Q. Should I convert to Roth IRA in 2010?

A. A lot of people have been asking about the new Roth rollover opportunity. After 2009, American taxpayers are now able to roll over amounts in qualified employer sponsored retirement plan accounts, such as 401(k) and profit sharing plans, and regular IRAs, into Roth IRAs, regardless of their adjusted gross income (AGI). Prior to 2010, individuals with more than $100,000 of adjusted gross income as specially modified were barred from making such rollovers.

What's so attractive about a Roth IRA? Here's a summary:

- Earnings within the account are tax-sheltered (as they are with a regular qualified employer plan or IRA).
- Unlike a regular qualified employer plan or IRA, withdrawals from a Roth IRA aren't taxed if some relatively liberal conditions are satisfied.
- A Roth IRA owner does not have to commence lifetime required minimum distributions (RMDs) after he or she reaches age 70 1/2 as is generally the case with regular qualified employer plans or IRAs. (For 2009, there was a moratorium on RMDs which is unlikely to be extended.)
- Beneficiaries of Roth IRAs also enjoy tax-sheltered earnings (as with a regular qualified employer plan or IRA) and tax-free withdrawals (unlike with a regular qualified employer plan or IRA). They do, however, have to commence regular withdrawals from a Roth IRA after the account owner dies.

The catch, and it's a big one, is that the rollover will be fully taxed, assuming the rollover is being made with pre-tax dollars (money that was deductible when contributed to an IRA, or money that wasn't taxed to an employee when contributed to the qualified employer sponsored retirement plan) and the earnings on those pre-tax dollars. For example, if you are in the 28% federal tax bracket and roll over $100,000 from a regular IRA funded entirely with deductible dollars to a Roth IRA, you'll owe $28,000 of tax. So you'll be paying tax now for the future privilege of tax-free withdrawals, and freedom from the RMD rules.

Should you consider making the rollover to a Roth IRA? The answer may be "yes" if:

> … You can pay the tax hit on the rollover with non-retirement-plan funds. Keep in mind that if you use retirement plan funds to pay the tax on the rollover, you'll have less money building up tax-free within the account.
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> … You anticipate paying taxes at a higher tax rate in the future than you are paying now. Many observers believe that tax rates for upper middle income and high income individuals will trend higher in future years.
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> … You have a number of years to go before you might have to tap into the Roth IRA. This will give you a chance to recoup (via tax-deferred earnings and tax-deferred payouts) the tax hit you absorb on the rollover.

> … You are willing to pay a tax price now for the opportunity to pass on a source of tax-free income to your beneficiaries.

You also should know that Roth rollovers made in 2010 represent a novel tax deferral opportunity and a novel choice. If you make a rollover to a Roth IRA in 2010, the tax that you'll owe as a result of the rollover will be payable half in 2011 and half in 2012, unless you elect to pay the entire tax bill in 2010.

Why on earth would you choose to pay a tax bill in 2010 instead of deferring it to 2011 and 2012? Keep in mind that absent Congressional action, after 2010 the tax brackets above the 15% bracket will revert to their higher 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%. The Administration has proposed to increase taxes only for those making $250,000, but it is difficult to predict who will get hit by higher rates. One thing remains clear: taxes will not stay at the same level, especially for wealthier taxpayers. What's more, there is one version of the health tax bill in the Senate and in the House of Representatives right now that would help finance healthcare reform with surtax on higher-income individuals, which could very well bring the top rates to 45%.

So if you believe there's a strong chance your tax rates will go up after 2010, you may want to consider paying the tax on the Roth rollover in 2010.

Your and your family's entire financial situation should be taken into consideration before you plan for a large rollover to a Roth IRA. There also are many variables that affect the analysis, such as whether the amount eligible for the rollover, the amount of deductible contributions within your current traditional IRA, your current and projected future tax rate, your beneficiaries' projected income tax rates, estate tax rates, etc.

If you are interested in discussing this opportunity or simply want to know more about the conversion rules, do not hesitate to call us.
