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Retirement Tax-Advantaged Planning: 2010's Liberalized IRA-to-Roth-IRA Conversion

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Next year will be a pivotal one for retirement planning, as it will be the first year in which taxpayers will be eligible to convert funds in regular IRAs (as well as qualified plan funds such as 401(k)'s) to Roth IRAs **regardless of such taxpayer's income level**. In essence, Roth IRAs hold two major advantages over regular IRAs:

1. Distributions from regular IRAs are typically taxed as ordinary income. By contrast, Roth IRA distributions are tax-free if they are "qualified distributions," that is, if they are made: (i) after the five-tax-year period that commences with the first tax year for which the taxpayer made a contribution to a Roth IRA; and (ii) when the account owner is 59 ½ years of age or older, or on account of death, disability, or the purchase of a home by a qualified first time homebuyer (limited to $10,000).

2. Regular IRAs are subject to the lifetime required minimum distribution ("RMD") rules that generally require minimum annual distributions to be made commencing in the first year following the year in which the IRA owner attains age 70 ½. By contrast, Roth IRAs are not subject to the lifetime RMD rules that apply to regular IRAs (as well as individual account qualified plans).

Should I convert – Things to Contemplate?

In most cases, the answer is yes. However, there are some things to carefully consider prior to making a final decision.

1. *Do You Have Adequate Funds to Pay the Income Taxes Due Upon Conversion?* Upon conversion of your regular IRA to a Roth IRA, you pay tax on any earnings and pre-tax contributions. This is in lieu of paying taxes upon subsequent withdrawals from a Roth IRA account. However, you should not tap your regular IRA to pay the income tax due upon conversion. If you

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do so prior to attaining age 59 ½ you will owe an additional 10% penalty on that amount. Additionally, you permanently relinquish the opportunity for tax-free compounding of that amount.

A. You cannot avoid this "conversion tax" by simply rolling over an amount equal to your after-tax (non-deductible) contributions. Each dollar you roll over from a regular IRA is considered a "blended" dollar. Therefore, a percentage of the amount rolled over into the Roth IRA account will be taxed regardless (except in the unlikely event that your IRAs are worth less than the amount of your after-tax contributions).

2. *Will the Rollover Disqualify You for Important Tax Benefits?* The conversion income could push you into a higher tax bracket and disqualify you from other tax benefits such as the dependent child and college tuition tax credits, student loan interest deductions, etc.

3. *How Much Time Do You Have Until Retirement?* Generally, the older you are, the less sense it makes to convert a regular IRA to a Roth IRA because you will have less time to make up for what you lost in taxes upon conversion.

4. *Do You Plan to Leave Your IRA to Your Heirs?* One scenario in which it makes sense for an older regular IRA holder to transfer funds to a Roth IRA is when he or she does it for estate planning purposes. Unlike traditional IRAs, Roth IRAs require *no minimum withdrawals during the IRA owner's life*. If the surviving spouse inherits the Roth IRA account, he or she is not required to take any minimum withdrawals. With a regular IRA, you are mandated to begin taking taxable withdrawals no later than the year after you turn 70 ½. Therefore, you lose out on the chance for that sum of money to continue compounding without paying taxes. In addition, conversion to a Roth IRA will reduce your taxable estate by the amount of income tax you pay upon conversion. This can significantly reduce estate/Oregon inheritance tax exposure for your heirs.

5. *Will Your Income Tax Bracket Drop After Retirement?* The clearest case in which converting from a regular IRA to a Roth IRA does not make sense is when you expect to drop into a much lower income tax bracket after retirement (say, from 25% to 15%). Why? You will have to pay income tax on the conversion at your current high rate. Instead, let the money compound in your regular IRA and pay taxes at your lower rate in retirement. However, if your tax rate is only expected to drop a few points after retirement (say, from 28% to 25%), conversion is probably still the preferred alternative.

Complicating Factor for 2010 Conversions

As aforementioned, a unique income tax rule will apply for IRA to Roth IRA conversions occurring during the 2010 tax year. Unless a taxpayer elects otherwise, none of the gross income resulting from the conversion is included in income in 2010. One-half of the income resulting from conversion will be includible in 2011, and the remaining half in 2012.

What to do in 2009 in Anticipation of Conversion

Taxpayers who intend to take advantage of the new conversion option next year should consider implementation of the following strategies:

- Taxpayers who are eligible to make deductible IRA contributions this year should do so. You will reduce your 2009 tax bill and, if you make the conversion to a Roth IRA next year, you will not have to remit the tax savings until 2011 and 2012.

• High-income taxpayers should consider making non-deductible IRA contributions this year. You can then roll over the accounts into Roth IRAs next year without any tax cost.

• While some high-income taxpayers plan to make large conversions in 2010, they plan to opt out of the ability to defer tax until 2011-2012 due to concerns that they will be in a higher tax bracket at that time. In such a circumstance, taxpayers should avoid the standard year-end planning wisdom of accelerating deductions and deferring income, but should, rather, do the reverse in an effort to avoid being pushed into the highest brackets by a large IRA to Roth IRA conversion. These taxpayers should be considering alternatives to defer deductions in 2010, and accelerate income from next year into 2009.

Although all taxpayers are eligible to convert regular IRAs and qualified plan funds to a Roth IRA during the 2010 tax year, such blanket eligibility does not necessarily make it a good idea. However, in almost every circumstance, conversion for at least estate planning purposes will add value through minimization of federal/Oregon inheritance tax. If you have any questions, or are interested in exploring whether a Roth IRA conversion makes sense in your particular tax and/or estate planning situation, please contact Randall L. Duncan or Jonathan D. Mishkin, LL.M. at (503) 242-0000, and we will be glad to assist you.

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