

2010 Roth Conversions – A New Opportunity

The 2010 tax year is one marked by change as we are presented with numerous modifications in federal tax laws. TravisWolff is perfectly positioned to guide our clients through the complexity of the new laws, including the new opportunity to convert a Traditional IRA to a Roth IRA and possibly defer payment of the associated income tax.

Before discussing the gravity of these changes and the retirement planning opportunities they present, the general treatment of both a Traditional IRA and a Roth IRA are outlined below.

A Brief Comparison of IRAs in General

	Traditional IRA	Roth IRA
Contributions	Subject to status and income restrictions ¹ , contributions may be deductible in the year made. The 2010 maximum contribution is the lesser of \$5,000 (\$6,000 if over age 50) or the amount of earned income.	Income restrictions on the ability to contribute. Contributions are never tax deductible. The 2010 maximum contribution is the lesser of \$5,000 (\$6,000 if over age 50) or the amount of earned income.
Earnings	Earnings are tax deferred.	The earnings are not taxable unless a withdrawal is made before the Roth account has been open for 5 years ² . A 10% penalty may also be incurred.
Distributions	Distributions cannot begin before age 59 1/2 without a 10% penalty and become mandatory when the participant reaches 70 1/2. Distributions are fully taxable to the extent they exceed cost basis.	Withdrawals of earnings are not taxable as long as the plan participant is older than 59 1/2 and has held the money in the account for at least 5 years. There are no mandatory distributions for primary account holders.
Penalties	Pre-age 59 1/2 withdrawals are typically subject to a 10% penalty.	Pre-age 59 1/2 withdrawals are typically subject to a 10% penalty.
Beneficiaries	Beneficiaries are required to take distributions over their life expectancy or the participant's life expectancy using IRS tables.	Spouses are not required to take distributions during their lifetime. Non-spouse beneficiaries are required to take distributions over their life expectancy.

New Legislation

Previously, those with income over certain limits were not allowed to contribute to a Roth IRA or convert their Traditional IRA account to a Roth. The new legislation keeps the basic rules, listed above, but now allows for those with adjusted gross income over \$100,000 to convert to a Roth IRA. Currently, this law is not scheduled to sunset.

Additionally, Congress left a loophole – even though the income restrictions on regular Roth IRA contributions continue to apply, taxpayers with higher incomes may contribute to a Traditional IRA (regardless of the deductibility of the

¹ Income restrictions apply only to those who are "active participants" in employer health plans.

² For a Roth IRA, the 5-year period begins on the date of the first contribution. If a regular IRA is converted to a Roth IRA, the 5-year period begins on the date of conversion.

contributions) and then convert to a Roth IRA. The ability to do this repeatedly is equivalent to the repeal of the income restrictions on regular Roth IRA contributions.

Furthermore, for 2010 only, taxpayers making the conversion in 2010 have the income recognition deferred over a two-year period, unless they choose to have the income included in tax year 2010. For example, if a \$100,000 account were converted in 2010 the entire fair market value of the account on the date of conversion would be taxed as ordinary income³. However, instead of recognizing the income all at once, a taxpayer recognizes \$50,000 on his/her 2011 tax return (tax paid in 2012) and the remaining \$50,000 on his/her 2012 tax return (tax paid in 2013). It is the income which is deferred, and that means that the income tax rates in effect in 2011 and 2012 will determine the amount of tax to be paid on all 2010 conversions. Currently, rates are scheduled to increase on January 1, 2011.

Benefits of Conversion

2010 may be the perfect time to convert a Traditional IRA to a Roth IRA for several reasons:

- **Tax Savings Today:** The current market provides a low-cost conversion opportunity; with a bear market, retirement investments may have lost 30-50% of their value in the last 18 months. 2010 may be a good time to convert since the value of the account is lower, and the taxes paid will be based on the fair market value of the account on the date of conversion.
- **Future Tax Savings:** For those subject to the scheduled increase in income tax rates beginning in 2011, electing to pay the income tax arising from conversion now means paying less income tax.
- **Income Diversification:** The Roth IRA may be able to provide tax diversification by adding tax-free income to the overall income received in retirement. Distributions from a Roth IRA are NOT included in taxable income on your income tax return, which could mean that less of your future social security income will be taxed as well.
- **Wealth Transfer Tool:** This may be a perfect way to enable beneficiaries to stretch the account tax-free over their lifetimes. Roth IRAs permit the undistributed amount in the account to continue to be invested and grow tax-free (not tax-deferred, as used in a Traditional IRA) over the beneficiary's lifetime.

Factors Involved

There is no "paradigm" of the perfect candidate for conversion but a handful of factors are strong indicators:

- The conversion tax can be paid with money outside of the retirement account.
- The retirement account has ample time to grow.
- Lifestyle is sustainable in retirement without depleting the retirement account.
- Tax rates during retirement will be greater than or equal to tax rates before retirement.

Our comprehensive tax model takes into account these and numerous other issues when analyzing whether the conversion will save a client and heirs income tax. We have attached the questionnaire we use to gather the specific data that is most relevant to determine if this opportunity is advantageous and to quote a range of estimated tax-savings by implementing this strategy.

For more information or to discuss this planning opportunity as it specifically relates to your needs, please contact a TravisWolff advisor.



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³ Previously non-deductible contributions (these constitute "cost-basis") will not be taxed upon conversion.