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The Financial Planning Newsletter

Roth Conversions Will Be the Rage in 2010. Should You Do It?:

Recently, there was a *Wall Street Journal* article dealing with this subject, and earlier in our March 2009 *Newsletter* we broached this topic. On the outside this may look like a simple concept. Convert your traditional IRAs to Roth IRAs and never pay tax again. Well, no one can quite do justice to a simple concept as the IRS can. What might take a few lines for most of us, the IRS has created volumes and some of the most complex sections of the tax code. So let's look at the complexity of the situation. Know that even though there are a few pages here, this distills several years of work of tax bureaucrats so there may be situations and complexities not addressed here.

Congress is giving all IRA-holding Americans a tremendous opportunity in 2010, or are they? In 2010, the income limits stopping many people from converting their traditional IRA to a Roth disappear. That's right, the $100k income limit goes away in 2010. So what exactly does this do for you?

There are a number of benefits, if you can overcome the obstacles (which will be covered subsequently). The biggest benefit is that once the conversion is done, you'll never have to pay taxes on those converted funds. A close second and still really big benefit is the lack of required minimum withdrawals. If you don't need the money, it can continue to grow tax-free for you and your beneficiaries. Suppose you get down the road a little and you decide you want to undo this conversion (and there are good reasons to consider this), well, this is one of the few areas the law allows a "do over," or, in IRS-lingo, a "re-characterization." Roth IRA funds pass income tax-free to your beneficiaries, and your beneficiaries can continue to grow these funds tax-free (although a beneficiary of a decedent's Roth IRA is subject to required minimum distributions). Let's suppose you'll owe estate taxes when you die. A traditional IRA will cause Income in Respect of a Decedent to be recognized. With a Roth IRA the income taxes have already been paid, so your heirs won't have to worry about either paying IRD or taking the IRD credit on their tax returns in later years. Suppose a trust is the beneficiary of your IRA? Well, the 35% income tax rate kicks in at a paltry income of $11,150. If the IRA is a Roth and your trust is the beneficiary, then there are no trust income taxes for the Roth distributions! Finally, income tax risk (the risk that tax rates will go up, and it's a biggie) is removed from your retirement accounts since the Roth is distributed tax free!

Hey, that sounds really good. What are the drawbacks? Are there any downsides? Well, of course there are hurdles to overcome and definite possibilities for unintended consequences. The

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number one problem is that income taxes are due for the tax year when the traditional IRA is rolled into the Roth IRA (a special rule applies for 2010 and we'll cover that soon). It's not only that income taxes are due, but the additional ordinary income could push you into a higher tax bracket. This could cause some of your other tax breaks to disappear. Further, you might encounter AMT as a result of this additional income. So, in any case, caution is recommended for these conversions. Generally, the best place to get the money to pay the additional taxes is from sources outside the IRA. Many people will balk at this. Of course, you could take the money from the IRA, but that really reduces the benefit of the conversion, especially for those in the 30% or more combined federal and state tax bracket. What the feds give, the feds can takeaway, right? Possibly the biggest drawback is not knowing whether the Roth rules will stay in place forever. If the government does away with Roth IRAs, or taxes don't increase, or even if they don't and you remain in a lower tax bracket in retirement than during your working years, you may end up paying more in taxes to do the conversion than if you had left well enough alone.

Let's suppose you've evaluated your situation and decided the Roth conversion is for you. How do you go about doing it? And what about that re-characterization mentioned earlier? How do I do that? We'll look at the 2009 rules, first. Then, we'll examine the 2010 rules and offer some guidance on how to decide between the years, if you're eligible for both. Post-2010 rules and re-characterization will finish up this special edition of our newsletter.

Who can do a Roth conversion? Traditional IRA owners including SEP and SIMPLE IRAs, participants in 401(k), 403(b) and 457 plans so long as there are eligible distributions, and spouses who inherit these arrangements. There are special rules for non-spouse beneficiaries. Since RMDs cannot be rolled over, people over 70 ½ can rollover the non-RMD amounts held in their IRAs. Of course in 2009, there are no RMDs so the entire account balance for a senior can be rolled over. For all conversions, the funds must be gone from the IRA or qualified plan by December 31st or the conversion is for the following year. This is different from the rules for contributing to IRAs that allow contributions to be made up until 4/15 of the following calendar year. Lastly, you do not have to convert your entire traditional IRA balance to a Roth. You can convert any portion of your traditional IRA, say as little as $1, or whatever amount you feel comfortable converting.

In 2009, Roth conversions are limited to those folks with modified AGI of $100,000 or less, and this applies to single or joint tax return filers, not to individuals. In other words, if you don't work and your spouse makes $101,000 then there's no conversion eligibility for either of you.

So what about 2010? There are several pieces of big news for 2010. First, the $100,000 MAGI limit goes away. Married filing separately will also be allowed to convert (previously they were unable to). Unique for 2010 is the tax deferral aspect of the law. For 2010 conversions, the taxpayer has the choice of paying the taxes due in tax years 2011 and 2012, effectively delaying the full tax bill until 4/15/2013 (that's right 2013!). Further, the choice of paying in 2010 or 50% in 2011 and 50% in 2012 doesn't need to be made until the 2010 tax return is filed. For some this could be as late as 10/15/2011. An important consideration for some taxpayers will be how best to handle ordinary income losses, such as with an S corporation.

