



## Roth IRA Conversions

FEBRUARY 2010

Roth IRAs have been in existence for many years now. However, the ability to convert balances in traditional IRAs to Roth IRAs had been subject to income limitations which had prevented many higher income taxpayers from considering this option. Starting in 2010, the income limitation for taxpayers who are eligible to convert their regular IRA to Roth IRAs has been repealed. This repeal has opened the door for virtually all taxpayers who have a traditional IRA to consider a conversion of their traditional IRA to a Roth IRA. The decision to convert a traditional IRA to a Roth IRA can be a complex one. This Alert will address some of the major considerations.

### Background

Traditional IRAs are tax deferred retirement savings vehicles. In some cases, an income tax deduction is available for the amounts contributed and in other cases no deduction is available. In either case, the earnings in the traditional IRA are not subject to tax until the amounts are withdrawn.

Roth IRAs, on the other hand, are funded with after tax contributions and no deduction is allowed when amounts are contributed to Roth IRAs. Earnings of a Roth IRA are exempt from tax and unlike a traditional IRA, there is no tax when distributions are taken from a Roth IRA. In

addition, the rules related to required minimum distributions do not apply to a Roth IRA owner.

Prior to 2010, the ability to convert from a traditional IRA to a Roth IRA was only allowed to those individuals with income of \$100,000 or less. However, for tax years beginning in 2010, this income limitation has been repealed, thus allowing anyone with a traditional IRA to consider a conversion to a Roth IRA.

### Taxation of Conversion

The rules surrounding the taxability of a conversion are complex, but simply put, an individual who opts to convert a traditional IRA to a Roth IRA during 2010 will be required to include in income one-half of the taxable amount in 2011 and one-half in 2012, unless he or she elects to be taxed on the entire amount in 2010. Amounts converted after 2010 still escape the \$100,000 limitation, but are not eligible for the two-year deferral which applies to conversions done in 2010. The amount subject to tax is equal to the value of the account as of the day of conversion less all after-tax contributions (i.e., basis), if any. The determination of the basis in your IRA is subject to special rules which are beyond the scope of this Alert.

There are many factors that should be considered before making the decision to

**Wilkin &  
Guttenplan, P.C.**

Certified Public Accountants  
and Consultants

1200 Tices Lane  
East Brunswick, NJ 08816

T 732.846.3000  
F 732.846.0618

www.wgcpas.com

*(Continued on reverse side)*

**TAX ALERT**

FEBRUARY 2010

**Wilkin &  
Guttenplan, P.C.**Certified Public Accountants  
and Consultants1200 Tices Lane  
East Brunswick, NJ 08816T 732.846.3000  
F 732.846.0618

www.wgcpas.com

convert or not. The following list, while not all-inclusive, contains some of the major factors that should be considered.

**Factors in Favor of Conversion**

- You expect to be in a higher tax bracket during retirement than in the year the conversion will be taxed.
- You have many years until retirement in order to recoup the tax cost of the conversion through account growth and earnings.
- You have substantial basis (after tax contributions) in your traditional IRA.
- You have tax benefits available in the conversion year which will reduce taxable income (i.e., net operating losses, tax credits, and charitable contribution carryforwards).
- You have funds available in non-retirement accounts to pay the tax on the conversion.

**Factors Against Conversion**

- You expect to be in the same or lower tax bracket during retirement than in year of conversion.
- You have relative few years until retirement in order to recoup the tax cost of the conversion through account growth and earnings.
- You funded the account mostly with pre-tax dollars.
- Significant federal and/or state income taxes will result from conversion.
- The tax on conversion will have to be paid out of IRA funds (and, worse, you are under age 59 ½ and, thus, subject to the 10% early withdrawal penalty).

- You will need the funds in the IRA to support you during retirement.
- The increased income associated with the conversion will have other adverse effects (i.e. an increase in Medicare premiums, loss of itemized deductions, etc.).

In addition to the factors listed above, which essentially focus on income tax considerations, there are many non-income tax reasons, including estate planning and overall retirement needs, which should also be considered when making the decision to convert to a Roth IRA. For example, individuals who have large IRA balances which they don't expect to use should consider a Roth conversion to enable them to leave their Roth IRA to their children or grandchildren. Distributions are still tax free and must be taken over the beneficiary's lifetime. Leaving a Roth IRA to a young beneficiary can lead to a significant accumulation of tax free income over his or her lifetime.

*For most high net worth taxpayers who do not need their IRA assets, this will be one of the most compelling reasons to consider a Roth conversion.*

**State Taxes**

The state tax consequences of a conversion to a Roth IRA could be different than the Federal tax consequences. New Jersey has adopted the Federal rules related to the taxation of conversions; however, due to differences in the rules related to the treatment of retirement plan contributions, the taxable amount of a conversion for New Jersey

(Continued on page 3)

**TAX ALERT**

FEBRUARY 2010

purposes will likely be different than the Federal amount. New York, on the other hand, follows the Federal rules with regards to both the taxation of the conversions and the treatment of contributions, so the taxable amount of a conversion should be the same for both Federal and New York purposes.

**Changing Your Mind**

To the extent you make the decision to convert an eligible account to a Roth IRA, you have the ability to undo (i.e., recharacterize) the conversion within a certain time period. This provision essentially gives you the benefit of hindsight so that if the values of your converted accounts drop within the same tax year as the conversion, you will not have to pay tax on the higher value. Once a recharacterization is done, however, there are restrictions on subsequent reconversions.

**Final Analysis**

There are many financial calculators available on the internet that can help evaluate the decision to convert. The ultimate decision is not only complex but is driven by both qualitative and quantitative considerations. The above does not address all the aspects which should be considered in the analysis to convert or not. We strongly encourage you to contact your W&G tax advisor before finalizing any decision on this topic.

*Any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer.*

**Wilkin &  
Guttenplan, P.C.**Certified Public Accountants  
and Consultants1200 Tices Lane  
East Brunswick, NJ 08816

T 732.846.3000

F 732.846.0618

[www.wgcpas.com](http://www.wgcpas.com)