New Roth IRA conversion opportunities in 2010

Beginning in 2010, more people should be able to convert a traditional IRA to a Roth IRA — and take advantage of potential tax benefits. Barring any last-minute changes to the tax code, a provision of The Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 will:

- Permanently repeal the income limit for Roth conversions
- Permit conversions by taxpayers who are married but filing separately
- Allow you to report income from Roth IRA conversions completed in 2010 equally over tax years 2011 and 2012

Why is now a good time to consider a Roth IRA conversion?

While you'll pay taxes now on the pre-tax assets you convert, your money will grow tax-deferred in the Roth IRA — and withdrawals will be tax-free as well, when you have met certain requirements. New 2010 conversion rules may make converting to a Roth IRA more attractive, depending on your circumstances.

- **No income limit.** The $100,000 income limit that currently exists for Roth IRA conversions will be repealed for 2010 and future years.

- **Special tax treatment for 2010 conversions.** Income from 2010 conversions can be reported either on your 2010 tax return or equally on your 2011 and 2012 returns.

- **Nondeductible IRA conversions.** Income limits for Roth IRA conversions are going away but income limits for Roth contributions remain in place. If you are not eligible for deductible IRA or non-deductible Roth IRA contributions, you may wish to fund a nondeductible traditional IRA and then convert to a Roth IRA in 2010 and subsequent years.

  Note: This strategy may work best if you do not have a large existing pre-tax IRA. When you convert traditional IRAs to a Roth IRA, if any IRA assets contain after-tax contributions, then all IRA assets must be combined to determine which portion will be subject to income tax. Assets from IRAs that contain both pre- and after-tax dollars are distributed on a pro rata basis, even if the after-tax contributions are kept in a separate IRA.

- **Low market value opportunity.** IRAs and qualified plans with depressed values are especially advantageous to convert. The current value will be taxed at conversion and the future growth will be tax-free (if qualifications are met).

- **Roth conversions can be recharacterized.** You have until October 15 of the year following the year you converted to recharacterize back to a traditional IRA for any reason. However, if you do recharacterize your 2010 Roth Conversion, a reconversion will not be allowed until the following year, and you will no longer be able to spread income tax from the conversion over two years.

- **Convert after-tax 401(k) assets.** If you hold after-tax money in a 401(k) plan, you can request a direct rollover of pretax contributions and earnings to a traditional IRA and convert after-tax assets and earnings directly to a Roth IRA. This allows you to fund a Roth IRA conversion and pay income taxes only on earnings from after-tax contributions.

- **Estate planning strategy.** Roth IRA conversions can reduce the size of your taxable estate because of the income tax already paid and can allow you to pass income on to beneficiaries income tax-free. The Roth assets may still be subject to estate tax.

Is a Roth IRA conversion right for you?

Roth IRA conversions can be a great opportunity but they are not for everyone. Before you convert to a Roth IRA, consider the following:

- Your tax bracket. Because you pay taxes when you convert pre-tax contributions and earnings to a Roth IRA, doing so is most effective if your tax bracket is lower now than it will be when you withdraw the assets.
- Your time frame. You need a significant amount of time to accumulate the earnings that will be distributed from the Roth tax-free. A minimum of five years is required, but a longer time frame is usually advisable. A Roth IRA conversion can be especially effective when the money is passed on to your heirs.
- Your ability to pay conversion tax with non-IRA assets. Paying taxes with non-IRA assets makes Roth conversions more advantageous. If you pay the taxes from the assets in your traditional IRA, you reduce the amount that will be able to grow tax-free in the Roth IRA. In addition, while assets you convert are not subject to penalty, any amount you withhold to pay for the conversion taxes is. In other words, if you pay taxes due on conversion with your IRA assets, that amount is treated as a distribution and is subject to income tax and a 10% IRS penalty if you are under age 59½.

Consider the following basic scenarios when you think about whether a conversion might be right for you, keeping in mind that your situation is unique and a decision should only be made in consultation with your financial and tax advisors.

Jim — Roth IRA conversion scenario #1

Jim is 45 years old and had pre-tax assets of $80,000 in a 401(k) plan with a previous employer that he rolled over to a traditional IRA. He is currently in the 33% tax bracket and is concerned that income tax rates are going to increase and push him to an even higher bracket in retirement. He has money available to pay conversion taxes from outside his IRA but his income has been too high to qualify for a conversion until now.

	Traditional IRA	**Roth IRA – after conversion**
Starting value	$80,000	$80,000

Taxes saved by not converting[1]	$26,400	$0
Value of IRA (age 65)	$309,575	$309,575
Value of taxes saved by not converting (age 65)[1]	$85,859	$0
Total value (age 65)	$395,434	$309,575
Taxes due on withdrawal[2]	($117,270)	$0
Value after taxes	$278,164	$309,575

[1] Invested in non-qualified account
[2] Assumes a 35% tax rate on IRA assets and a 15% tax rate on the non-IRA account

Jim decides to convert to a Roth IRA in 2010 and report the income equally on his 2011 and 2012 tax returns. Based on a 35% tax bracket in retirement and a 7% rate of return, Jim's Roth IRA account would be worth $31,411 more at age 65 than his traditional IRA.

Ray and Betty - Roth IRA scenario #2

Ray and Betty are anticipating drawing on their retirement assets in five years. Ray is 55 years old and has pre-tax assets of $500,000 in a traditional IRA. He is considering a $50,000 conversion to a Roth IRA. The couple is currently in the 28% bracket and they believe that their bracket will decrease to 25% in retirement. They do not have assets outside of their retirement plan to pay the taxes that would be due on a conversion. Because Ray is under age 59 1/2, the tax withheld from the IRA will be subject to a 10% penalty as well as ordinary income tax.[1]

	Traditional IRA	**Roth IRA**
Starting value	$50,000	$36,000
Value at age 60	$66,911	$48,821
Taxes due	($10,037)	$0
Value after taxes	$56,875	$48,821

[1] The penalty tax must be paid from outside the IRA.

In this scenario, a Roth IRA would be worth about $8000 less than a traditional IRA assuming a lump sum distribution in five years and a 6% rate of return.

The scenarios are hypothetical and being provided for general education purposes and with the understanding that they are not intended to be used or interpreted as specific legal, tax or investment advice. The scenarios do not address or account for your individual investor circumstances. Investment decisions should always be made based on your specific financial needs and objectives, goals, time horizon and risk tolerance.