

## **Roth IRA Conversions: Figure In the Variables**

The floodgates are finally open to high-income taxpayers: Beginning in 2010, an individual can convert a traditional IRA into a Roth IRA, regardless of his or her income level. Prior to this year, a conversion was allowed only in a year in which the individual's modified adjusted gross income (MAGI) did not exceed \$100,000.

Normally, such a conversion is taxed at ordinary income tax rates in the year of the conversion. However, for a conversion in 2010, the participant may pay the tax over the following two years—2011 and 2012.

These changes have been in the works for years. They were included in the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), which was enacted in 2006.

Should a high-income taxpayer convert or not this year? The answer is not always as simple as it first appears.

Background: As with a traditional IRA, a participant may contribute up to \$5,000 to a Roth IRA (less any traditional IRA contributions) for the 2009 tax year. An extra \$1,000 "catch-up contribution" is allowed for someone age 50 or older. But the ability to make contributions is phased out for taxpayers with a MAGI above certain income levels.

One key benefit of Roth IRAs is that "qualified distributions" are completely exempt from income tax. To qualify, a distribution must be made from a Roth in existence for at least five years and after the participant has reached age 59½, upon the death or disability of the participant or to pay for first-time home-buyer expenses (up to a lifetime limit of \$10,000). Pre-age 59½ withdrawals are also subject to a 10% tax penalty.

Furthermore, unlike a traditional IRA, minimum lifetime distributions are not required. This enables a participant to preserve a bigger nest egg for heirs.

Nevertheless, the decision to convert or not must take into account a number of variables. These include the following:

- \*The age of the IRA participant, his or her spouse (if married) and the ages of the beneficiaries
- \*The value of the assets in the traditional IRAs
- \*The tax year of the conversion
- \*The need to receive Roth IRA distributions in the future
- \*The projected investment rate of return

\*The participant's current income tax rate and expected tax rate in the future

\*State and local tax liability on the conversion

\*Amounts that were contributed to traditional IRAs on a nondeductible basis

\*Whether any portion of the tax must be paid out of IRA funds

These variables will have a substantial impact on the decision. For example, if the tax must be paid out of IRA funds, it will dilute the benefit of the conversion. Other "wild cards," such as inflation and the likelihood of future tax rate increases, should also be considered. Note that a partial conversion of funds in a participant's traditional IRAs is permitted.

Bottom line: Do not make assumptions about Roth IRA conversions. Online calculators often do not include all the necessary variables. With professional guidance, an informed decision can be reached.