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"An investment in knowledge always pays the best interest." - Benjamin Franklin

For some people, conversion of at least part of their traditional IRA assets to Roth in 2010 could ultimately save a lot of tax dollars.

The new year has brought two major tax related issues of high importance. The first of these—regarding Roth IRAs—is presented below. The second—the elimination of the U.S. Estate Tax in 2010—will be sent very soon.

ROTH IRAS AND THE NEW 2010 RULES

The following is an outline of the rules governing Roth IRAs, along with the new 2010 conversion rules. Many people believe there are potential opportunities in conversion this year, if the facts are favorable for the taxpayer.[1]

1. What is a Roth IRA?

   a. Roth IRAs, which began in 1998, are retirement accounts similar to IRAs but where contributions or conversions from qualified plans are taxable income (no deduction), and qualified distributions are income tax free
   b. Required minimum distributions
      i. Roth IRAs are not subject to the lifetime minimum distribution rules which govern IRAs, and do not have a required beginning date for the participant
      ii. Following the death of the participant, a Roth IRA is subject to the minimum distribution rules applicable to traditional IRAs as if the participant died before the required beginning date.
      iii. Distributions from a Roth IRA, and conversions to a Roth IRA, do not fulfill required minimum distribution requirements for traditional IRAs
   c. Roth IRAs do not have a maximum age for making contributions, unlike traditional IRAs.
   d. Note that the 10% penalty for distributions before age 59 ½ generally applies.

2. Requirements for a qualified distribution

   a. Five year period – this period begins on January 1 of the first year in which a contribution is made to any Roth IRA for the participant
   b. One of the following:
      i. The distribution is made after the participant attains age 59 ½
      ii. The distribution is made after the participant's death
      iii. The distribution is attributable to the participant being totally disabled (as defined in §72(m)(7))
      iv. The distribution is for certain purchases of a "first home", and is up to $10,000
   c. The basis of property distributed from a Roth IRA is its fair market value on the date of distribution

3. Tax treatment of nonqualified distributions

   a. Distributions which are nonqualified are first deemed to be a return of the participant's contributions (which have already been taxed) to the extent that all previous distributions from the Roth IRA have not exceeded the contributions

b. If both regular and rollover contributions have been made, the distributions are deemed to come from the regular contributions first
c. If distributions are deemed to be made out of rollover contributions, the amount which was previously included in gross income due to the rollover is distributed first
d. Lastly, the balance of the distribution is made from earnings, which are taxed as ordinary income

4. Annual contribution limits

   a. The maximum amount that can be contributed to a Roth IRA for 2010 is $5,000, or $6,000 for participants over age 50, reduced by the amount of the participant's contributions to a traditional IRA in such year
   b. Adjusted Gross Income (AGI) cannot exceed $95,000 for a single taxpayer, $150,000 for a married taxpayer filing jointly, or $0 for a married taxpayer filing separately, indexed for inflation after 2006.

5. Conversion of a traditional IRA to a Roth IRA pre-2010

   a. A traditional IRA may be converted to a Roth IRA, except that an inherited IRA cannot be converted to a Roth IRA
   b. Conversion was not permitted if modified AGI exceeded $100,000 (until 2010, when there is no AGI limit)
   c. After age 70 ½, conversion is only permitted after the required minimum distribution from all regular IRAs and qualified plans for that year have been distributed (RMD funds are not eligible for rollover to any IRA or conversion to a Roth IRA)
   d. The amount converted is includible in the participant's taxable income for the year of conversion (except for certain 2010 conversions where it can be taxed ½ in 2011 and ½ in 2012)
   e. The 10% penalty does not apply to a conversion from a traditional IRA to a Roth IRA before age 59 ½, provided that the tax due is paid from a source other than the Roth IRA

6. Roth recharacterizations (in any year)

   a. A conversion from an IRA to a Roth IRA can be recharacterized back to an IRA, by doing a trustee to trustee transfer of the assets transferred to the Roth IRA back to a traditional IRA along with any net income on the converted assets, thus undoing the rollover. This is possible even where the assets have declined in value, by transferring the entire Roth IRA back to a traditional IRA, including its "earnings" (in this case, losses).
   b. The deadline for a recharacterization is the extended due date of the taxpayer's income tax return for the year in which the conversion occurred. Extended due date includes extensions, and thus can be as late as October 15.
   c. It appears that you can recharacterize more than one account. So, if you convert one IRA account into two Roth IRA accounts (say large cap equities in one, small cap equities in another and fixed income in a third), and one account performs better than the other during the period allowed for recharacterization, you might chose to recharacterize the lower performing account(s) and leave the best performing account converted (and thus pay the income tax on the value of that account as of the date it was converted).

7. Designated Roth Account

   a. A Designated Roth Account (DRA) is sometimes referred to as a Roth 401(k)
   b. Any participant in a 401(k) plan (after 2005) may elect to have part or all of the participant's elective deferral go into a DRA
   c. There is no income ceiling for contributions, and no age limit for making contributions to a DRA
   d. The maximum amount which a participant may contribute to a DRA is the maximum amount of the participant's elective deferral contribution

e. A DRA is subject to the same lifetime and post-death minimum distribution rules as non-Roth 401(k) plans
f. Qualified distributions do not have the first time homebuyer exception, and the five year period is computed per DRA
g. Nonqualified distributions carry out proportionate amounts of pre-tax and after-tax money

8. Conversion to a Roth IRA in 2010

a. Effective in 2010 and later years, the $100,000 income limit on Roth IRA conversions is repealed. Also, married taxpayers filing separately are eligible to convert to a Roth IRA
b. Amounts converted in 2010 are included in gross income ½ in 2011 and ½ in 2012 (under the tax rates effective for those years), unless the participant elects to have all of the amount converted taxed in 2010
c. Amounts converted after 2010 are subject to tax in the year of conversion.

If you would like to explore this topic further, please contact Michael Strauss at (847) 562-1400.

NOTE: The information contained in this document is a summary of the relevant law, and as such simplifies certain rules and does not cover all applicable rules and exceptions.