

# 2010 Roth IRA Conversions: Tax Opportunity?

By Paula Calimafde, Kevin D'Anna

Starting in 2010, individuals with an adjusted gross income over \$100,000 will be able to take advantage of the benefits of a Roth IRA by converting a portion or all of a traditional IRA or rolling over retirement plan money into a Roth. Not only do earnings grow tax free inside the Roth IRA, but once certain requirements are met, all distributions coming from the Roth are income tax free. With proper planning, it is possible to leave money inside a Roth IRA for decades growing tax free; this could prove to be an exceptional retirement and estate planning opportunity.

Currently, only individuals with adjusted gross income at or below \$100,000 are allowed to convert a traditional IRA to a Roth IRA. Starting in 2010, this adjusted gross income limit will no longer apply, so that converting a traditional IRA to a Roth IRA ("Roth IRA Conversion") will now be available for those in higher income brackets

An IRA, or individual retirement account, is a personal savings plan that provides tax incentives to encourage people to save money for retirement. In a traditional IRA, depending on your particular situation, the money saved can be fully deductible (i.e., tax is not paid on amounts saved). On the other hand, in a Roth IRA (named for its chief legislative sponsor, Senator William Roth of Delaware), money saved is non-deductible (i.e., tax is paid on amounts saved).

Deductible amounts saved in a traditional IRA grow tax-free until such time as they are distributed. In a Roth IRA, however, because the tax is paid up front, amounts saved grow tax-free and are distributed tax-free, provided certain conditions are met.

When a traditional IRA is converted to a Roth IRA, because the amount of money saved was previously deductible, tax has to be paid on the converted amount. However, for those choosing to convert to a Roth IRA in 2010, this tax, if desired, can be paid over a two-year period (2011-12). In other words, the law allows you to defer paying any income tax on amounts converted in 2010 and then split the tax due over the next two calendar years. (This tax deferral is only available to conversions made in 2010; thereafter income tax will be due in the year of conversion.) Once the IRA is converted, funds in the Roth will grow tax-free and once certain conditions are met can be distributed tax-free as they would if originally saved in a Roth IRA. In lieu of converting an IRA—or in addition to converting it—you may be able to roll over a portion of your qualified retirement plan account to a Roth IRA, depending upon your age and the terms of the plan. Conversions of nondeductible IRAs will generate some very exciting planning opportunities since income tax will only be due on the earnings, if there are any.

## Benefits

If the income tax rate applicable to distributions from a traditional IRA is higher than the tax rate in effect at the time of conversion, the switch to the Roth IRA will allow a family to receive a greater return than if the money had remained in a traditional IRA. If tax rates are higher at the time of conversion than at the time of distribution, it is not always true that retaining the funds in a traditional IRA will provide greater wealth than a conversion to a Roth. In part, this is because the Roth IRA is not subject to forced required minimum distributions. Many believe that income tax rates will increase in the future, particularly because the highest tax rate today is at a historic low.

Roth IRAs are not subject to required minimum distribution rules which generally mandate that 5% owners who attain age 70½, and who participate in a qualified retirement plan (401(k), etc.), must withdraw a certain amount annually to avoid penalty. If funds remain in your traditional IRA, then, beginning at age 70½, you will be required to commence distributions. Of course, this will reduce the amounts saved in your traditional IRA which thereby cuts down on the amount of tax free compounding. It also requires income tax be paid on the amount withdrawn, since the money is coming from a traditional IRA or retirement

plan). Not only can the original owner postpone taking distributions out of the Roth IRA indefinitely, so too can the surviving spouse, if he/she is the sole beneficiary and treats the IRA as his/her own.

Converting a traditional IRA to a Roth IRA may also reduce your income tax liability on social security benefits. As mentioned, traditional IRAs are subject to required minimum distribution rules. Required minimum distributions are included in your adjusted gross income. If adjusted gross income reaches a certain level, as much as 85% of your social security benefits will be subject to income tax. Thus by converting some or all of a traditional IRA to a Roth IRA, you may be able to exclude certain amounts of your Social Security benefits from income tax.

### **Example**

Assume you have a traditional IRA with a balance of \$1,000,000. In 2010, you can convert the entire balance to a Roth IRA, paying income tax on the converted amount at an assumed 28%. [Of course, you may choose to convert only a portion of the traditional IRA.] Assuming all tax is paid in the year of conversion, you would net \$720,000, which would then be invested in, and, provided certain conditions are met, eventually distributed from your Roth IRA tax-free.

Comparing that scenario against investing the same \$1 million—at 6% over a 10-year period, and assuming a 35% tax rate at distribution—the benefits of the Roth IRA can be seen. It should also be noted that taxes on converted amounts can be paid with funds outside of the Roth IRA. In other words, the full \$1,000,000 can be contributed by conversion into a Roth IRA as long as the owner has sufficient funds outside of the account to pay the tax. This would only magnify the benefits available through a Roth IRA as illustrated below because more funds would be held in the tax-free environment.

### **TRADITIONAL IRA**

\$1,000,000 at 6% for 10 years = \$1,790,848  
Less tax at distribution of \$626,797 (35%)  
TOTAL: \$1,164,051

### **ROTH IRA**

\$720,000 at 6% for 10 years = \$1,289,410  
Less tax at distribution of 0 (0%)  
TOTAL: \$1,289,410

To maximize benefits in a tax-free world, the goal is to keep amounts in that environment for as long as possible. Thus, it would not be advisable from a tax viewpoint to pay out either the regular IRA or the Roth IRA any sooner than required under the law by the required minimum distributions. Because Roth IRAs are not subject to required minimum distributions while the owner, and possibly the owner's spouse, are living, the advantage would tilt significantly to the Roth IRA simply because of the impact of tax-free growth. The longer you and possibly your spouse lived, the more wealth would be accumulated for your family in the Roth because of the absence of required minimum distributions.

Of course, the opportunities available through Roth IRA conversions are not quite as simple as portrayed here. There are a number of requirements alluded to above that must be met. The law also allows you up to 22 months to re-characterize the conversion and put yourself back to where you would have been prior to the conversion.

With proper planning, the 2010 Roth IRA Conversion can be a powerful retirement and estate planning tool.