

## MP&S TAX ALERT: ROTH IRA CONVERSION MAY 2010

### ROTH IRA CONVERSION 2010 MEANS A NEW OPPORTUNITY FOR HIGHER-INCOME TAXPAYERS

#### Is a Roth IRA conversion right for you?

You've filed — or at least extended — your 2009 income tax return, so it's time to start thinking about 2010 and beyond. If you're a higher-income taxpayer, one new opportunity you may have heard about is the Roth IRA conversion. But is it right for you?

The Roth IRA is a smart way to save for retirement — or to build wealth for heirs — because qualified withdrawals (including withdrawals of earnings) are tax free. But most higher-income taxpayers have been ineligible to benefit from this savings vehicle.

Income-based phaseouts reduce, and in many cases eliminate, the ability of higher-income individuals to contribute to a Roth IRA. (See Chart 1.) In addition, until recently, taxpayers were ineligible to convert a traditional IRA to a Roth IRA if their modified adjusted gross incomes (MAGIs) were greater than \$100,000, or if they were married and filed separate income tax returns (and did not live apart for the entire year).

**Chart 1**  
2010 modified adjusted gross income (MAGI) limits for making Roth IRA contributions

Filing status	Partial contribution	No contribution
Single or head of household	\$105,000 – \$119,999	\$120,000 or more
Married filing jointly or qualifying widow(er)	\$167,000 – \$176,999	\$177,000 or more
Married filing separately*	\$0 – \$9,999	\$10,000 or more

\*Unless you don't live with your spouse at any time during the year, in which case the single or head of household limits apply.

Beginning this year, however, generally anyone, regardless of income and marital filing status, can convert a traditional IRA into a Roth IRA. Before you start making conversion plans, it's important to consider both the potential benefits and the income tax implications of doing so.

#### Traditional vs. Roth

Both a traditional and a Roth IRA allow you to build wealth on a tax-advantaged basis but impose a 10% early withdrawal penalty (with certain exceptions) on distributions before age 59½. The 2010 maximum contribution limit is also identical for both IRAs: the lesser of \$5,000 or 100% of earned income for the year, reduced by any contributions to other IRAs. And if you're age 50 or older, you may also be able to make a "catch-up" contribution of up to \$1,000.

But that's where the similarities end. Contributions to a traditional IRA may be tax deductible and earnings grow on a tax-deferred basis, but withdrawals are subject to ordinary income taxes. Contributions to a Roth IRA, on the other hand, aren't deductible but qualified withdrawals are tax free.

The MAGI limits for contributing also vary. For traditional IRAs, the ability to *deduct* contributions is phased out at relatively low MAGIs for taxpayers who participate in an employer-sponsored plan, such as a 401(k), or whose spouses participate in such a plan. (See Chart 2.)

**Chart 2**  
2010 modified adjusted gross income (MAGI) limits for deducting traditional IRA contributions

<b>Filing status</b>	<b>Partial deduction</b>	<b>No deduction</b>
Single or head of household and you're <i>not</i> covered by an employer-sponsored retirement plan	No MAGI limit applies.	No MAGI limit applies.
Single or head of household and you're covered by an employer-sponsored retirement plan	\$56,001 – \$65,999	\$66,000 or more
Married filing jointly or qualifying widow(er) and neither you nor your spouse is covered by an employer-sponsored retirement plan	No MAGI limit applies.	No MAGI limit applies.
Married filing jointly or qualifying widow(er) and you aren't covered by an employer-sponsored retirement plan but your spouse is	\$167,001 – \$176,999	\$177,000 or more
Married filing jointly or qualifying widow(er) and you're covered by an employer-sponsored retirement plan	\$89,001 – \$108,999	\$109,000 or more
Married filing separately*	\$0 – \$9,999	\$10,000 or more

\*Unless you don't live with your spouse at any time during the year, in which case the single or head of household limits apply.

