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A Window of Opportunity Has Opened: Consider Converting a Traditional IRA to a Roth IRA During 2010

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Executive Summary: Converting your investments in traditional IRAs to a Roth IRA during 2010 can be an important planning opportunity for many clients. This conversion allows you to move from a tax deferred environment into a tax free environment. While this opportunity is normally open to those with income below a certain cap amount, beginning in 2010 no such income cap exists. Further, while such conversion is an income taxable event (but without any penalties), conversions during 2010 give you the option to defer the taxable income by recognizing 1/2 in 2011 and 1/2 in 2012. If interested in moving forward with a 2010 conversion, you will likely be better off converting early in 2010 since you are given the power to change your mind by the 2010 tax filing deadline (which can be as late as October 15, 2011, if you extend the due date for your 2010 tax return) and return the assets to the traditional IRA as if the conversion never occurred. If the assets in the Roth IRA appreciate during the year, then you will still be paying income tax based on the lower date of conversion value. If the value of the Roth IRA depreciates during 2010, you may want to transfer the assets back to a traditional IRA to avoid paying income tax on a higher income amount. This Newsletter article reviews the 2010 conversion opportunity and who may want to take full or partial advantage of it.

I. Traditional IRAs and Roth IRAs.

A. **Traditional IRAs: Generally Deductible on the Way in and Taxable on the Way Out.** Traditional IRAs can be funded with income tax deductible (or non-deductible) contributions, either made directly to the IRA or from a rollover of contributions previously made to a qualified retirement plan ("QP") account at work. When amounts are withdrawn from the IRA, the IRA owner/beneficiary is normally subject to ordinary income tax on the distributed amount. While the assets remain in the IRA account, no income tax is paid on the income earned or gain realized by the IRA investments. In order to prevent people from holding assets in an IRA and continuing to defer income taxes on those assets for too long after they reach retirement age, the government forces the IRA owner to take out a minimum distribution each year, beginning no later than April 1 of the calendar year following the calendar year in which the account owner reaches 70 1/2 years old. Upon the owner's death, the IRA beneficiary(ies) are then subject to their own minimum distribution rules. If the minimum required distributions are not made on a timely basis, a 50% penalty will apply, based on the amount which should have been distributed.

B. **Roth IRAs: Generally Non-Deductible on the Way In and Not Taxable on the Way Out.** Roth IRAs are funded with after tax contributions (i.e., no income tax deduction is available for the contributed amount). Like traditional IRA accounts, the income and gains realized by the Roth IRA's assets are not taxed while they remain in the Roth IRA account. Unlike traditional IRAs, the distributions from Roth IRAs are not generally subject to income tax. In addition, the account owner is not subject to the minimum distribution rules during his or her lifetime. However, after the owner's death, the beneficiaries of a decedent's Roth IRA are subject to their own minimum distribution rules.

II. **Pre-2010 IRA Conversion Rules.** Under pre-2010 law, a traditional IRA account owner whose income was below a threshold amount could convert his or her traditional IRA to a Roth IRA and pay the income tax on this conversion as if the full traditional IRA was distributed and then contributed to the Roth IRA in the same year. The converted amounts would not be subject to early withdrawal penalties, although minimum required distributions already due from the traditional IRA cannot be converted. Conversions have not been a common planning strategy in the past, since converting often did not make a lot of economic sense if you needed to use the IRA assets to pay the income taxes, and since the people who could generally afford to pay these taxes with non-IRA assets were often above the income limit.

III. **A Window of Opportunity Has Opened for Conversions Taking Place During 2010 and Beyond.**

A. **No Income Limit.** Beginning in 2010, there is no longer any income limit on the ability to convert a traditional IRA to a Roth IRA.

B. **For 2010 Only, You Can Elect to Defer Taxable Income to 2011 and 2012.** Anyone converting an IRA in 2010 can elect either to have all of the taxable income from the conversion taxed in 2010, or to recognize 1/2 of the income in tax year 2011 and the other 1/2 in tax year 2012, without interest or penalties. Initially, many advisors thought that electing to defer the payment of income taxes to the two later tax years was an easy decision. However, as it appears increasingly likely that tax rates may rise after 2010, many advisors are concluding that, in many cases, it may make more sense to go ahead and pay the resulting income tax on the 2010 return. The final decision will depend on your particular situation.

C. **Consider Converting Early in 2010.** If you plan to convert your traditional IRA, you should consider doing so early in 2010. The sooner in 2010 you convert, the longer you have to change your mind. You can undo the conversion as late as the extended due date for filing your 2010 income tax return as long as the return is considered to be filed timely. You may wish to undo the conversion if the converted amount goes down in value during the year, if you decide that you are no longer able to afford to pay the resulting income tax liability, or you otherwise wish to change your mind. In addition, if the value of the account goes up during the year, you will be paying less in income taxes from the conversion since the taxable income recognized is based on the conversion date value and not the year end value.

