roth *IRAs*

NEW PLANNING OPPORTUNITIES IN 2010

Since their introduction in 1998, Roth IRAs have provided one of the best tax breaks around. Investors who meet the holding requirements can withdraw their contributions to Roths, and the earnings on those contributions, tax free. Until now, however, Roths have not been available to higher-earning taxpayers.

Under new tax laws that took effect on January 1, 2010, all taxpayers, regardless of their income, can convert a traditional IRA to a Roth IRA. This provides a great financial planning opportunity for many people by maximizing the long-term value of their retirement savings. Many factors go into deciding whether, when, and how much to convert from a traditional IRA to a Roth IRA, so you'll need to look closely at your own financial situation before taking the plunge.

With Roth IRAs, contributions are made with after-tax dollars and are not tax deductible. However, you're never required to withdraw money from a Roth, so the account can grow tax free for your lifetime.

UNDERSTANDING IRAs

Before you begin your analysis, you'll need to know the differences between traditional and Roth IRAs. With traditional IRAs, contributions to the accounts are usually made with pre-tax dollars and are tax deductible. When you reach the age of 70 and a half, you must begin to withdraw assets from the account, and those withdrawals are taxed as ordinary income. You can't contribute to a traditional IRA after you begin taking the mandatory distributions. When you die, your beneficiaries must continue to withdraw from your IRA, and those withdrawals are also subject to tax.

With Roth IRAs, contributions are made with after-tax dollars and are not tax deductible. However, you're never required to withdraw money from a Roth, so the account can grow tax free for your lifetime. If you do withdraw funds from the account, they're not subject to income tax. You can continue to contribute to a Roth IRA, even one that you converted, regardless of your age, as long as you meet certain criteria. Although your beneficiaries must withdraw from your Roth IRA after your death, those withdrawals aren't subject to tax.

If you like the idea of tax-free growth and withdrawals, you'll need to consider the financial cost of converting. (Note that other types of qualified retirement plans, such as 401(k) plans, simplified employee pension IRAs, 403(b) plans, and 457(b) plans, can be converted to a Roth IRA, too.) When you transfer money from a traditional IRA to a Roth IRA, you must pay income taxes on the portion of the withdrawn funds that represents pre-tax earnings and contributions. If all of your contributions to your traditional IRA have been tax-deductible, then the entire amount withdrawn and transferred to the Roth will be subject to income tax. If you've made some non-deductible contributions to your traditional IRA, then a portion of the amount you convert to the Roth IRA will be taxed—you're not allowed to convert just the non-deductible contributions.

ADDITIONAL TAX CONSIDERATIONS

You aren't required to convert your entire traditional IRA to a Roth at one time. You can convert funds piecemeal, as you can afford it, over a number of years. In particular, you should figure out how much you can convert each year without bumping yourself into a higher tax bracket or the alternative minimum tax system. If your traditional IRA has fallen in value in recent years, however, you may want to convert as much as possible in 2010, before the value recovers; this will keep the tax bill on the conversion as low as possible.

If you convert a traditional IRA into a Roth IRA in 2010, you'll have some tax reporting options that won't be available after this year. You can choose to report all of the income on your 2010 income tax return, or report one-half of the income in 2011, and the balance in 2012. For example, if you convert $100,000 from your traditional IRA to a Roth IRA in 2010, you won't need to report any additional income in 2010, but will report $50,000 of income from the conversion in each of 2011 and 2012. If you're worried that tax rates will increase after 2010—probably a very realistic concern—you can pay the entire tax bill in 2010 instead. Fortunately, your 2010 income tax return isn't due until April 2011 (or October 2011, if you extend the due date), and by then you'll probably have a better idea of which years will produce the lowest income tax liability.

What happens if you convert your traditional IRA to a Roth, and in retrospect it turns out to have been a bad move? For example, assume you convert $100,000 of assets to a Roth in April 2010, and pay income taxes on that amount in April 2011. If the value of the converted assets later falls to $80,000, you will have paid income taxes on $20,000 of value that no longer exists. Fortunately, the tax rules give you a window of opportunity to treat the conversion as if it didn't occur. This is called a "recharacterization." In most cases, you'll have until October 15 of the year after the conversion year to undo (or recharacterize) the conversion. In order to take full advantage of the flexibility that the recharacterization rules provide, you should put converted funds into a new Roth IRA (instead of adding them to an existing Roth), and consider opening a separate Roth IRA for each type of investment you hold. This will allow you to recharacterize the accounts that don't perform well, and leave the winners alone.

IS IT FOR YOU?

There's no one-size-fits-all answer to whether a Roth IRA conversion makes sense. In general, you should convert only if the benefit of the tax-free income from the Roth will be greater than the cost of conversion. A conversion usually works best for people who 1) can pay the conversion taxes out of non-IRA assets, 2) don't think they'll need the converted funds for at least 10 years; 3) will be in the same or a higher tax bracket in retirement; and 4) want to leave income-tax free assets to their heirs. In addition to the tax aspects, however, you should think about the investment and estate-planning factors. Consider your desire to gain control over your retirement funds in the years ahead (no minimum required withdrawals from a Roth), along with the flexibility in managing investments and cash flow that a Roth can provide (no income tax on withdrawals you do make).

Before making a final decision to convert, consult your tax or financial adviser for more information and an analysis of the costs and projected benefits of converting in your particular circumstances. You can jump-start the process by crunching some numbers yourself using online calculators, such as those at www.rothretirement.com and www.fidelity.com/rothevaluator.

The tax rules governing IRAs are complex, but with some careful analysis and planning, a conversion to a Roth IRA may provide significant tax and financial planning benefits long into the future.

Amy Kanyuk speaks and writes frequently about tax and estate planning topics, and has been selected numerous times by her peers for inclusion in Best Lawyers in America, in the fields of tax law and trusts and estates.