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IRA Conversions

Overview: Starting in 2010, the income limits for converting a traditional IRA to a Roth IRA will be eliminated. This will allow many previously ineligible investors to convert their IRAs and grow their retirement dollars tax free. Still, the rules governing conversion eligibility can be complex, as is the individual conversion decision. The following should hopefully shed some light on what investors should consider regarding IRA conversions.

Note: The information in this article is meant to raise awareness of the topic addressed and should not be considered tax advice. It is always important to consult a tax planner prior to engaging in actions that may have tax consequences.

Very soon, many high-income investors will face important decisions regarding their individual retirement accounts. Starting January 1, 2010, the income limits for converting a traditional IRA to a Roth IRA will disappear.

Consider what *The Wall Street Journal* had to say about the change in the conversion rules: “The change — one of the biggest and most important on the IRA landscape in years — will widen the entryway to one of the best deals in retirement planning. With a Roth IRA, virtually all income growth and withdrawals are tax-free.”¹

The intricacies of such a significant change can be complex, but the following should provide a basic overview of some of the larger items to consider about IRA conversions.

It is important to note that the limits being eliminated are specifically for conversions. The limits regarding who can contribute directly to a Roth IRA will still apply. Thus, investors who are over the limits and want to contribute to a Roth IRA each year would have to do so via conversion from a traditional IRA.

For 2009, investors who are married filing jointly see their contribution limits phase out once their modified AGI exceeds \$166,000, and they lose their Roth IRA contribution eligibility with a modified AGI above \$176,000. For those with a filing status of single or head of household, the limits are \$105,000 and \$120,000, respectively.

Changes in 2010

Currently, investors with income in excess of \$100,000 cannot convert their traditional IRAs to Roth IRAs. In 2010, this income limitation vanishes.

Also, only for 2010, there is a special tax consideration. Investors converting their IRAs during this year have the option to stretch their tax liabilities over two years — paying half on their 2011 tax return and the other half on their 2012 tax return. Investors choosing this option would have these tax liabilities due on April 15, 2012 and April 15, 2013, respectively. Any conversions occurring after 2010 will have to see the resulting tax liabilities owed in the same tax year.

How Does a Roth Conversion Work?

There are three ways to convert traditional IRAs to Roth IRAs:

- σ Indirect Roth conversions occur when traditional IRA holders request and constructively receive distributions from their IRA and deposit the amount in a Roth IRA within 60 days. In this situation, the check is made payable to the traditional IRA holder.
- σ Direct Roth conversions occur when traditional IRA holders directly move their IRA assets to the receiving Roth IRAs without taking constructive receipt of the assets. In this scenario, checks are made payable to the receiving financial institutions for the benefit of the Roth IRA and forwarded as soon as administratively feasible to the receiving financial institutions.
- σ Investors can convert their traditional IRAs to Roth IRAs by simply redesignating the traditional IRAs as Roth IRAs, provided the transaction is completed with the same trustee, custodian or issuer. Redesignating traditional IRAs as Roth IRAs, though physically accomplished via a transfer, is treated as a distribution and subsequent qualified rollover contribution.

In each of these cases, the tax law allows for transfer of assets other than cash to the Roth IRA provided that they are the same assets they received from the traditional IRA. It should be noted that the first method involves the most risk, as missing the 60-day deadline would result in the receipt of the check for conversion being treated as a distribution.

What to Consider

It is important to keep in mind that investors with a modified AGI of less than \$100,000 are currently eligible to convert their IRAs. This change simply opens this option to a wider range of investors.

Investors' personal IRAs are eligible for conversion. So are IRAs inherited from spouses. However, other inherited IRAs are not eligible for conversion.

Once IRAs have been converted, those assets cannot be withdrawn within five years of the conversion. Such a withdrawal results in a 10 percent early withdrawal penalty, even for investors older than age 59 ½.

It is also important to note that a conversion is not necessarily permanent. If the conversion ends up being a mistake, the conversion can be recharacterized back to a traditional IRA without penalty if done in a timely manner. For example, if an investor converts an IRA to a Roth IRA and then experiences a drop in the account's value, it may make sense to recharacterize the account back, then convert at a later date and pay less tax.

Conversion Questions

Here are some questions and answers that may be of some help for those deciding if a conversion makes sense.

Is there enough money available outside the IRA to meet needs? Roth IRAs do not have required minimum distributions. For investors who wish to leave their traditional IRAs to their heirs, they can convert them to Roth IRAs, pay the resulting tax bill, then leave the assets untouched to be passed on.

How does the current tax bracket compare with what's expected in the future? Investors who expect their tax rate to be lower in the future — say, due to retirement — may end up paying higher taxes now through a conversion than simply paying taxes later when they receive distributions. On the other hand, investors who expect their tax rates to increase — say, young investors who expect their earning power to increase — may see a substantial benefit by paying a lower tax rate now and letting their assets grow tax free.

How much time is given to pay the tax bill resulting from a conversion? As mentioned earlier, tax liabilities for conversions occurring in 2010 can be stretched over a two-year period. Regardless of when the conversion occurs, the tax bill will come due. To get the most benefit out of the conversion, those tax liabilities should be paid using outside dollars, not money currently in the IRA, which could be subject to early withdrawal penalties. Another option is to do a partial conversion if the money is either not available to comfortably pay the conversion taxes, or if a full conversion results in moving to a higher tax bracket.

Will the IRA be left to charity? Donating an IRA to charity is a tax-free event. In this case, it would not be prudent to convert to a Roth because this would create an unnecessary tax bill.

Summary

For many individuals, the new rules governing IRA income limits in 2010 represent a window of opportunity. The conversion decision is not an easy one, as there are many factors to consider. Investors should work with their trusted advisor and tax experts to determine the tax implications of their decisions.

Kelly Greene, **Making a Good Deal for Retirement Even Better.** *The Wall Street Journal*, June 20, 2009.

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