Deciding on which year to convert, 2009 or 2010 depends to a great extent on eligibility. Those who are eligible and most concerned with rising taxes would be excellent candidates for 2009 conversions. Most likely your IRA balance is lower in 2009 than it was in 2008 or even 2007 so the resultant tax bill will be lower. Conversion in 2009 locks in the start date for the 5 year holding period (there are actually two 5 year holding periods for Roth conversions).

Let's take a look at these 5 year rules. For every Roth IRA there is a 5 year rule. The start date for the first 5 year holding period is straightforward. Any Roth account deposits (contributions or conversions) are treated as though the money arrived in the Roth account on January 1 of that year. So, even if you convert or contribute to a Roth in December 2009, the 5 year holding period starts on January 1, 2009. The 5 year holding period determines whether distributions are qualified and not subject to income taxation. To avoid income taxes, you must be over 59 ½ AND have met the 5 year holding period. For Roth IRA contributions, the start date is established only once and is not re-started for every contribution.

The second 5 year rule applies only to converted IRAs. This second rule also applies only to the 10% penalty, not income tax. Further, this rule only applies to those under 59 ½, unlike the previous rule. Converted funds not held for 5 years and withdrawn prior to age 59 ½ will be subject to a 10% penalty tax. To further aggravate you, this 5 year rule starts again for every conversion. Make a conversion today and there is a 5 year rule applying to this conversion (starting January 1 of this year). Make another conversion next year and there is a new 5 year holding period for that conversion (starting on January 1 of next year). For clarity's sake, let's take this one step further with a quick example. If you decide to convert some funds in March and then convert some more in, oh say July of the same calendar year, then both of these conversions have the same 5 year rule applying to them which starts on January 1 of that calendar year.

So starting in 2009 has the benefit of starting the 5 year clock(s). Further, you have better knowledge of the present than you do of the future. You know today your account balances, your tax rates, and your income situation. If there is uncertainty about those for 2010 and beyond, then a 2009 conversion might be best.

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On the other hand, you may not be eligible in 2009 and must wait until 2010. The 2010 conversion of course gives you the option of waiting until as late as 2013 to make the final tax payment to the IRS for converted amounts.

If you decide to convert in 2009 and you find out before October 15, 2010 that it wasn't such a good idea after all, the conversion can be re-characterized. This is one of the few "do over" opportunities in the tax code. To re-characterize a Roth conversion, the first thing the taxpayer has to do is to wait for 30 days or until the next calendar year, whichever is later. Well, why would anyone want to undo the conversion anyway? Well, taxes, man, sometimes it can be all about taxes. If you make the conversion, pay the taxes and then see a drop in account value, you can re-characterize and get your taxes paid plus interest returned to you.

This tax optimization opportunity offers several tactical approaches you may benefit from. These approaches may be an area of congressional scrutiny in the years ahead, but for now they are perfectly legal and you should know about them so you might benefit from them. The first tactical approach you might take is to convert to multiple new Roth IRAs. This will allow you to cherry pick accounts for re-characterization. For example, you might open two Roth conversions, one for your stock funds and the other for your bond funds. Then, if one of these asset classes suffers, you can undo the conversion and get your tax money paid on those converted funds (plus interest) returned to you.

Another tactic is to be sure to convert only to new Roth accounts that have no previous monies (contributions or conversions) in them. This will help you to keep track of the 5 year rule for conversions. It will also help you to take best advantage of re-characterizations. This process will help you get the best results from a Roth conversion.

This approach of converting and then re-characterizing can go on year after year with the same monies so you can get the lowest tax cost for your Roth conversions. Further, once the time for re-characterization has passed (October 15 of the following year), you can combine your individual asset class Roth IRAs into one large Roth IRA so your account management can be simplified.

Post-2010 is very similar to current rules, except for the income limit of $100,000 has been removed. Both the contribution limits and the contribution amounts for Roth accounts will continue to be adjusted upward with inflation.

One final tip is to fill-up your tax bracket. What does that mean? Let's say you're in the 25% tax bracket, and your income is $105,000. In 2010, the 25% tax bracket might end at $140,000 (in 2008, the 25% tax bracket ended at $131,450), for a married taxpayer filing jointly. In this example, you could convert $35,000 ($140,000-$105,000) while remaining in the 25% tax

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bracket for every dollar of taxable income. Converting more than the $35,000 will result in those additional dollars being taxed at a higher federal rate, as high as 35% or more (nobody knows what rate changes might become law).

Many taxpayers will not want to pay the taxes on these conversions with assets outside of their tax-deferred accounts. I expect to see many small conversions year after year. This approach will allow taxpayers to convert to Roth IRAs and spread their taxes due over several years. Further, I don't expect many people to use the multiple account approach, not that it's a bad approach, it's that many people won't want to hassle with the account management.

So there you have nearly everything you ever wanted to know about Roth IRA conversions. We offered some tips on timing between 2009 and 2010 conversions, including the great tax payment advantages of converting in 2010. Further, you now know about re-characterizations and how to minimize your taxes for the conversions through the use of re-characterizations. Remember, the primary reason for the Roth conversion is to save money on your taxes since tax rates will inevitably be going up and you want to negate the problems of tax risk in your retirement accounts. For those contemplating these conversions, the bottom line for the conversion to be profitable is your tax rate during the withdrawal time period is higher than the tax rate you're paying during the conversion time period!

There's only one corner of the universe you can be certain of improving, and that's your own self.

Aldous Huxley (1894-1963)

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