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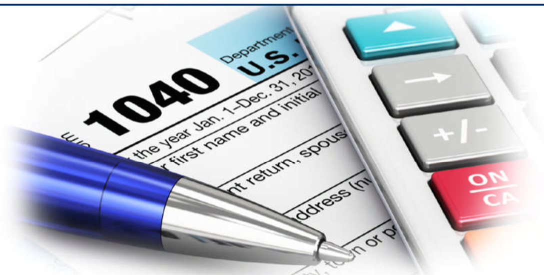

CLIENT ALERT TAX

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IRA Conversions in 2010

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On May 17, 2006, President Bush signed the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") into law. TIPRA included a provision dealing with conversions of traditional individual retirement accounts ("IRA") to Roth IRAs which would make such conversions available to more taxpayers.

With a traditional IRA money can be placed into the account on a pre-tax (tax deductible) basis. That investment is allowed to grow on a tax-deferred basis until withdrawn and taxed in retirement as ordinary income. Perhaps the greatest disadvantage of the traditional IRA is its forced distributions based on age. Withdrawals must begin at age 70½ (more precisely, April 1 of the calendar year after age 70½ is reached) and be taken each year thereafter according to a complicated Internal Revenue Service ("IRS") formula. There is a heavy penalty imposed by the IRS if an IRA owner fails to make the required withdrawal when required to do so.

In contrast to a traditional IRA, contributions to a Roth IRA are not tax-deductible, but the investment (including capital gains, dividends, and interest) grows on a tax-free basis. Withdrawals are generally tax-free, subject to certain stipulations (i.e., tax free when the account has been opened for at least 5 years for principal withdrawals and the owner's age is at least 59½ for withdrawals on the growth portion above principal). A significant advantage of the Roth IRA over a traditional IRA is that there are no mandatory withdrawal requirements. Historically, the greatest disadvantage of the Roth IRA was that eligibility to contribute to a Roth IRA phased out at certain income limits, which excluded taxpayers in higher income brackets from making contributions to Roth IRAs.

Prior to the enactment of TIPRA, the law permitted taxpayers to convert a traditional IRA to a Roth IRA if they: (1) paid federal income taxes on any pre-tax contributions as well as any growth in the account's value; (2) had modified adjusted gross income ("MAGI") of less than $100,000 in the year of conversion; and (3) were not married filing separately. These requirements effectively precluded upper income taxpayers from enjoying the benefits of a Roth IRA.

TIPRA eliminated the MAGI limit and filing status restriction on conversions starting in 2010. Thus, regardless of a taxpayer's income, contributions made to a traditional IRA in previous years can now be converted to a Roth IRA in 2010 and beyond. However, upon conversion the distributed amount is considered taxable income. The federal income taxes due on a 2010 conversion can be paid in 2010 or spread over the following two years (2011 and 2012) to spread the tax payment. Conversions in subsequent years are included in income during the tax year in which the conversion is completed. By removing the MAGI limitation, TIPRA made the conversion of a traditional IRA to a Roth IRA available to anyone that can afford the conversion cost. To optimize the conversion benefit, it is highly recommended that the tax cost be funded with other taxable non-IRA assets.

The conversion rules are complicated and a potential conversion must be carefully planned; therefore you should consult your tax advisor at our firm if you want to pursue converting your traditional IRA to a Roth IRA. We look forward to hearing from you.

About the Author: Mr. Fernandez focuses his practice on structuring and implementing estate and tax planning strategies for individuals and closely held businesses. His work includes assisting clients with all of the legal and tax aspects of the administration of decedent's estates. If you have any questions, please contact Mr. Fernandez (afernandez@wispearl.com) or one of the other attorneys in Wisler Pearlstine's Tax, Estate Planning and Administration Practice Groups.

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