Taxpayers with MAGIs exceeding the limits can still contribute to traditional IRAs, but they can't deduct their contributions. Although account assets grow tax deferred, 100% of the earnings distributed are taxable. So even though Roth IRA contributions aren't deductible either, Roth IRAs are more attractive because earnings are tax free (assuming only qualified withdrawals are made).

Plus, the way the distributions are treated differs. With a Roth IRA, distributions are presumed to be contributions first, then earnings. For example, let's say you contribute \$10,000 to your Roth IRA and it grows to \$30,000. You're permitted — subject to certain limited exceptions — to withdraw the \$10,000 without any tax consequences. The remaining \$20,000, when withdrawn, may be subject to tax and penalty in certain situations.

On the other hand, distributions from a traditional IRA come out on a pro-rata basis, meaning that, if you make \$10,000 of nondeductible contributions and the account grows to the same \$30,000, one-third of your \$10,000 distribution would be subject to tax and, perhaps, penalty.

The MAGI limits for Roth IRAs are generally higher than those for traditional IRAs, but taxpayers with MAGIs exceeding the limits aren't allowed to contribute at all. So if your MAGI exceeds the limits, converting a traditional IRA to a Roth IRA may be your only opportunity to reap a Roth IRA's benefits.

### **Estate planning benefits**

Another important difference between traditional and Roth IRAs is that you must take required minimum distributions (RMDs) from traditional IRAs beginning after age 70½ — regardless of whether you need the funds. With a Roth IRA, you can leave the funds untouched for as long as you wish, the advantage being that you can allow the funds to continue to grow tax free. Further, you aren't permitted to make contributions to a traditional IRA starting in the year you reach age 70½, whereas there is no age limit on Roth IRA contributions.

A Roth IRA has another estate planning advantage over a traditional IRA: When you pass your Roth IRA to your loved ones, distributions to them are income-tax free. With a traditional IRA, on the other hand, beneficiaries have to pay income taxes on all distributions, so income taxes can greatly reduce their inheritance. Plus, because you're paying the taxes associated with a Roth IRA, you're essentially making a tax-free gift to your family.

A Roth IRA's ability to grow tax free is especially powerful when the beneficiary is relatively young. Although the beneficiary will have to take RMDs on inheriting the IRA, the RMDs will be lower than if the beneficiary were older, and there potentially will be a long period for assets remaining in the account to continue to grow tax free.

For example, Jim has designated his 30-year-old granddaughter, Carrie, as beneficiary of his \$1 million IRA. Depending on whether it's a Roth IRA or a traditional IRA, there could be a huge impact on the amount that Carrie nets after paying income tax. Presuming the IRA grows at 6% per year, and Carrie is in the 28% tax bracket:

		<b>Roth IRA</b>	<b>Traditional IRA</b>
Carrie's age	Distributions to date*	Balance at year end	Balance at year end
30	\$ 18,762	\$1,041,238	\$1,033,942
50	\$ 753,946	\$2,130,744	\$1,771,616
70	\$3,033,918	\$3,054,026	\$1,839,119
90	\$7,884,941	\$1,121,685	\$ 269,116

\*Represents RMD from Roth IRA. For traditional IRA, the actual amount withdrawn is higher — it's the amount which, when netted for taxes, will provide Carrie the same amount as the Roth IRA RMD.

Note: Amounts are rounded to the nearest dollar.

### **Income tax considerations**

When converting to a Roth IRA, the full amount of the conversion from your traditional IRA is treated as a taxable, but penalty free, distribution. This means that the account balance on the date of conversion will be included in your taxable income for the year.

But if you make the conversion in 2010, you have an option of deferring half the taxable income to 2011 and the other half to 2012. Not only can deferring tax be beneficial, but splitting the income between two years might prevent you from being pushed into a higher tax bracket. Of course, you also need to keep in mind that tax rates are scheduled to go up in 2011 if Congress doesn't take action.