For those who want to maximize this opportunity, you may want to convert the Traditional IRA account into multiple Roth IRA accounts, with each utilizing different investments. With this strategy, you will be able to retain the Roth IRA which contained the investments that appreciated in value, and roll back into the Traditional IRA the Roth IRA investments which contained the investments that depreciated in value.

IV. Should You Take Advantage of the Window of Opportunity and Convert?

A. **Income Tax Payment is Primary Negative.** The main negative is the payment of the income taxes now (either 1/2 in 2011 and 1/2 in 2012, or if elected, all in 2010) so you will no longer be able to invest and earn on the amount paid to the government in taxes. You may also need to increase your estimated tax payments to avoid late payment penalties. It is normally the case that the conversion will only make economic sense if you can afford to use non-IRA assets to pay the resulting income tax liability. In effect, you will be increasing the value of your IRA retirement savings but decreasing the value of your non-IRA savings.

B. **If You Plan to Live Off of the IRA Funds For Your Retirement.** The financial analysis normally shows that the younger you are (i.e, the longer number of years you have to invest and earn in the Roth IRA) and if you can pay the income taxes with non-IRA funds, the more likely that the conversion will make sense to do in your case. However, the older you are and the more you need the IRA funds for your retirement, the less likely that the conversion will make sense to do in your case. You also need to consider if your income tax rates will be lower now or in the future when distributions will more likely be made. In general, you would rather pay tax based on a lower tax rate. In any case, this is primarily a financial planning type calculation that you should discuss with your financial advisor. For those who wish to do this analysis on their own, conversion calculators may also exist on the internet to help with this analysis.

C. **If You Do Not Think You Will Need the IRA Funds For Your Retirement.** If you do not think you will need the IRA funds for your retirement, then this becomes an estate planning consideration. If (i) you are able to use non-IRA funds to pay the resulting income tax liability and (ii) your estate is large enough that you may end up paying estate taxes at your death (assuming the estate tax comes back as expected), this conversion to pass more wealth may make a lot of sense. You will recognize less taxable income in future years by not having any minimum distribution requirements, which may reduce taxation of Social Security benefits, may reduce Medicare premiums and may prevent loss of other possible tax benefits. Even more significant, your family may receive a triple benefit from this conversion, including (i) no required minimum distributions during your life so more assets can stay in the Roth IRA longer, (ii) the income tax paid resulting from the conversion escapes the estate tax, whereas when the traditional IRA is passed on to beneficiaries, the built in income tax is subject to estate tax and receives only a partial offset (you can normally deduct the estate tax paid on the IRA from the income recognized on IRA distributions), and (iii) the beneficiaries will not have to pay any income tax on the Roth IRA distributions. In effect, you are able to pass a tax advantaged, after tax asset to your beneficiaries in a tax advantaged manner. Of course, you should take steps to consider your particular situation with your professional advisor(s) before undertaking this type of conversion.

D. **Risk of Future Income Taxation of Roth IRA Distributions.** One issue that needs to be considered is the future possibility that Congress, in an attempt to raise taxes, decides to means test or otherwise tax Roth IRA distributions. We already have an example of this when Congress decided to tax previously untaxed social security benefits.

E. **Special Planning May Be Needed Where Traditional IRA Includes After Tax Contributions.** In theory, after tax contributions included in the traditional IRA will not be subject to income tax upon the conversion to a Roth IRA. This is the case if all of your traditional IRA assets are converted in the same tax year. However, if only a portion of all of your traditional IRAs is being converted (even if you are converting all of a single traditional IRA where you have more than one traditional IRA account), then only the relative percentage of the after tax contributions to the total value of assets in all the traditional IRA accounts will be considered free of income tax upon the conversion. Strategies may be available to avoid this result so you can avoid tax on all of your after tax contributions in the year of conversion, especially where you have access to a qualified plan where you can contribute your IRA assets or you can make in-service distributions.

F. **Asset Protection Benefit.** In many states, including Georgia, the law prohibits most creditors from accessing the owner’s traditional and Roth IRA account assets, both in and out of bankruptcy. The conversion of a traditional IRA to a Roth IRA could further this asset protection since the income tax resulting from the conversion can be paid from non-IRA assets and would therefore be removed from possible access by a creditor. It should be noted that this IRA asset protection may not be available to the beneficiaries of the IRA account after the owner’s death. However, this type of asset protection can be achieved for the family beneficiaries by passing these IRA accounts in trust, as opposed to passing them directly to the individual family beneficiary. This “trust as beneficiary” strategy can be very effective but, depending on the structure of the trust, it may cause the IRA assets to be distributed sooner under the minimum distribution rules. Depending on the level of asset protection concern, special trust language can be used to achieve both asset protection and long-term income tax deferral.