tax qualified retirement plan such as a 401(k), simplified employee pension (SEP), profit sharing or money purchase plan into a Roth IRA. For individuals who don't need to draw on their IRA, this change can substantially augment the transfer of wealth to designated beneficiaries. Alternatively, it can create additional resources for those who will draw on the account in retirement.

You may have set up a traditional IRA to receive deductible and/or nondeductible contributions annually or to receive a tax-free rollover from a qualified plan of a previous employer. Some employer-sponsored retirement plans even allow for in-service distributions prior to retirement. Prior to 2010, rollovers from traditional IRAs and company-sponsored retirement plans to Roth IRAs were not allowed if the taxpayer's modified adjusted gross income (AGI), was greater than \$100,000. This limitation will be eliminated for tax years after 2009.

## Benefits of a Roth IRA

Why would you want to convert a traditional IRA or another qualified retirement plan to a Roth IRA? There are two primary reasons:

1. There is no requirement to take distributions from a Roth IRA.
  - > A Roth IRA has no required minimum distributions once you reach age 70½, allowing those who don't need to draw on the account many additional years of tax-free compounding of their investment balances. The tax-free compounding period can include the life of a designated beneficiary.
  - > On the other hand, if you need to take distributions before age 59½, a Roth IRA makes it much easier to do so without incurring a 10% early withdrawal penalty. The penalty is more likely to exist with early distributions from traditional IRAs and company-sponsored retirement plans. Distributions from a Roth are considered to come first from contributions which are not subject to the penalty or income tax. Next, distributions come from converted amounts and are tax free, but could be subject to a 10% penalty if you are under age 59½ and the account has been open less than five years. Finally, earnings are considered distributed after contributions and conversions and will likely be taxable if the taxpayer is younger than 59½ or if the account has been open less than five years. However, there are a few exceptions to these general rules.
2. Roth IRAs can provide tax-free growth to the account holder, his or her spouse, and one or more designated beneficiaries, as opposed to the tax-deferred growth of a traditional IRA.

## Cost to Convert

The Roth's tax-free earnings do, however, come with a cost: Taxable income is recognized when converting from a traditional IRA and/or an employer-sponsored qualified plan to a Roth IRA. However, if nondeductible contributions were made in prior years that amount of the conversion would not be recognized as income. In addition, the taxable rollover amount will not be subject to the 10% early withdrawal tax even if you are under 59½. If the conversion occurs in 2010, one-half of the income can be included in gross income in 2011 and one-half in 2012, unless you make an election to pay tax on the entire amount in 2010. Conversions after 2010 will be taxable in the year the conversion takes places.

Although it is difficult to generalize, and the possible benefit is based upon unknown future events such as income and estate tax rates, earnings, spending habits, years until death, etc., we believe that converting to a Roth IRA makes sense for many people, and in certain situations the savings will be substantial. However, converting to a Roth IRA is unlikely to make sense if you would need to access the funds in a traditional IRA or qualified plan in order to pay the income taxes on the conversion (doing so could subject the funds not rolled over to the Roth IRA to the 10% early withdrawal penalty and you would lose the benefit of future tax-free growth).

## Additional Risks and Benefits to Consider

By converting, you are accelerating but locking in your income tax rate. This removes some uncertainty and eliminates the risk of an increase in tax rates but also eliminates the benefit of a potentially lower tax rate in the year of distributions.

If you believe you could benefit from this opportunity and you like the idea of creating an account that will provide tax-free growth, you should consider funding a traditional IRA with nondeductible contributions. Starting in 2010, the account can be immediately converted to a Roth to provide tax-free growth. Anybody who has earned income, receives alimony, or is the spouse of somebody who has earned income can make nondeductible contributions to an IRA.

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Analyze your current income tax situation, project what your income tax liability would be on a conversion, and determine where the funds will come from to pay the taxes. As stated above, they should not come from your existing retirement funds, nor should you borrow the money. The amount to convert is not an all-or-nothing decision – partial conversions are permitted.

You may wish to reassess who the beneficiary of your account will be. A beneficiary other than your spouse could defer the distributions over their life expectancy and keep the account growing on a tax-free basis for many years. Inheriting a Roth IRA can provide financial security like virtually no other asset.

Many taxpayer retirement accounts have experienced fairly dramatic declines recently, making it a good time to convert to a Roth if you are optimistic about future tax-free growth opportunities. However, if account values continue to decline, a “do-over” provision allows the account to be converted back to a traditional IRA before filing your tax return for the year of the conversion. Taxpayers who make the conversion in January 2010 could have until October 15, 2011 to place the funds back into a traditional IRA. The assets could then be converted back to a Roth at a later date (as soon as 30 days), with less income to recognize on the conversion.

There is always a chance that laws could change, causing future income to be taxable, but most new legislation includes grandfather provisions to protect taxpayers.

Finally, we have found that nobody is too old, too young, too rich or too poor to potentially benefit from this opportunity.

**We welcome the opportunity to meet with you to discuss how we can help you meet your business goals. For more information or any questions you might have on this topic, please contact your Baker Tilly tax advisor or e-mail us at [tax@bakertilly.com](mailto:tax@bakertilly.com).**