As noted in the Spring 2009 edition of Estate Planning & Tax Advisor, beginning in 2010, the income limitation for converting a traditional IRA to a Roth IRA no longer applies, thereby allowing higher income taxpayers to convert to Roth IRAs. In addition, one can now directly roll over an eligible rollover distribution from an employer’s qualified pension, profit sharing or 401(k) plan into a Roth IRA. Any amount that is so rolled over is subject to the same rules for converting a traditional IRA into a Roth IRA.

Advantages in Making a Roth IRA Conversion

The advantages in making a Roth IRA conversion are considerable. In exchange for paying income tax on the amount of the conversion, qualified distributions from the Roth IRA are always tax-free, whether to the owner (who is not required to take any distributions) or to the beneficiary (who generally must take required minimum distributions after the death of the Roth IRA owner). Compare this with a traditional IRA, in which the contributions, while tax-free going into the account, are fully taxable as they are withdrawn, and distributions must begin after the IRA owner attains age 70½. However, there are a number of factors to be considered in determining when, if and how much to convert to a Roth IRA.

Factors to be Considered

The timing of the Roth IRA conversion is important. In order for a distribution to be completely tax-free, it must be made (1) five years after the IRA owner first made a Roth IRA conversion and (2) on or after the owner (a) attains age 59 ½; (b) becomes disabled; (c) dies; or (d) uses the Roth IRA funds to acquire, build or rebuild his or her first home.

Therefore, the earlier a Roth IRA conversion is made the sooner the five-year period will expire. It should be remembered that a Roth IRA conversion is not an all or nothing election. You can elect to convert a portion of your traditional IRA to a Roth IRA. The income on a Roth IRA conversion made in 2010 will be reportable ratably in 2011 and 2012, unless the participant elects to recognize the income in 2010. Any income recognized on a Roth IRA conversion made after 2010 must be reported in the year of the conversion. The maximum federal income rate for 2010 is 35% but will increase to 39.6% on and after 2011 absent Congressional action to prevent the increase. In addition, the reduction in the deduction for personal exemptions and certain itemized deductions for high income taxpayers does not apply in 2010 but will again be applicable beginning in 2011 unless Congress acts. Thus, for some individuals, 2010 may be a uniquely favorable time to make the conversion.

A number of additional factors should be considered before making a decision as to when, if and how much to convert to a Roth IRA:

The IRA owner’s age. The younger the age of the IRA owner the more beneficial a Roth IRA conversion could be since it would lengthen the period of time the Roth IRA could grow tax-free. As noted above, required minimum distributions...
do not have to be made until after the death of the Roth IRA owner (and the owner’s spouse if the spouse is the designated beneficiary).

**The amount of investments outside the Roth IRA.** The extent to which the IRA owner does not need to withdraw funds from the converted Roth IRA to pay some or all of the taxes that will become due as a result of the Roth IRA conversion is a key consideration. If the income taxes due as a result of the IRA conversion must be paid from the converted account, it is probably unwise to make the conversion.

**Roth IRA owner’s projected total rate of tax at retirement.** Very often, when the Roth IRA owner retires he or she will move to a state that has a lower income tax rate or no income tax (like Florida or Nevada). Therefore, the total income tax cost of converting to a Roth IRA could be higher than the income tax cost of not converting and paying income tax at the time of distribution. This would reduce the advantage of a Roth IRA conversion, but would generally not be sufficient to overcome the advantages of a Roth IRA conversion.

**A Roth IRA Conversion Can be Reversed**

The election to make a Roth IRA conversion is not irrevocable. The converted Roth IRA can generally be “recharacterized” as a traditional IRA up to the due date (including extensions) for filing the income tax return for the year of the Roth IRA conversion. Thus, if a Roth IRA conversion is made in 2010 an election to recharacterize the Roth IRA as a traditional IRA could be made on or prior to October 15, 2011. In other words, one can make a Roth IRA conversion in 2010 and then recharacterize it as a traditional IRA if subsequent developments make such a recharacterization beneficial.

In conclusion, the advantages of making a Roth IRA conversion are significant, but it is better to look before you leap. Therefore, you should first consult with your tax and financial advisers before making a determination of when, if and how much you should convert to a Roth IRA.▲

**Helpful Tip:** Another benefit of a Roth IRA is that if the beneficiary is the spouse of the Roth IRA owner, the surviving spouse can treat the Roth IRA as his or her own, deferring all required minimum distributions until after the death of the surviving spouse.

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