



The rules governing the conversion of traditional IRAs to Roth IRAs are set to change in 2010. This presents a great opportunity for many investors who are prohibited from either contributing to, or converting to, Roth IRAs under the current income limits. After a brief description of the two account types, this article outlines some of the pros and cons of converting to a Roth IRA. It is meant to serve as an introduction to the topic, not as an exhaustive review.

Traditional IRA vs. Roth IRA

Traditional IRA: In a traditional IRA, contributions may be made on either a pre-tax (tax deductible) or after-tax basis (no tax deduction). The investments then grow on a tax-deferred basis until withdrawn in retirement. Upon withdrawal, pre-tax contributions plus any appreciation are taxed at the investor's ordinary income tax rate.

Roth IRA: Unlike the traditional IRA, contributions to the Roth IRA are always made on an after-tax basis. The investments then grow and are distributed on a tax-free basis (provided qualified distribution rules are met).

Roth Conversions: In a Roth conversion, eligible taxpayers are allowed to convert some or all of their traditional IRA, 401(k), 403(b), or 457(b) savings to a Roth IRA account. The taxpayer will, however, owe taxes on pre-tax contributions plus appreciation at the time of conversion.

What Changes in 2010?

In 2010 both the eligibility rules and the timing of the tax payment changes for Roth IRA conversions. In 2010 and beyond, taxpayers with modified adjusted gross incomes above \$100,000 per year will become eligible to convert to a Roth IRA for the first time. Moreover, in 2010, and only in 2010, taxes triggered by the conversion will not have to be paid in full in the year of conversion. Rather taxpayers will have the option of spreading the tax liability over two years, 2011 and 2012.

Benefits of Conversion

1. Protection Against Future Tax Increases

The tax cuts instituted by the Bush Administration are set to expire at the end of 2010. In light of the growing national deficit and the challenges of Medicare and Social Security spending, it seems likely that tax rates will increase in coming years. Traditional IRA savings that are converted to a Roth IRA in 2010 may, therefore, be taxed at the lower current rate rather than at the future potentially higher rate. Any taxpayer that thinks he/she will be in the same or a higher tax bracket at the time of withdrawal, has a long time horizon, and can pay the taxes from sources other than his/her traditional IRA, would likely benefit from conversion.

2. Legacy Planning

Distributions from Roth IRAs are not required at any age, unlike traditional IRAs for which required minimum distributions (RMDs) begin at 70 ½ years of age.

Consequently, for investors who do not need to take distributions, and who want to leave a financial legacy, the Roth IRA allows their investments to grow tax-free until the date that they pass to heirs.

3. Tax Diversification

Another benefit of Roth IRAs is that they allow retirees to control their taxable income by using a mixture of tax-deferred and tax-free savings to finance retirement living.

Provided the RMD is met, a retiree may choose to limit IRA withdrawals above a certain amount in a given year to avoid being bumped into a higher tax bracket or to remain eligible for certain benefits or tax deductions.

Disadvantages of Conversion

1. Increased Tax Liability

When a traditional IRA is converted to a Roth IRA, ordinary income taxes are owed on any portion of the conversion amount that has not previously been taxed. In 2010, the taxes can be deferred into 2011 and 2012, but they will still need to be paid.

2. IRA Aggregation Rules

The IRA aggregation rules present a special challenge for investors who may own a combination of pre-tax IRAs and non-deductible IRAs. For such investors, even if they choose only to convert the non-deductible IRAs, all of their IRAs will need to be aggregated in determining what percentage of the conversion amount is taxable. Hence if an investor has \$20,000 in a non-deductible IRA plus \$80,000 in a pre-tax IRA, and chooses to convert just the \$20,000 in the non-deductible IRA, only 20% of the converted amount (\$20,000 divided by \$100,000) or \$5,000 will be deemed non-taxable at the time of conversion. The investor would need to pay ordinary income taxes on the other \$15,000.

3. Opportunity Cost

Assuming the conversion taxes are paid from a taxable source outside of the traditional IRA, there is still an opportunity cost associated with what that money could have earned had it remained invested in a taxable account. Nonetheless, the ongoing return lost to annual taxes plus the long-term capital gains tax at liquidation of the given taxable asset, most likely are less than the ordinary taxes that would be incurred on a future withdrawal from a traditional IRA.

Who Should Convert?

Generally speaking, anyone who expects to be in the same or a higher tax bracket at the time of IRA withdrawals, has a long time horizon, and is able to pay the conversion taxes from outside the IRA, is a good candidate for conversion. A couple of specific examples are shown below:

Example 1:

Taxpayer Jane made a \$5,000 non-deductible contribution to a traditional IRA in 2008, and makes another \$5,000 non-deductible contribution in 2009. Jane has no other IRAs. She is forty years old, an active participant in her employer plan, and her income is too high to be eligible for a deductible traditional IRA contribution or a Roth IRA contribution. By the end of 2009, Jane's contributions have grown to \$12,000. In early 2010, Jane will be able to convert the entire \$12,000 balance to a Roth IRA and only \$2,000 of the converted amount (the appreciation) will be taxable to her, just 17% of her total IRA balance. Jane will pay the taxes incurred from her taxable account. She will never have to pay taxes on this Roth IRA account again.

Example 2:

Retiree John has a \$200,000 traditional IRA, which he will not need to tap during his lifetime due to ample non-IRA assets. John wants to leave this IRA to his only child. In 2010, he converts the entire balance to a Roth IRA and pays the income taxes incurred from a taxable account. Although the value of the Roth IRA will still be included in John's gross estate, because there are no RMDs from a Roth IRA, the value of the account may actually grow larger than would otherwise be possible under the distribution rules that govern traditional IRAs. The taxes John pays at conversion will reduce his gross estate. In effect, John will have prepaid income tax on behalf of his future beneficiary without it counting as a taxable gift.