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CLIENT BULLETIN

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Roth IRA Conversions--New Opportunities for 2010

With the lure of tax-free distributions, Roth IRAs have become popular retirement savings vehicles since their introduction in 1998. But if you're a high-income taxpayer, chances are you haven't been able to participate in the Roth revolution. Well, new rules apply in 2010 that may change all that.

What are the general rules for funding Roth IRAs?

There are three ways to fund a Roth IRA--you can contribute directly, you can convert all or part of a traditional IRA to a Roth IRA, or you can roll funds over from an eligible employer retirement plan (more on this third method later).

In general, you can contribute up to \$5,000 to an IRA (traditional, Roth, or a combination of both) in 2010. If you're age 50 or older, you can contribute up to \$6,000 in 2010. (Note, though, that your contributions can't exceed your earned income for the year.)

But your ability to contribute directly to a Roth IRA depends on your income level ("modified adjusted gross income," or MAGI), as shown in the chart below:

If your federal filing status is:	Your 2010 Roth IRA contribution is reduced if your MAGI is:	You can't contribute to a Roth IRA for 2010 if your MAGI is:
Single or head of household	More than \$105,000 but less than \$120,000	\$120,000 or more
Married filing jointly or qualifying widow(er)	More than \$167,000 but less than \$177,000	\$177,000 or more
Married filing separately	More than \$0 but less than \$10,000	\$10,000 or more

What's changed?

Prior to 2010, you couldn't convert a traditional IRA to a Roth IRA (or roll over non-Roth funds from an employer plan to a Roth IRA) if your MAGI exceeded \$100,000 or you were married and filed separate federal income tax returns.

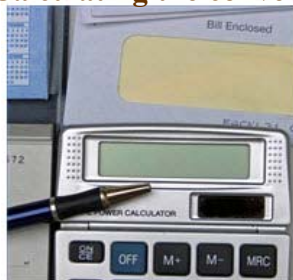
In 2006, however, President Bush signed the Tax Increase Prevention and Reconciliation Act (TIPRA) into law. TIPRA repealed the \$100,000 income limit and marital status restriction, beginning in 2010. What this means is that, regardless of your filing status or how much you earn, you can now convert a traditional IRA to a Roth IRA. (There's one exception--you generally can't convert an inherited IRA to a Roth. Special rules apply to spouse beneficiaries.)

And don't forget your SEP IRAs and SIMPLE IRAs. They can also be converted to Roth IRAs (for SIMPLE IRAs, you'll need to participate in the plan for two years before you convert). You'll need to set up a new SEP/SIMPLE IRA to receive any additional plan contributions after you convert.

What hasn't changed?

TIPRA did not repeal the income limits that may prevent you from making annual Roth contributions. But if your income exceeds these limits, and you want to make annual Roth contributions, there's an easy work-around. You can make nondeductible contributions to a traditional IRA as long as you have earned income at least equal to the contribution, and you haven't yet reached age 70½. You can simply make your annual contribution first to a traditional IRA, and then take advantage of the new liberal conversion rules and convert that traditional IRA to a Roth. There are no limits to the number of Roth conversions you can make. (You'll need to aggregate all of your traditional IRAs when you calculate the taxable portion of the conversion--more on that below.) *(continued on next page)*

Calculating the conversion tax



When you convert a traditional IRA to a Roth IRA, you're taxed as if you received a distribution with one important difference--the 10% early distribution tax doesn't apply, even if you're under age 59½. (The IRS may recapture this penalty tax, however, if you make a nonqualified withdrawal from your Roth IRA within 5 years of your conversion.)

If you've made only nondeductible (after-tax) contributions to your traditional IRA, then only the earnings, and not your own contributions, will be subject to tax at the time you convert the IRA to a Roth. But if you've made both deductible and nondeductible IRA contributions to your traditional IRA, and you don't plan on converting the entire amount, things can get complicated.

That's because under IRS rules, you can't just convert the nondeductible contributions to a Roth and avoid paying tax at conversion. Instead, the amount you convert is deemed to consist of a pro-rata portion of the taxable and nontaxable dollars in the IRA.

For example, assume that your traditional IRA contains \$350,000 of taxable (deductible) contributions, \$100,000 of taxable earnings, and \$50,000 of nontaxable (nondeductible) contributions. You can't convert only the \$50,000 nondeductible (nontaxable) contributions to a Roth, and have a tax-free conversion. Instead, you'll need to prorate the taxable and nontaxable portions of the account. So in the example above, 90% ($\$450,000/\$500,000$) of each distribution from the IRA in 2010 (including any conversion) will be taxable, and 10% will be nontaxable.

You can't escape this result by using separate IRAs. Under IRS rules, you must aggregate all of your traditional IRAs (including SEPs and SIMPLEs) when you calculate the taxable income resulting from a distribution from (or conversion of) any of the IRAs.

Special deferral rule for 2010 conversions only

But even if you have to pay tax at conversion, TIPRA contains more good news--if you make a conversion in 2010, you can take advantage of a special deferral rule that applies only to 2010 conversions. You can report half the income from the conversion on your 2011 tax return and the other half on your 2012 return. Or you can instead elect to report all of the income from the conversion on your 2010 tax return.

For example, if your only traditional IRA contains \$250,000 of taxable dollars (your deductible contributions and earnings) and you convert the entire amount to a Roth IRA in 2010, you can report half of the resulting income (\$125,000) on your 2011 federal tax return, and the other half (\$125,000) on your 2012 return. Or you can instead report the entire \$250,000 on your 2010 tax return.

Should you use the special 2010 deferral rule? The answer depends in part on your tax rate in 2010 versus what you think your tax rates will be in 2011 and 2012. Keep in mind that tax rates are scheduled to increase in 2011, if the Bush tax cuts are allowed to expire. The top tax rate will increase to 39.6% in 2011, up from 35% in 2010.

And speaking of employer retirement plans...

You can also roll over non-Roth funds from an employer plan (like a 401(k)) to a Roth IRA. Prior to 2010, the income limits and marital status restrictions also applied to employer plan rollovers to Roth IRAs (commonly referred to as conversions). As with traditional IRA conversions, these restrictions have been removed beginning in 2010, and now anyone can roll over funds from an employer plan to a Roth, regardless of income level or marital status.

Like traditional IRA conversions, the amount you convert will be subject to income tax in the year of conversion (except for any after-tax contributions you've made). But the good news is that the special deferral rule discussed earlier also applies to amounts you roll over from an employer plan to a Roth IRA in 2010. You can report half of the conversion income on your 2011 tax return, and the other half on your 2012 return, or you can instead elect to report all of the income on your 2010 tax return. And even non-spouse beneficiaries can roll over inherited employer plan funds to a Roth IRA, as long as it's done in a direct (not 60-day) rollover.

Is a Roth conversion right for you?

The answer to this question depends on many factors, including your current and projected future income tax rates, the length of time you can leave the funds in the Roth IRA without taking withdrawals, your state's tax laws, and how you'll pay the income taxes due at the time of the conversion. And don't forget--if you make a Roth conversion and it turns out not to be advantageous (for example, the value of your investments declines substantially), IRS rules allow you to "undo" the conversion. You generally have until your tax return due date (including extensions) to undo, or "recharacterize," your conversion. For most taxpayers, this means you have until October 15, 2011, to undo a 2010 Roth conversion.

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