

## **A Guide to Roth Conversions**

### **2010 Rules**

- There are no longer income limitations on Roth conversions for taxpayers.
- If a taxpayer converts in 2010, the income will be recognized as 50% in 2011 and 50% in 2012. The taxpayer can elect out of this and recognize all the conversion income in 2010. You cannot decide to apportion the income deferral any different way.
  - o One strategy is to convert both spouses' IRAs and elect the deferral on one and avoid the deferral on the other, effectively spreading the tax over 2010, 11 and 12.
  - o If the conversion income is deferred over 2011 and 2012, distributions during those years will accelerate the income recognition required.

### **Reasons to Convert to a Roth IRA**

- Tax-free yields for qualified distributions.
- Suspension of required minimum distributions at age 70 ½
- Taxpayers with favorable tax attributes may be able to convert without a tax liability.
- Taxpayers benefit from paying the income tax before estate tax is imposed (increased tax efficiency through the estate).
- Paying the tax on the conversion from outside sources is essentially a transfer of assets from a taxable environment into a potentially tax-free environment.
- Creation of a tax hedge, with tax rates expected to increase.
- The tax-free status carries to beneficiaries.
- Federal tax brackets become less favorable for single tax payers, a Roth will not trigger additional income tax for a surviving spouse.
- Taxpayers are allowed to recharacterize the conversion if they change their mind, essentially getting a mulligan on the decision.

## **The Two 5-Year Rules**

### ***Qualified Distributions***

- For interest or gain to qualify as tax free in a Roth IRA distribution, the taxpayer must be 59 ½ and have had the taxpayer must have had a Roth IRA open for at least 5 years.
  - o The distributions from a Roth IRA come out of basis first, and gain last, making conversions much more feasible for those over 59 ½ who may need some immediate income.

### ***Separate 5-Year Rule on Conversions***

- Every Roth Conversion has a separate 5-year holding period for taxpayers under 59 ½. Remember, distributions are only subject to the 10% penalty if the distribution is “taxable”.
  - o Because distributions on Roth IRAs come out of basis first, there is a rule that the 10% early withdrawal penalty will apply to those non-taxable distributions for the first 5 years after a conversion.
  - o This rule is to keep people from converting simply to escape the 10% penalty.

## **Converting IRAs with basis**

- When an IRA has basis (after-tax contributions), that basis will not be taxed on a conversion.
  - o All IRAs must be considered for basis computations.
  - o Example – John has 3 IRAs each for \$100k. One of his IRAs has 100% basis and the other 2 are pre-tax IRAs. John wants to convert his 1 after-tax IRA hoping it will be tax-free. All IRAs must be considered however. His total basis computation is \$100k out of \$300k or 33%. When he converts his \$100k IRA, only 33% will not be subject to tax.
  - o There are some tricks to separating basis for conversion purposes that may or may not apply. Rules also differ when coming from qualified plans like a 401k.

## CPA & Legal considerations

- Rising tax rates in 2011, 12 may incline the taxpayer to not defer the income recognition.
- Be aware of setting up protective estimates for 2011 and 2012.
- Be aware of AMT consequences because of state and local taxes. Remember these taxes are not deductible for AMT.
- Remember a taxpayer has until October 15<sup>th</sup> if the taxpayer extends their return.
- Recharacterizations and reconversions should be monitored closely.
- Some states treat Roth conversions differently than federal law.
- Roth IRAs are not tax efficient for charitable distributions because distributions are already tax-free.
- Roth IRAs can be great vehicles to fund GST exemption trusts or Bypass Trusts.
- Be aware of how a conversion will affect Social Security taxation, as well as Medicare premiums withheld from Social Security.
- Be aware of the benefits of tax-free income later in life as it relates to Social Security taxation.

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