Roth Conversion in 2010
A Tax Tip Seniors Should Consider

By Robert C. Anderson, CELA

Coming in 2010, thanks to tax legislation enacted in 2006[1], all taxpayers, regardless of taxable income, will be able to convert a Traditional IRA whose earnings will be taxed to a Roth IRA whose earnings are not taxed after a five-year holding period.

<u>The Advantages of Conversion</u>

Even better, the IRA owner who converts in 2010 can elect to defer 50 percent of the taxable income into tax year 2011 and 50 percent into tax year 2012. By spreading the tax over two years, most taxpayers will be able to keep the extra taxable income from the Roth conversion in lower brackets.

Previously, Internal Revenue Code (IRC) 408A(c)(3)(B) did not allow taxpayers with modified adjusted gross income of $100,000 and over to convert a Traditional IRA to a Roth IRA.

With the $100,000 income limit removed in 2010, the advantage of *tax-free* growth as opposed to *tax-deferred* growth will be available to all income levels. This legislation can also help taxpayers whose income is less than $100,000 by allowing them, as well as higher-income taxpayers, to defer the tax into the next two tax years of 2010 and 2012. Keep in mind that the actual tax due for 2011 can be deferred until April of 2012 and the taxes due for 2012 can be deferred until April of 2013.

Another plus for seniors is that owners of Roth IRAs are not subject to required minimum distributions (RMDs) after age 70 ½. Therefore, Roth IRA owners will be able to enjoy tax-free earnings until death, as well as their spouses who are named as beneficiaries.

The Roth conversion analysis for seniors should be viewed in the usual tax stages which apply to them. At age 59 ½, taxpayers can begin to make penalty-free withdrawals from Traditional IRAs and other tax-qualified retirement plans. Later, when Social Security benefits are received, a portion of Social Security benefits may become taxable as taxable income exceeds certain levels. Then, age 70 ½ triggers RMDs. Then some seniors will have to cash-in their Traditional IRAs at a big tax cost to pay for unexpected nursing home, assisted living or home health care costs. When an IRA is lost to long-term costs, a Roth IRA is better to have since there will be no tax cost.

Another advantage to a Roth conversion in 2010 is due to the fact that the values of most Traditional IRAs went down in 2008 and early 2009. By converting in early 2010, the hoped-for market increase in 2010 and later means increased tax-free earnings. If, however, the market drops, then the taxpayer may undo the conversion and *re-characterize* the funds back into a Traditional IRA.

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[1] Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), enacted in 2006

The Disadvantages of Conversion

The biggest disadvantage is that the amount converted into a Roth will be added to taxable income for tax year 2010 or split between tax years 2011 and 2012. If taxable income will decrease in 2013 and beyond and a taxpayer is only concerned about himself or herself, a Roth conversion loses its appeal.

If a Roth conversion will push a senior's tax on Social Security benefits into a higher bracket, a Roth conversation may lose its appeal.

Another disadvantage exists if the taxpayer will have no available projected cash to pay the tax due in April of 2012 and April of 2013. It makes no tax sense to have to sell appreciated stocks and bonds or withdraw IRA funds to cover the Roth conversion tax.

Another disadvantage exists for a Traditional IRA which is funded with an annuity which has an ongoing surrender period. By converting such a product, the surrender penalty may be triggered.

Timing Considerations

A taxpayer converting to a Roth IRA in 2010 has two elections. He or she can include all the taxable income equal to the amount converted in tax year 2010 or can include one-half in tax year 2011 and one-half in tax year 2012. Will taxable income be higher or lower in 2010, 2011 and 2012? Will deductions be available in 2010, 2011 and 2012? What is the chance that tax rates may increase in future years as Congress attempts to deal with future deficits?

Running the Numbers

To assist taxpayers in assessing the pros and cons of converting in 2010, financial calculators are available from financial companies, such as Met Life, to run the numbers. These calculations can determine whether the loss of the money, which is spent on taxes in 2011 and 2012, is less than the of the future tax savings from the Roth.

Qualitative Factors

There are certain qualitative factors which may apply.

1. Supporting One's Survivors

A senior may not need the subject IRA funds for the senior's own retirement needs and may prefer to create a tax-free legacy for the senior's spouse and/or other loved ones. If this is the case, a 2010 Roth conversion makes sense. The elimination of RMDs allows more tax-free growth during the owner's life, then more tax-free growth for his or her surviving spouse. Then after the spouse dies, the funds remaining in the Roth can be stretched out over the children's or other heirs' life expectancy. The post-death earnings will be tax free as well as amounts withdrawn. This may be especially useful to children or other loved ones are in a tax bracket higher than the senior.

2. Tax Diversification
Assuming a tax payer has other financial assets, such as tax-deferred and/or appreciated capital gain assets, by adding a tax-free Roth, the taxpayer will enjoy greater flexibility in making tax-smart withdrawals. The taxpayer can more easily avoid moving into a higher marginal tax bracket and funds are needed.

3. Tax on Social Security Taxes
A Roth conversion may be ideal during the times a taxpayer's income decreases due to retirement and before he or she receives Social Security benefits. On the other hand, a Roth conversion may push most of a taxpayer's Social Security benefits into the taxable range, then the cost of a conversion may be too high.

4. Creditor Issues
Some states do not offer the same creditor protection for Roth IRAs as they do for Traditional IRAs.

5. Estate Taxes
By paying the income tax on the IRA up front before death, the ultimate estate tax, if applicable, on the Roth IRA will result in a small estate tax savings.

Back-Door Roth IRA Contribution Advantage

The elimination of the $100,000 Roth *conversion* income limit can be used to avoid the income limit on a Roth IRA *contribution* for a taxpayer whose income exceeds the *contribution* limit. The first step is for the taxpayer to contribute to a *nondeductible* Traditional IRA which is not subject to any income limits. The second step is to convert the nondeductible IRA to a Roth in 2010.

Conclusion

In 2010 all taxpayers, regardless of income, can take advantage of the golden opportunity to convert their Traditional IRA into a Roth IRA. There are many pros and cons, all of which need to be examined. Attorneys need to be the first to inform their clients of this opportunity and offer reasoned advice. Consultation with the client's tax preparer and financial advisor is recommended. The use of a financial calculator is a desirable assessment tool as well.