Mahoney&Associates OnPoint POSITION PAPER

April 27, 2010

Considerations - Traditional IRA to Roth IRA Conversion

Background:
In 2010, an important Roth IRA rule change went into effect as part of the Tax Increase Prevention and Reconciliation Act signed by President George W. Bush in 2006. In the past, individuals could not convert their traditional IRA to a Roth IRA if their income exceeded $100,000 and those who were married filing separately could not convert regardless of what they earned. Effective January 1, 2010, traditional IRA holders are able to convert to a Roth IRA *with no income limit*. Also, *as a one-time offer for 2010 only*, the law allows the taxes on the entire conversion amount either to be reported in full for 2010, or spread out equally over the next two tax years (2011 and 2012 only). The married-filing–separately restriction was also repealed.

Income Limits for Conversions Eliminated:
Although the contribution phase-out limits for Roth IRAs remain, the change in the law made permanent the elimination of the income limit for converting a traditional IRA to a Roth IRA. For the first time, individuals earning a Modified Adjusted Gross Income (MAGI) of $100,000 or more are able to convert their traditional IRAs to Roth IRAs.
The married-filing–separately restriction was repealed as well, adding further to the number of potential beneficiaries of this change in the law.

Special Tax-Payment Allowance:
As a one-time offer for 2010 only, the law allows the taxes on the entire conversion amount either to be reported in full for 2010, or spread out equally over the next two tax years (2011 and 2012 only). For example, if an individual converts a $50,000 traditional IRA to a Roth IRA in 2010, he can report the entire $50,000 for 2010 or, if he prefers, divide the amount in two equal parts and report $25,000 for 2011 and $25,000 for 2012. This "two-payment plan" helps spread out the tax bite. *It will not apply to conversions made in 2011 or beyond.*

Income Limit on Funding Roth IRA Retained:
While the rule change removed the income cap for Traditional IRA to Roth IRA *conversions*, it did not affect the income cap for funding new Roth IRAs. Taxpayers who earn $110,000 per year or more ($160,000 for married joint filers) are not eligible to contribute to a Roth IRA.

How *Not* to Pay the Conversion Tax:
Paying the taxes from converting an IRA is made easier with the two-year tax rule stated above. In order to maximize the conversion benefit, taxes should be paid out-of-pocket from sources *other than* the individual's IRA. This would defeat the purpose of the tax-free withdrawals. Individuals should make sure they have funds outside their IRA to pay their taxes.
Roth IRA Pros and Cons:

Pros	Cons
Up to $12,000 per couple contributions for those who qualify	After-tax contributions
Tax-free withdrawals after meeting minimum holding period and age requirements	Contribution income limits of $110,000 single; $160,000 for married joint filers
No Required Minimum Distributions after age 70 ½	Withdrawals made prior to age 59½ can be subject to a 10% early withdrawal penalty
Heirs do not pay income tax on withdrawals	Roth IRA conversions trigger an immediate tax liability (except for the special two-year income inclusion rule for 2010 conversions)
Provides tax diversification and flexibility against fluctuation in future tax rates	--
Tax-free withdrawals can be made prior to age 59½ if account owner becomes disabled or uses the proceeds (capped at $10,000) for a first-time home purchase provided the account has been held at least five tax years	--

To Convert or Not To Convert:
Although investors may not have recovered losses from the recent market downturn, it *may* be a good time to convert their lower-balance IRA accounts to a Roth IRA to save on taxes. Here are some conversion considerations:

- The amount of the individual's existing IRA is small.
- Most of their existing IRA contributions are non-deductible, which would minimize the taxes due on the conversion.
- Their retirement is many years away.
- The potential tax-free payout appears to outweigh the up-front taxes due on the conversion.
- Their retirement tax bracket will be the same as, or higher than, their current bracket.

These conversions should *not* be made automatically nor should *all* IRA account-holders convert their accounts. Our recommendation is that they discuss the advantages and disadvantages of conversion with their financial planning advisor.

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