## “Making the Most of the 2010 IRA-to-Roth-IRA Conversion Rules”

This year is the first in which taxpayers may convert funds in regular IRAs (as well as qualified plan funds) to Roth IRAs regardless of their income level. What's more, taxpayers have the choice of paying the tax on the conversion when they file their 2010 returns, or deferring the tax hit on the conversion to the 2011 and 2012 tax years. As this article explains, these rules favor taxpayers who want to convert to a Roth IRA before year-end but are hesitant to do so because of the current uncertainty over post-2010 tax rates. They can convert before year-end and wait until Apr. 18, 2011, the due date of their 2010 return, to see how the conversion should be handled for best tax results.

**Conversions to Roth IRAs.** This year, for the first time ever, all taxpayers, regardless of their modified adjusted gross income (AGI), may convert amounts in a traditional IRA to amounts in a Roth IRA. Married individuals filing separately also are eligible. Before 2010, only taxpayers with modified AGI of $100,000 or less could make such conversion, and married individuals filing separately were not eligible regardless of modified AGI. (Code Sec. 408(c)(3))

Amounts from a SEP-IRA or a SIMPLE IRA also may be converted to a Roth IRA, but a conversion from a SIMPLE IRA may be made only 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. sections 1.408A-4) Distributions from a Code Sec. 401(a) qualified plan also may be rolled over to a Roth IRA. Code Sec. 408A(d)(3).

A conversion from a regular IRA to a Roth IRA generally is subject to tax as if it were distributed from the traditional IRA and not re-contributed to another IRA (Code Sec. 408A(d)(3)(A)(i), but isn't subject to the 10% premature distribution tax. (Code Sec. 408A(d)(3)(A)(ii);Reg. Section 1.408A-4, Q&A 7))

**Why make a IRA-to-Roth IRA conversion?** Roth IRAs have two major advantages over regular IRAs:

> (1) Distributions from regular IRAs are taxed as ordinary income (except to the extent they represent nondeductible contributions). By contrast, Roth IRA distributions are tax-free if they are “qualified distributions,” that is, if they are made (1) after the 5-tax-year period that begins with the first tax year for which the taxpayer made a contribution to a Roth IRA, and (2) when the account owner is 59 1/2 years of age or older, or on account of death, disability, or the purchase of a home by a qualified first-time homebuyer (limited to $10,000). (Code Sec. 408A(d)(2))
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> (2) Regular IRAs are subject to the lifetime required minimum distribution (RMD) rules that generally require minimum annual distributions to be made commencing in the year following the year in which the IRA owner attains age 70 1/2. By contrast, Roth IRAs aren't subject to the lifetime RMD rules that apply to regular IRAs (as well as individual account qualified plans). (Code Sec. 408A(c)(5))

A similar comparison could be made between distributions from qualified retirement plans and Roth IRAs.

There are other tax advantages: Because distributions from Roth IRAs are tax-free (if they are qualified distributions), they (a) may keep a taxpayer from being taxed in a higher tax bracket that would otherwise apply if he were withdrawing taxable distributions, (b) don't enter into the calculation of tax owed on Social Security payments, and (c) have no effect on AGI-based deductions. What is more, the benefits flow through to beneficiaries of Roth IRA accounts, who also can make tax-free withdrawals from such accounts (they are, however, subject to the same annual post-death minimum distribution rules that apply to beneficiaries of regular IRAs).

**Who should make IRA-to-Roth IRA conversions?** The consensus view is that the conversion route should be considered by taxpayers who:

- Have a number of years to go before retirement (and are therefore able to recoup the dollars that are lost to taxes on account of the conversion)
- anticipate being taxed in a higher bracket in the future than they are now and
- can pay the tax on the conversion from non-retirement-account assets (otherwise, there will be a smaller buildup of tax-free earnings in the depleted retirement account).

**Unique choice for 2010 conversions.** A unique income inclusion rule applies for IRA-to-Roth-IRA conversions occurring in 2010. Unless a taxpayer elects otherwise, none of the gross income from the conversion is included in income in 2010; half of the income resulting from the conversion will be includible in gross income in 2011 and the other half in 2012. Taxpayers who elect to include all of the 2010 rollover income on their 2010 return cannot change the election after the due date of that return. (Code Sec. 408A(d)(3)(A))

A major wild card in making this choice is the tax-rate picture after 2010. In the “worst-case scenario”—Congress doesn't act and the EGTRRA sunset rule is allowed to go into effect—after 2010 the tax brackets above the 15% bracket will revert to their pre-2001 levels. That means the top four brackets will be 39.6%, 36%, 31%, and 28%, instead of the current top four brackets of 35%, 33%, 28%, and 25%. Other possible scenarios include Congress's allowing the current tax rate structure to stay in effect for everyone, possibly for a year or two, or increasing taxes rates for high income individuals only. One way or the other, the tax rate picture for at least 2011 and hopefully 2012, ought to be clear by the time tax return seasons rolls around next spring.

Much of year-end tax planning this year is a chancy proposition because of the currently uncertainty over tax rates. Not so with a conversion to Roth IRA. IRS FAQs (“Employee Plans News—October 8, 2010—2010 Rollovers and Conversions to a Roth IRA”) confirm that taxpayers can elect to not have the two-year spread apply by simply including in gross income on their 2010 tax return the entire amount of the taxable income from a 2010 distribution rolled over to a Roth IRA. Thus, taxpayers who believe converting to a Roth IRA is a good long-term move will have the luxury of doing so before year-end and then waiting until Apr. 18, 2011, the due date of their 2010 return, to see how they should handle the conversion (i.e., to elect or not elect out of deferral).

- Those taxpayers who find that their rates won't go up in the near future can defer the tax hit on their 2010 conversion to Roth IRA, and pay the bill ratably when they file their 2011 return in 2012, and when they file their 2012 return in 2013.

- High income taxpayers who find that their tax rates will go up after this year can elect out of the deferral option and pay the tax on their Roth IRA conversion when they file their 2010 returns. Of course before doing so, such taxpayers will need to consider the overall impact of the election-out on their tax bills, and the time value of money.

**CAUTION:** Under Code Sec. 408A(d)(3)(E)(j)(I), an individual who rolls over a 2010 eligible retirement plan distribution to a Roth IRA cannot retain the benefit of the two-year spread for inclusion of the income from the distribution to the extent that he receives distributions from the Roth IRA in 2010 or 2011. Where the 2010 distribution income is being included in gross income over two years: the income inclusion from the 2010 distribution is accelerated, and the 10% early withdrawal tax under Code Sec. 72(t) applies to the distributed amounts.