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Your Accounting for a New Economy

Are You Ready for the IRA-to-Roth-IRA Conversion Rules?

Next year for the first time taxpayers will be able to convert funds in regular IRAs and other qualified plan funds to Roth IRAs regardless of their income level. As with any new option, the new conversion possibility poses both tax planning challenges as well as opportunities for the coming years.

The Basics

In 2009, taxpayers (not including married persons filing separately) with modified adjusted gross income (AGI) of \$100,000 or less may convert their holdings in a traditional IRA to holdings in a Roth IRA. (Code Sec. 408A (c)(3)(B))

Funds in a SIMPLE IRA or a SEP-IRA may also be converted into a Roth IRA, but for a SIMPLE IRA this can only be done 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. (Reg. § 1.408A-3)

Funds converted from a regular IRA to a Roth IRA are taxed at the same rate as funds distributed from a traditional IRA and not recontributed to another IRA (Code Sec. 408A(d)(3)(A)(i)). However, those funds are not subject to the 10% premature distribution tax. (Code Sec. 408A(d)(3)(A)(ii); Reg. § 1.408A-4, Q&A 7)

After December 31, 2007, distributions made from a Code Sec. 401(a) qualified plan may also be rolled over to a Roth IRA. (Code Sec. 408A(d)(3))

The Times They Are A-Changin’

For tax years starting subsequent to the 2009 tax year, the modified AGI limit of \$100,000 on conversions of a regular IRA to a Roth IRA is eliminated. In addition, unlike the current year, married taxpayers filing separately will be able to convert funds in a traditional IRA to a Roth IRA. (Code Sec. 408A(c)(3))

The Benefits

Roth IRAs have two major advantages over traditional IRAs.

1. Regular IRAs are taxed as ordinary income (except to the extent they represent nondeductible contributions). Qualified Roth IRA distributions are tax-free. Qualified Roth IRA distributions are – 1. Distributions made after the 5-year period that begins with the first tax year for which the taxpayer made a contribution to a Roth IRA. 2. Distributions made when the account owner is 59 and ½ years of age or older, or on account of death, disability, or the purchase of a home by a qualified 1st-time homebuyer. (\$10,000 limit) (Code Sec. 408A(d)(2))
2. Regular IRAs have lifetime Required Minimum Distribution (RMD) rules that in most instances requires annual minimum distributions be made commencing in the year following the year in which the IRA owner attains 70 and ½ years of age. Roth IRAs are not subject to RMD rules. (Code Sec. 408A(c)(5))

Is an IRA to Roth IRA Conversion Right For You?

While the answer may vary depending on the specifics of your situation you may want to consider converting your regular IRA to a Roth IRA if:

1. You are a long way from retirement and have time to recoup the money that is lost to taxes due to the conversion.
2. You anticipate entering a higher tax bracket in the future.
3. You are able to pay the conversion related taxes through non-retirement account assets.

Complications

Complicating the situation further is a unique income inclusion rule that will take effect for conversions that occur in 2010. Unless the taxpayer chooses to elect otherwise, the gross income from the conversion will not be counted as income in 2010. Rather, half will be included in income in 2011 with the remainder counted as income in 2012. (Code Sec. 408A(d)(3)(A))

Another thing you will want to consider before taking advantage of the conversion is the changing tax-rates after 2010. Assuming Congress takes no additional action, the tax brackets above the 15% bracket will actually revert back to their pre-2001 levels. These changes could lead to significantly higher tax rates for those in the higher tax brackets. In addition, there's talk that the health reform plans currently being debated in Congress could lead to an added surtax for higher-income taxpayers.

Be Prepared

If you intend to take advantage of this opportunity and convert some or all of your funds in a traditional IRA to a Roth IRA below are some strategies for you to consider:

- If you are not in a higher tax bracket and you can afford to make deductible IRA contributions this year, you should do so. This will help to reduce your current year's tax bill and you won't have to pay back the tax savings until 2011 and 2012.
- Higher income taxpayers should consider making nondeductible IRA contributions this year as well. Once in place they will be able to roll over those accounts next year in Roth IRAs at no tax cost.
- Higher income taxpayers who plan to make large IRA to Roth IRA conversions next year and plan to opt out of the offer of tax deferrals until 2011 or 2012 because they believe they may be in a higher tax bracket in subsequent years should disregard traditional year-end-tax-planning wisdom and instead accelerate income rather than deductions for 2009 to avoid being pushed into an the highest income tax bracket when the conversions hit next year.

Bottom Line

The tax implications involved in converting a traditional IRA to a Roth IRA can sometimes be confusing and difficult to untangle. Before taking advantage of an opportunity like this it's a good idea to meet with a professional who can explain all of your options. If you have any questions about the tax repercussions stemming from your potential conversion contact Brad Gross, Tax Partner at (214) 461-1406 or by email at bgross@lgt-cpa.com.