2010 CHANGES TO THE ROTH IRA RULES OPENS CONVERSION UP TO UPPER INCOME TAXPAYERS

With the end of the year fast approaching, I want to bring your attention a change taking place next year regarding Roth IRA rules. Surveys have shown that not a lot of people are aware of the coming changes, which some clients may want to consider in order to diversify their retirement income sources.

Back in May of 2006 there was a pretty significant change to the tax laws involving converting a traditional IRA to a Roth IRA**.** In the year 2010 everyone can convert their traditional IRAs to a Roth IRA - and that's an opportunity that not everyone had in the past.

Current Roth IRA Conversion Rules
Under the current tax law for Roth IRA conversions - which was written in 1997 - individuals were permitted to convert a traditional IRA to a Roth IRA. There were only two stipulations that taxpayers had to worry about - paying taxes on the converted money and an income limit which determined eligibility to convert.

With a traditional IRA money can be placed into the account on a pre-tax (tax deductible) and after-tax basis. That investment is allowed to grow on a tax-deferred basis until withdrawn in retirement.

If an individual wanted to convert a traditional IRA to a Roth IRA they had to pay income taxes on any pre-tax contributions as well as any growth in the investment's value. After all, once converted to a Roth, all of the investment could now be withdrawn on a tax-free basis in retirement.

Unfortunately, that same 1997 tax law also contained a provision limiting who could make a conversion. Upper income taxpayers - those with adjusted gross incomes of more than $100,000 - whether single or married - were not eligible to make such a conversion.

In addition, if you earned $110,000 or more ($160,000 for married joint filers) then you also weren't eligible to contribute to a Roth IRA. These two tax laws effectively precluded upper income taxpayers from enjoying the benefits of a Roth IRA. They couldn't convert their traditional IRA to a Roth, and they couldn't fund one either.

IRA Conversions in 2010
But back in May of 2006 President Bush signed a $70 billion tax cut provision that changed the eligibility rules for Roth IRA conversions. Starting in 2010, taxpayers with modified adjusted gross income of more than $100,000 will be allowed to convert a traditional IRA to a Roth IRA. This change applies to all years beyond 2010 - and the income taxes due on the 2010 conversion can be spread over two years. So the 2010 conversion amount may be included as taxable income in 2011 and 2012 - helping to spread out the tax bite. Conversions in subsequent years are included in income during the tax year in which the conversion is completed.

Removing the Roth IRA conversion cap however doesn't mean anyone can fund a Roth IRA, but it does mean that anyone can convert an existing IRA to a Roth IRA.

Does a Partial IRA Conversion Make the Most Sense?
Because converted assets will be considered taxable income, a conversion could push some clients into a higher tax bracket. A partial conversion may be the answer. Converting only a portion of the assets may allow you to stay in a lower tax bracket. Clients can convert additional assets in future years.

Ideally, clients would have the cash on hand to pay the income tax on converted assets. A partial conversion could help limit the conversion taxes to an amount you can pay without dipping into IRA assets. You would first want to determine how much tax you can handle out of pocket and use that amount to figure out how much to convert.

A Note about Non-deductible Contributions
Although clients can convert part of a traditional IRA to a Roth, they cannot pick and choose which portion of the traditional IRA money they want to convert. If their traditional IRA contains both deductible and non-deductible contributions, they will not be able to stipulate which contributions to convert.

Instead, taxes will be pro-rated based on the percentage of nondeductible assets in the account. If, for example, non-deductible contributions represent one quarter of a client's IRA, then 25% of the converted funds will be tax free. The IRS does not permit moving the entire chunk of non-deductible assets into the Roth without also taking any pre-tax contributions into account.

Clients should have been tracking their non-deductible contributions on IRS Form 8606. Since the form is cumulative and includes all past non-deductible contributions, you need only the most recent one.

Should you make nondeductible contributions to a traditional IRA now in anticipation of the 2010 conversion rule change? This would likely work best if there is little or no existing deductible IRA balance to muddy the waters. Even then, any earnings between now and then would still be subject to tax.

Spreading the Tax Liability over Two Years
As mentioned above, for 2010 conversions only, the IRS will allow clients to spread the tax liability over two years (2011 and 2012). This means they could allocate one half of the conversion to their 2011 taxes and the remaining half to their 2012 taxes—no matter if it is a full or partial conversion.

However, splitting the conversion income between 2011 and 2012 is beneficial only if your tax rate won't rise. Since tax hikes in 2011 and 2012 are almost a certainty for top earners, it may make sense to pay the tax in full for the 2010 tax year.

Roth IRA Conversion Examples
There is one important rule to keep in mind when it comes to converting a traditional IRA to a Roth IRA - you need to pay income taxes on any portion of the conversion that you haven't already paid taxes on.

Example 1
For example, let's say you started to fund traditional IRAs in 2006 and by 2010 you've got $20,000 in your account. Furthermore, let's say this account consisted of four years of $4,000 non-deductible contributions - a total of $16,000 in non-deductible contributions and $4,000 in account growth.

In this example, you'd need to pay income taxes on the $4,000 in fund growth when you convert to a Roth IRA. But the good news is you'll never have to pay income taxes on this account again.

Example 2
In this second example, let's assume that you funded the that same traditional IRA with before-tax dollars - meaning you were able to take a deduction on your tax return for the money placed in the traditional IRA.

In this example, you haven't paid income taxes on any of the money in the account, so when you convert it to a Roth IRA taxes are owed on the entire account balance. In this case you'd have to pay income taxes on all $20,000 in your fund.

Example 3
If you have an existing traditional IRA (with tax-deductible contributions) and you start to fund a non-deductible IRA, then you need to be aware that tax rules state that any conversion is done on a pro-rata basis. Let's say you had $100,000 in a regular IRA and you had $25,000 in a non-deductible IRA.

If you wanted to convert $25,000 to a Roth, then you'd owe taxes on $20,000 because the pro-rata share of your non-deductible contributions is only $5,000.

Deciding to Convert to a Roth IRA
While it might be very exciting for some individuals to learn that they can use this 2010 law to convert a traditional IRA to a Roth IRA, it's important to mention that Roth IRAs are not for everyone.

It's always best to make an informed decision and if you ever have a question about what's right in your particular situation it might be a good idea to consult with a financial advisor before deciding if taking advantage of the rule change in 2010 is right for you.

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