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Roth IRA Conversions in 2010

For years, the tax laws precluded high-income taxpayers from creating or contributing to Roth IRAs or from converting a traditional IRA account to a Roth IRA. If your adjusted gross income exceeded \$100,000 (indexed for inflation), you could not take advantage of a Roth IRA. This AGI limit applied to both single and married taxpayers. In 2010, the income limits on Roth conversions disappear. In addition, while taxpayers who convert their traditional IRA to a Roth IRA typically have to pay income tax in the year of conversion as though they received a distribution of their traditional IRA in full, taxpayers who convert their traditional IRA to a Roth IRA in 2010 can spread the federal income tax owed on the converted amount over two tax years. The taxpayer also may elect out of the two-year stretch period for the payment of taxes upon conversion, and pay all of the taxes that arise due to the conversion in one year. As with many changes in the tax laws, what might seem like a tremendous opportunity on the surface may not be as desirable once your specific situation has been analyzed.

The Basics

Although they may contain after-tax dollars, traditional IRA accounts typically consist of assets that have never been taxed. The Internal Revenue Code permits certain taxpayers to contribute pre-tax dollars to IRAs, and many people have rollover IRAs from employment related retirement accounts, such as 401(k)s. In return for the ability to contribute pre-tax dollars, the taxpayer must leave the property in the IRA until age 59 1/2 before making withdrawals or face a stiff penalty along with a tax bill. Under a traditional IRA, the taxpayer must begin taking required minimum distributions from the account after reaching the age of 70 1/2. Distributions are subject to tax at the taxpayer's marginal rate at the time of withdrawal (to the extent the withdrawals consist of pre-tax contributions and associated gain). In contrast to traditional IRAs, Roth IRAs consist of dollars that are taxed before being deposited into the account. Subject to some exceptions for early withdrawals, withdrawals from Roth IRAs are free from income tax so the earnings of a Roth IRA are never taxed. In addition, required minimum distributions do not apply to a Roth IRA until the account owner's death.

Things to Consider

The decision to convert your traditional IRA to a Roth IRA needs to be made based on your individual circumstances. There are many factors you should consider before making the decision. These include:

- Your current tax situation compared with your anticipated tax situation at age 70 1/2 (or an earlier age if you anticipate taking distributions before the I.R.S. requires). The anticipation of a higher marginal tax bracket in retirement may make a conversion to a Roth IRA attractive. If you expect to be in a lower tax bracket upon retirement, keeping the traditional IRA might be the best choice. This analysis involves a whole host of variables, of course, including your future career and earnings as well as the future social and tax policy of the government.
- Your time horizon for use of the IRA assets. If you have a long time horizon before you will need to use the IRA assets (or until they likely will pass to your beneficiaries), you have more time to make up for the tax due upon conversion by allowing your assets to grow tax free. This requires analyzing your current and future cash-flow needs in deciding whether or not to convert.
- Your ability to pay the taxes due upon conversion without using the IRA property. An analysis of your current asset mix should be a factor in your conversion decision, including the allocation of your portfolio between liquid and illiquid assets, or qualified and unqualified accounts.

The Key Variables

Your counselors at Chapman and Cutler LLP advise that you examine your entire financial situation before making the decision to convert or to keep your traditional IRA. Your age, current needs, future goals and ultimate plans to provide for your family, charities and any other beneficiaries all play a significant role in the decision.

While there is no one-size-fits-all approach to making the Roth IRA conversion decision, your Chapman and Cutler LLP Trusts and Estates attorneys advise that clients who meet the three basic criteria referenced above will most likely benefit from a conversion, especially those clients who view their IRA as a vehicle for wealth transfer as opposed to a retirement account. If you (1) believe your future marginal income tax rates will be higher, whether because of increased earnings or governmental increases of income tax rates, (2) have sufficient liquid assets outside of your IRA to pay the taxes due upon converting your traditional IRA to a Roth IRA, either in the year of conversion or by taking advantage of the deferral period offered for 2010 Roth IRA conversions, and (3) have a sufficiently long time horizon and a positive outlook with respect to future investment growth opportunities that tax-free growth and distributions offered by the Roth IRA will offset the current payment of taxes, you likely will benefit from a conversion.

For many people, other variables such as future income needs and current account characteristics need to be analyzed to make the proper decision. For example, if you own a unique asset in your traditional IRA for which you anticipate tremendous and rapid growth, a Roth IRA conversion may be desirable whether or not you meet the three key variables.

It is important to keep in mind that a Roth IRA conversion made early in the year can be reversed. For example, if the assets you transfer from your traditional IRA to your Roth IRA decrease in value

shortly after the conversion, the tax laws allow you to reverse the conversion and recharacterize the new Roth IRA as a traditional IRA. This recharacterization must be done by the date on which your income tax is due for the year of conversion, including extensions.

Now that 2010 has arrived, you should begin thinking about your traditional IRA and whether taking advantage of the generous 2010 rules permitting higher earners to convert and divide the taxes due over two years is the correct decision for you. Please contact a Chapman and Cutler LLP Trusts and Estates attorney to discuss your personal circumstances.

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