

CLIENT REPORT:

Preparing for the 2010 IRA-to-Roth IRA Conversion Opportunity

As the end of 2009 approaches, a significant opportunity awaits many individuals. Beginning in 2010, taxpayers will be able to convert their traditional IRA (and funds that have been rolled over from a qualified plan) to a Roth IRA, regardless of their income level or filing status. What's more, the tax on the taxable income generated from a 2010 conversion will be able to be deferred until 2011 and 2012. This new conversion option presents both tax planning opportunities and challenges for 2009, 2010 and 2011.

Before 2010, only individuals with modified adjusted gross incomes (AGI) of \$100,000 or less could convert amounts in their traditional IRA to a Roth IRA. Moreover, married taxpayers filing separate returns have also been prohibited from converting their traditional IRA to a Roth IRA as well. However, beginning in 2010, the \$100,000 AGI limit on conversions of traditional IRAs to Roth IRAs is eliminated completely. This special treatment gives everyone regardless of his or her income level the opportunity to convert a traditional IRA to a Roth IRA. Additionally, filing status restrictions are also lifted, allowing married taxpayers filing a separate return to convert a traditional IRA to a Roth IRA.

It is important to understand that an IRA conversion is treated as a taxable distribution, taxed as ordinary income at your marginal tax rate. This in effect accelerates the taxable income that you would eventually pay on distributions from a traditional IRA once you retire, but does so in exchange for never taxing any future appreciation in the value of your account from what it is today. That is often a significant tax advantage. You should also note that unlike a withdrawal from an IRA, a conversion does not trigger any 10 percent early withdrawal penalty.

Although conversion to a Roth IRA does trigger immediate taxable income, Congress provided a special incentive in 2010 to jumpstart Roth conversions under the new rules: In 2010 (and 2010 only), individuals will have the choice of recognizing their conversion income in 2010 or averaging it over 2011 and 2012. You must elect one option. This allows you to pay taxes on the converted amount ratably over two years, instead of recognizing it all as income in one year. You will be taxed at the rates in effect for 2011 and 2012.

For some taxpayers, their tax rate may rise after 2010 even if their income does not. President Obama has proposed, and Congress is expected to enact, legislation to restore the top two pre-2001 marginal income tax rates after 2010. This means that the top two brackets will be 39.6 percent and 36 percent after 2010. Consequently, if you do not want to take the chance that your income tax rate will be higher in 2011 and 2012 than in 2010, you may want to elect to pay the full tax on the Roth conversion in your 2010 income tax return, at 2010 income tax rates.

Higher-income individuals who plan to pay the entire conversion tax in 2010 instead of ratably in 2011 and 2012 because of the anticipated increase in the top marginal tax rates, may want to avoid, for yearend 2009, the traditional year-end-planning techniques of accelerating deductions and deferring income. Alternatively, consider doing the opposite this year to avoid being pushed into the highest brackets by a large IRA-to-Roth-IRA conversion.

Taxpayers are expected to convert their traditional IRAs to Roth IRAs for a variety of reasons. Roth IRAs have two major advantages over traditional IRAs:

- Roth IRA distributions are tax-free if they are qualified distributions. To be qualified, they must be made after a five-year holding period has passed and after the account holder reaches age 59 1/2, or on account of death, disability, or the qualified purchase of a first home.
- Roth IRAs are not subject to the required minimum distribution (RMD) rules that apply to traditional IRAs (as well as individual qualified plans). Therefore, a Roth IRA account holder who reaches age 70 1/2 does not need to begin taking distributions; instead, the funds can continue to grow tax free until they are needed or are passed on heirs.

The tax-free nature of qualified Roth IRA distributions may prevent individuals from being taxed in a higher tax bracket that would otherwise apply if he or she were withdrawing taxable distributions from a traditional IRA. Moreover, these distributions --unlike those from traditional IRAs--do not effect the calculation of tax owed on Social Security payments and do not affect AGI-based deductions.

An IRA to Roth IRA conversion should be considered by individuals who:

- Can afford the tax on the converted amounts;
- Anticipate being in a higher tax bracket in the future than they are currently in; and
- Have a significant amount of time before reaching retirement to allow assets to grow tax-free and recoup dollars that may have been lost due to the conversion tax.

If you are planning on taking advantage of the Roth IRA conversion opportunity next year, consider some of the following strategies this year:

- Because of the economic slowdown, many individuals are postponing retirement. Roth IRAs, unlike traditional IRAs, generally have no age limitation on contributions from earned income or on mandatory payouts. This is an advantage for individuals who are extending their careers beyond traditional retirement age.
- If you are able to make deductible IRA contributions this year, do so. This can help you reduce your 2009 tax bill and, if you convert to a Roth IRA in 2010, you will not have to pay back the tax savings until 2011 and 2012, if you elect to ratably pay the tax over the two-year period.
- Additionally, you may want to consider making nondeductible IRA contributions this year since you can later roll over the amounts into Roth IRAs next year at no tax cost.

If you anticipate being below the \$100,000 AGI level this year, consider converting to a Roth IRA right away while your traditional IRA account balance is still low because of stock market declines. If your situation is different from what you anticipate before you file your 2009 return, you might consider "recharacterizing" your 2009 Roth conversion back to a traditional IRA and then converting to a Roth IRA in 2010 instead.

There are a significant number of tax and financial considerations that come into play when determining whether to convert your traditional IRA to a Roth. If you have any questions about traditional IRA to Roth IRA conversions and the new 2010 planning opportunity, please contact our office.

Sincerely yours,

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