Roth IRA conversions:
Check your comfort level

BAKER TILLY

Candor. Insight. Results.

If you put money in a Roth IRA today and follow the rules, you may never pay tax on those funds in the future. Although contributions to a Roth IRA are not deductible, qualified distributions or withdrawals are not subject to tax or penalties, and there are no required minimum distributions at age 70½, as with a traditional IRA. You can contribute to a Roth IRA as long as you have earned income. To make things even more intriguing, you can convert other retirement accounts, such as 401(k) plans, profit-sharing plans, 403(b) annuity plans, 457 plans, SEP IRAs, SIMPLE IRAs, to a Roth IRA. For 2010, there are no income limitations for Roth IRA conversions.

However, converting another retirement account to a Roth IRA account requires the owner to pay tax on the converted amount. Depending on how much you convert (you can convert a portion of a retirement account or all of it), you may end up with a significant tax bill. While it may seem counterintuitive to pay tax today to avoid tax in the future – especially because no one can predict the future – discussing it with your tax and investment advisors can help you understand risks and potential rewards. A Roth IRA conversion in 2010 may provide you with an opportunity to do some powerful tax planning that may not present itself again. Because a conversion analysis requires assumptions about the future, the results will give you direction, but not a conclusive answer, as to whether a conversion makes sense. That's where a conversation with your tax advisor can help guide you to a decision that makes sense in light of the potential benefits when weighed against the risks of predicting the future.

With the ability to convert beginning in 2010 regardless of income, the most common question being asked is, "Does a Roth IRA make sense for me?" Unfortunately, there is no easy answer because there are many variables to consider. Here are some questions you should discuss with your tax advisor as you explore a Roth IRA conversion.

- What is the length of time to retirement and how many years does your financial plan cover? The younger you are, or the more years you will be retired, the more advantageous it is to convert.
- What are your future cash flow needs and sources? Will you need the IRA funds to meet your living expenses during retirement, or do you plan to pass them to heirs or charity at death?
- Do you have a source of outside funding to pay the tax that will be owed on the funds you convert? If you plan to use the funds in the IRA to pay the tax on the conversion, a conversion may not be advisable.
- What is your current tax bracket and what will it be during retirement? If you expect your tax rate to be higher in retirement, it is an indication that a conversion might be a good option.
- Are you planning to change residency from a high-tax state to a low-tax state (e.g., Florida)? If so, you probably should delay converting until after you move to avoid paying higher state income taxes.
- Are you a business owner experiencing losses in your business? Do you have carryover tax credits (such as the research and development credit, tip credit, or empowerment zone credit)? If so, a conversion to a Roth IRA may be an excellent way to utilize those losses and credits.

Conversion Timing

If an IRA conversion fits your situation, the next consideration is when you should make the change. Conversions can be made without regard to income level starting in 2010 and beyond. For conversions made in 2010, you can report the entire amount of income from the conversion on your 2010 tax return, or elect to report half of the amount on your 2011 return and half on your 2012 return. Conversions made after 2010 must be included in full for the year of conversion.

(continued)

If you make a conversion, there is an opportunity to undo the conversion and switch back to a traditional IRA through a process called "recharacterization." Recharacterization may be appropriate for a number of reasons, but it is typically used in cases where the value of the account has declined after the conversion. To make recharacterization even more powerful, you should convert to multiple Roth IRAs to segregate funds by risk profile. Then, you can recharacterize only the accounts that have decreased in value and leave the accounts that have increased in value. The decision to recharacterize can be made as late as October 15 of the year following conversion. And, you can always "reconvert" the traditional IRA back to a Roth IRA later, but reconversion can only take place at the later of the tax year following the original conversion or 30 days after the recharacterization. If you decide to convert to a Roth IRA, doing so sooner, rather than later, typically will help you take advantage of these provisions.

There is no easy answer to the question, "Does a Roth IRA make sense for me?" Your tax professional can perform an analysis of your assets, income, cash-flow needs, and estate planning or other financial planning goals. He or she can then have a candid conversation with you about any tax liability and help simplify the decision-making process.

This article originally was featured in the *Baker Tilly Tax Strategist* electronic monthly newsletter, featuring hot topics, tax savings ideas, case studies, and other relevant information to help you navigate through the inevitable challenges that arise and capitalize on tax opportunities that come your way. Send an e-mail to tax@bakertilly.com with any questions or to subscribe to the newsletter.