Determining whether converting to a Roth IRA makes sense depends on your specific situation. For example, if you believe you'll be paying taxes at a *higher* rate during retirement because you'll be in a higher tax bracket or tax rates will increase, then converting to a Roth IRA likely is a smart move. A conversion also may make sense if you can fund your retirement from other resources and leave the Roth IRA balance to grow tax free for your heirs.

The hitch, however, is that, for the maximum benefit, you must be able to pay the tax on the conversion with funds from *outside* the IRA. If you use a portion of the IRA funds to pay the tax and you're under age 59½, that portion will be considered an early withdrawal and be subject to the 10% early withdrawal penalty.

Now also may be a good time to convert to a Roth IRA if your IRA investments have been devalued because of the weak economy. Your tax hit will be minimized and you can avoid tax on any future appreciation.

But if you believe you'll be paying taxes at a *lower* rate during retirement, you may want to leave your funds in your traditional IRA. Why? Your tax liability may be lower if you pay taxes later. In addition, if you lack funds outside the IRA to pay the taxes associated with converting, a Roth IRA conversion probably isn't right for you.

### **Converting isn't right for all**

Roth IRAs have many tax-saving advantages over traditional IRAs. But just because everyone can now convert their traditional IRAs to Roth IRAs doesn't mean everyone should do so. Before you take any action, please let us help you assess your retirement and estate planning needs and determine if converting to a Roth IRA is right for you.

## **CONVERSION FAQs**

Here are a few frequently asked questions regarding converting to a Roth IRA.

***After I convert my traditional IRA to a Roth IRA, am I eligible to make contributions to the Roth IRA?*** Only if your MAGI doesn't exceed the applicable limits. If you're retired, also keep in mind that you must have some *earned* income, because contributions can't exceed 100% of earned income. The other normal Roth contribution rules also apply.

***Can I convert other retirement savings vehicles into a Roth IRA?*** If your employer-sponsored plan permits, you can roll over funds from your pre-tax 401(k), 403(b), or 457 plan to a Roth IRA. Until this year, the \$100,000

MAGI limit had also applied to such rollovers, so these rollovers now provide another opportunity for higher-income taxpayers to take advantage of Roth benefits. As with traditional IRA conversions into Roth IRAs, you will owe tax on the employer plan rollover (conversion) of non-Roth funds to a Roth IRA.

Bear in mind that, generally, you can make the rollover to the Roth IRA only after separating from the employer sponsoring the plan, such as by changing jobs to a new employer or retiring. There are certain exceptions in the law, however, that allow employers to permit you to make the rollover when you turn age 59½ — and, in some cases, even earlier. Even though most employers allow such rollovers, not all do.

You may also convert your Simplified Employee Pension (SEP) IRA or your Savings Incentive Match Plan for Employees (SIMPLE) IRA. When converting a SIMPLE IRA to a Roth IRA, be aware of early distribution penalties for accounts that are less than two years old.

***Can I convert a Roth 401(k) or Roth 403(b) plan to a Roth IRA?*** You may be able to roll it over into a Roth IRA, which may be advantageous because Roth 401(k)s and Roth 403(b)s have RMDs. Thus, without the rollover you'll miss the opportunity to allow those funds to continue to grow tax free. There would be no income tax to pay on such a rollover of Roth funds from the employer-sponsored plan to a Roth IRA.

There are no income limits on rollovers from a Roth 401(k) or Roth 403(b) to a Roth IRA. As with rollovers of other employer-sponsored plans, except in certain limited circumstances, you can make the rollover only after separating from service with the employer sponsoring the plan.

***Can I convert my inherited IRA?*** It depends on whom you inherit it from. If you inherit the IRA from your spouse, you can roll the funds into your traditional IRA and then convert it to a Roth IRA. But if you inherit the IRA from anyone other than your spouse, you're not eligible to convert it to a Roth.

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## **FOR MORE INFORMATION**

For more information, please contact your MP&S tax advisor or Steven Eliach, JD, LLM, the Principal-in-Charge of the MP&S Tax Practice, by phone at 212.503.6388 or by email at [seliach@markspaneth.com](mailto:seliach@markspaneth.com).

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