

GETTING READY FOR NEXT YEAR'S LIBERALIZED IRA-TO-ROTH-IRA CONVERSION RULES

Next year will be a pivotal one for retirement planning, as it will be the first year in which taxpayers will be able to convert funds in regular IRAs (as well as qualified plan funds) to Roth IRAs regardless of their income level. This new conversion option poses significant tax planning challenges and opportunities for 2009, 2010 and 2011. This *Hot Topic* takes a look at the new conversion option, and explains how to prepare for it.

- **Conversions to Roth IRAs.** For 2009, taxpayers (other than married persons filing separately) with modified adjusted gross income (AGI) of \$100,000 or less may convert amounts in a traditional IRA to amounts in a Roth IRA. Amounts from a SEP-IRA or a SIMPLE IRA also may be converted to a Roth IRA, but a conversion from a SIMPLE IRA may be made only after the 2-year period beginning on the date on which the taxpayer first participated in any SIMPLE IRA maintained by the taxpayer's employer.

For purposes of conversions to Roth IRAs, AGI is defined as it is for traditional IRA purposes except it does not include income resulting from the conversion from a traditional IRA to a Roth IRA. AGI - for purposes of determining conversion eligibility only - does not include any required minimum distribution from an IRA.

A conversion from a regular IRA to a Roth IRA is subject to tax as if it were distributed from the traditional IRA and not recontributed to another IRA, but isn't subject to the 10% premature distribution tax.

After Dec. 31, 2007, distributions from a certain qualified plan also may be rolled over to a Roth IRA.

- **Major change coming next year.** For tax years beginning after 2009, the \$100,000 modified AGI limit on conversions of traditional IRAs to Roth IRAs is eliminated. Additionally, married taxpayers filing a separate return will be able to convert amounts in a traditional IRA into a Roth IRA (currently they are barred from doing so).
- **Why make a IRA-to-Roth IRA conversion?** Roth IRAs have two major advantages over regular IRAs:
 - (1) Distributions from regular IRAs are taxed as ordinary income (except to the extent they represent nondeductible contributions). By contrast, Roth IRA distributions are tax-free if they are "qualified distributions," that is, if they are made (a) after the 5-tax-year period that begins with the first tax year for which the taxpayer made a contribution to a Roth IRA, and (b) when the account owner is 59 ½ years of age or older, or on account of death, disability, or the purchase of a home by a qualified first-time home buyer (limited to \$10,000).
 - (2) Regular IRAs are subject to the lifetime required minimum distribution (RMD) rules which generally require minimum annual distributions to be made commencing in the year following the year in which the IRA owner attains age 70 1/2. By contrast, Roth IRAs aren't subject to the lifetime RMD rules that apply to regular IRAs (as well as

individual account qualified plans).

A similar comparison could be made between distributions from qualified retirement plans and Roth IRAs.

There are other tax advantages: Because distributions from Roth IRAs are tax-free (if they are qualified distributions), they may keep a taxpayer from being taxed in a higher tax bracket which would otherwise apply if he were withdrawing taxable distributions, don't enter into the calculation of tax owed on Social Security income, and have no effect on AGI-based deductions. What is more, the benefits flow through to beneficiaries of Roth IRA accounts, who also can make tax-free withdrawals from such accounts (they are, however, subject to the same annual post-death minimum distribution rules which apply to beneficiaries of regular IRAs).

- **Who should make IRA-to-Roth IRA conversions?** The consensus view is the conversion route should be considered by taxpayers who:
 - have a number of years to go before retirement (and are therefore able to recoup the dollars that are lost to taxes on account of the conversion);
 - anticipate being taxed in a higher bracket in the future than they are now; and
 - can pay the tax on the conversion from non-retirement-account assets (otherwise, there will be a smaller buildup of tax-free earnings in the depleted retirement account).
- **Complicating factor for 2010 conversions.** A unique income inclusion rule will apply for IRA-to-Roth-IRA conversions occurring in 2010. Unless a taxpayer elects otherwise, none of the gross income from the conversion is included in income in 2010; half of the income resulting from the conversion will be includible in gross income in 2011 and the other half in 2012.

A major wild card in making this choice is the tax-rate picture after 2010. Absent Congressional action, after 2010 the tax brackets above the 15% bracket will revert to their pre-2001 levels. That means the top four brackets will be 39.6%, 36%, 31%, and 28%, instead of the current top four brackets of 35%, 33%, 28%, and 25%. The Administration has proposed to increase taxes only for those making \$250,000, but it is difficult, at this point in time, to predict who will get hit by higher rates. What's more, there are proposals on the table to help finance health reform with a surtax on higher-income taxpayers.

- **What do to this year.** Taxpayers who intend to take advantage of the new conversion option next year should consider the following strategies:
 - Non-high-income taxpayers who are able to make deductible IRA contributions this year should do so. They'll reduce their 2009 tax bill and, if they make the conversion to Roth IRA next year, they won't have to pay back the tax savings until 2011 and 2012.
 - High income taxpayers should consider making nondeductible IRA contributions this year. They can then roll over the accounts into Roth IRAs next year at no tax cost.
 - Some high-income taxpayers plan to make large conversions in 2010 but to opt out of

the deferral of tax until 2011 and 2012 because they fear they will be in a higher tax bracket in those years than in 2010. These taxpayers should avoid the standard year-end-planning wisdom of accelerating deductions and deferring income but should, rather, do the reverse in an effort to avoid being pushed into the highest brackets by a large IRA-to-Roth-IRA conversion. These taxpayers should be considering ways to defer deductions to 2010, and accelerate income from next year into 2009.

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