

Roth IRA Conversion

Roth IRA Conversion -- Rules Set to Change in 2010

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Existing Conversion Rules

- A **Roth IRA conversion** is the process of moving assets from an IRA holder's Traditional IRA to Roth IRA, which generally creates a taxable event.
- IRA holders cannot convert their traditional IRA to a Roth IRA if their Modified Adjusted Gross Income (MAGI) exceeds \$100,000 in the year they wish to convert. This limit applies to both single and married filers.
- An IRA holder that is married and filing a separate tax return is also not eligible to convert their traditional IRA to a Roth IRA.
- Ordinary income taxes are due on all pre-tax assets that are converted from a traditional IRA to Roth IRA.
- If an IRA holder has both pre-tax and non-deductible assets in their existing IRA's (including traditional, SEP and SIMPLE IRAs) the IRS requires a pro-rata formula to be applied to the conversion of non-deductible and after tax contributions. (see example B)
- Required Minimum Distributions (RMDs) taken from a traditional IRA and any dollars converted do not factor into the MAGI limit when doing a conversion.
- RMDs cannot be converted and must be satisfied **before** converting from a traditional IRA to a Roth IRA.

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New Legislation

- President Bush signed the **Tax increase Prevention and Reconciliation Act (TIPRA)** on May 17, 2006, which changes the rules for IRA conversions.
- Beginning in 2010, the \$100,000 MAGI limit for converting a traditional IRA to a Roth IRA will no longer apply.
- Conversions will also be available to IRA holders who are married and filing a separate return.
- For conversions that occur in 2010, IRA holders may elect to pay taxes on the conversion in equal installments over a two year period (2011 and 2012)
- What would this new legislation allow?
- This new legislation may create an opportunity for a contribution and conversion strategy.
- An IRA holder that was previously not eligible to contribute to a Roth IRA may now have an opportunity to build on what can become their Roth IRA. This can be accomplished by contributing to a traditional IRA until a conversion can take place in 2010. The conversion will allow the IRA holder to enjoy the chief benefit of a Roth IRA, tax –free growth.

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Benefits of an IRA Conversion

- An IRA Conversion can allow the IRA holder to enjoy tax free income in the future. There are a number of considerations that can help determine if converting a traditional IRA to a Roth IRA is favorable. One consideration is the period of time before retirement, a longer time period until retirement will allow for more tax-free growth. Another consideration is if the IRA holder is in a lower tax bracket during the conversion than in retirement, he/she will pay less in ordinary income taxes on the IRA assets converted. These considerations, and others, should be discussed with the client's tax professional to see if a conversion will be in their best interest.
- Other benefits of an IRA conversion include:
- **RMDs not required on a Roth IRA**
- Beneficiaries may be able to enjoy tax-free benefits when inheriting the Roth IRA

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Example A

- Phil has been unable to contribute to a Roth IRA because he exceeds the MAGI contribution limit (\$114,000 for single filers and \$166,000 for joint filers). He has not made any previous traditional IRA contributions because he participates in his company's qualified plan and his IRA would be non-deductible. Also, Phil does not have a traditional IRA funded by other means (such as a rollover from a previous employer). Over the next four years, Phil could implement a strategy of building up a "non-deductible" traditional IRA that would allow him to convert in 2010. The contribution limit is \$4,000 through 2007, and will increase to \$5,000 in 2008.
- Phil contributes the amounts of:

<u>Year*</u>	<u>Non-deductible Contributions*</u>	<u>Earnings over 4 yrs**</u>
2006	\$4,000	\$1,243
2007	\$4,000	\$ 900
2008	\$5,000	\$ 725
2009	<u>\$5,000</u>	<u>\$ 350</u>
Total	\$18,000	\$3,218

*Fund in January for current tax year

**Assumes 7% return for holding until January of 2010, but does not guarantee a return. Returns are calculated annually and are for illustrative purposes only.

This chart does not represent any currently available investments.

If Phil converts his traditional IRA (which contains only non-deductible contributions) to a Roth IRA in 2010, he will only pay taxes on the \$3,218 earnings since there were no pre-existing traditional IRA assets.

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Example B

- Joe has a traditional IRA worth \$100,000, of which \$10,000 is non-deductible contributions. Joe wants to take advantage of converting some of his traditional IRA to a Roth IRA.
- **Can Joe convert \$10,000 of non-deductible contributions and not owe any taxes?**
- The answer is **NO**. Any conversion has to be done on a **pro-rata** basis between the non-deductible money and the account value. If Joe wants to convert only \$10,000 of his account value, it can only be done as a percentage of the overall account value, which is 10 percent ($\$10,000/\$100,000=10\%$).
 - Note: This is true even for non-deductible contributions or after tax rollover that are kept in a separate IRA. The IRS looks at all traditional, SEP and SIMPLE IRA balances as one “account”, not just the account with non-deductible contributions.
- In this example, the conversion of \$10,000 would be broken down as \$1,000 tax-free and \$9,000 as taxable. This would leave Joe with a remaining non-deductible basis of \$9,000 for any future distribution or conversion.
- The IRS requires additional filing for non-deductible contributions and distributions/conversions that contain non-deductible and/or after tax rollovers assets. The client should consult with a tax professional for assistance.

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Summary of Roth IRA Conversion Changes

- Beginning in 2010, the \$100,000 MAGI limit for converting a traditional IRA to a Roth IRA will no longer apply.
- IRA holders not previously eligible to contribute to a Roth IRA or convert their traditional IRA to a Roth IRA, will now have the opportunity to maximize traditional IRA contributions before converting their assets to a Roth IRA.
- Before considering this strategy, it is important for the IRA holder to understand that because of the long time frame, the legislation could still be modified. Also, remember that if an IRA holder has both pre-tax and non-deductible and/or after tax rollover assets in their existing IRAs (including traditional, SEP and SIMPLE IRAs); the IRS requires a **pro-rata** formula to be applied to the conversion of non-deductible and after-tax contributions. IRA holders should consult their tax professional for information regarding their situation prior to making planning decisions.