

## CONVERTING TRADITIONAL IRAS TO ROTH IRAS IN 2010



### What new rules went into effect January 1, 2010 regarding the ability of higher income taxpayers to convert (i.e., roll-over) their Traditional IRA into a Roth IRA?

Before January 1, 2010, only those taxpayers with "modified adjusted gross income" of less than \$100,000 and who were not married filing separately could convert their Traditional IRA to a Roth IRA. But, because of a special provision contained in the Taxpayer Relief Act of 1997, effective as of January 1, 2010, such income limit and filing status restrictions on Roth IRA conversions are eliminated. Therefore, effective January 1, 2010, everyone with a Traditional IRA can convert to a Roth IRA.

### If I decide to make a conversion, are any of the proceeds which are rolled-over from my Traditional IRA to the newly created Roth IRA subject to federal income tax at such time?

Yes. Any Traditional IRA funds that are rolled-over to the Roth IRA as a result of a conversion are subject to federal income tax for the year that conversion occurs under the rules which presently govern regular IRA distributions as if there were no roll-over, with one important exception.

### What is the exception?

Unless the IRA owner (referred to as the "taxpayer" or "TP") elects otherwise (or unless some or all of the amount converted

is actually distributed to the TP prior to 2012), for *conversions in 2010 only*, none of the gross income from the conversion is included in the TP's gross income in 2010, rather 1/2 of the income resulting from the conversion is includable in gross income in 2011 and the other half is included in gross income in 2012.

### What considerations would persuade me to consider making a conversion?

In many respects, although not in every case, a Roth IRA is preferable to a Traditional IRA. Some of the more significant advantages are as follows:

- First of all, while distributions from a Traditional IRA which are attributable to previously tax-deductible contributions and the related earnings are fully taxed as ordinary income, distributions of both contributions and the associated earnings from a Roth IRA are entirely **tax-free**, as long as they are "qualified distributions." To be a "qualified distribution," the Roth IRA must have been held for at least 5 years and the distribution must be received after age 59 ½ (or on account of disability or death).
- Secondly, a Roth IRA is not subject to the "Required Minimum Distribution" ("RMD") rules that otherwise govern a taxpayer's Traditional IRA. In general, the net effect of the RMD rules is to cause distributions to be made over the joint life expectancy of the TP and his individual designated beneficiary of the IRA once the TP has attained age 70 ½. By not being subject to the RMD rules, the Roth IRA is therefore potentially able to pass more of the IRA's value, as tax-free income, to the TP's designated beneficiaries.
- Thirdly, annual contributions can be made to a Roth IRA even if the TP has reached age 70 ½.
- Fourthly, Roth IRA investments grow tax-free just like Traditional IRA investments.

## Which IRA owners are the best candidates for making such a conversion?

As a general rule, subject to some exceptions, a conversion makes the most sense for the following types of IRA owners:

- Those who expect to be in a higher income tax bracket when withdrawals from the IRA might commence than he or she is in now when the income attributable to the converted IRA is taxed.
- Those who have at least 10 years to go before retiring, so they have time to recover, through subsequent savings and investments, the funds used to pay the federal income tax due as a result of the conversion.
- Those who do not contemplate having to make significant withdrawals from the Roth IRA prior to their death, and, **if withdrawals are in fact made**, do not contemplate having to make withdrawals that are not “Qualified Distributions.”
- Those who do not intend to **transfer** the IRA to a charity at death, rather than intending to maximize the IRA funds available at the TP’s death to his non-charitable beneficiaries.
- Those who are able to pay the income taxes due as a result of the conversion from assets other than the assets held by the IRA.
- Those who have incurred substantial losses in the market value of their Traditional IRA in recent years, and the losses have not yet been recovered. In other words, it might be advantageous for such taxpayers to make the conversion when the IRA assets are at or near their minimum value so that they can pay a lower federal income tax upon conversion. As a result, the TP would hopefully enjoy the market value recovery of such assets within a tax-free Roth IRA.

## If I make a Traditional IRA-to-Roth IRA conversion, and by October 15 of the calendar year following the calendar year of the conversion, the value of my IRA has substantially decreased in value since the date of the conversion, can I change my mind about making the conversion and thus avoid having to pay federal income tax on what is essentially an “inflated” value of my IRA?

Yes. A taxpayer may elect (on a timely filed federal income tax return for the year of the conversion) to “re-characterize” an IRA roll-over (e.g., Traditional IRA-to-Roth IRA conversion) by causing the roll-over amount to be re-transferred from the Roth IRA to a Traditional IRA in a trustee-to-trustee transfer, **provided** (1) the transfer includes any net income attributable to the roll-over while held by the Roth IRA, and (2) both trustee-to-trustee transfer, and communication of such re-characterization to the Roth IRA custodian and the Traditional IRA custodian, are made by October 15 of the year following the year of such roll-over. Furthermore, the making of any re-characterization does not prohibit the TP from later **re-converting** the Traditional IRA-to-Roth IRA a second time in a subsequent year (subject to certain time limitations).

## Is the same post-2009 Roth IRA roll-over opportunity as described above also available to participants in tax-qualified retirement plans (such as 401(k) plans) who receive “eligible roll-over distributions” from such plans and want to roll-over such distributions to Roth IRAs?

Yes, subject, of course, to the same federal income taxation rules that apply to Traditional IRA-to-Roth IRA conversions (i.e., roll-overs).

*For more information on converting Traditional IRAs to Roth IRAs, we encourage you to contact one of your UHY Advisors’ tax professionals.*

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