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Private Client Alert

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2010 Conversion of a Traditional IRA to a Roth IRA

Currently, only taxpayers with modified adjusted gross income of $100,000 or less (who are not married filing separately) may convert a traditional IRA to a Roth IRA. Beginning January 1, 2010, the $100,000 limitation will be eliminated, and all taxpayers (including married taxpayers filing a separate return) may make such a conversion. The value of the converted IRA in excess of basis (if any) will be included in the taxpayer's income, but the 10% premature distribution tax (before age 59½) will not apply to the conversion. Under current law, earnings of a Roth IRA (like a traditional IRA) are not subject to income tax.

Why Convert?

Roth IRAs have several major advantages over traditional IRAs. All Roth IRA distributions are tax-free so long as they are "qualified distributions." In addition, Roth IRAs are not subject to the lifetime required minimum distribution rules, which generally require that distributions begin the year after the owner reaches age 70½.

A unique tax deferral rule also applies to 2010 conversions – taxpayers may spread the income from the conversion over two years. Taxpayers making this election will be taxed on one-half of the conversion income in 2011 and the other half in 2012 (at the 2011 and 2012 federal income tax rates, respectively). However, a taxpayer who anticipates that his or her income will be taxed at higher rates in 2011 or 2012 can "elect out" of this deferral rule and pay all of the tax in 2010.

Who Should Convert?

A conversion might be useful if you (1) do not anticipate retirement in the near future, (2) expect to be in a higher tax bracket when you take the money out of the account, and (3) can pay the tax on the conversion out of discretionary funds not needed for basic living needs. Further, a conversion may work best if you expect that you will not need to withdraw funds from the Roth IRA for living needs, and want to maximize the inheritance of your descendants. Since the minimum distribution rules do not apply, you can allow the tax-free earnings to accumulate until withdrawn tax-free by your descendants after your death (such withdrawals are subject to post-death annual minimum distribution rules). However, you should not convert an IRA you intend to distribute to charity on your death (or the death of both husband and wife).

Another consideration is the risk that Congress will change the taxation of Roth IRAs in the future – such as imposing a tax on the IRA's income, either as it is earned or upon distribution.

Before making a decision on conversion, consult with your tax advisor.

If you have any questions, please feel free to contact one of the attorneys listed below:

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