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The *Advisor*

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The Roth IRA Conversion for 2010

Effective fund oversight in difficult times

For individuals looking for a way to potentially save on income taxes in the future, converting a traditional IRA into a Roth IRA may be a great option. However, there are some important issues to consider. Below are questions from a reader of the Advisor, Andrew from Scottsdale, AZ about Roth IRA Conversions.

Andrew: Why would I want to convert my existing IRA into a Roth IRA?

The Advisor: There are some advantages to rolling your IRA to a Roth IRA. First, it is important to remember that distributions from a Roth IRA are tax free, whereas distributions from a standard IRA are taxed at the individual's ordinary income tax rate. Secondly, owners of a Roth IRA are not required to take minimum distributions at age 70 ½, allowing your Roth IRA dollars to grow income tax free virtually indefinitely. A conversion may make sense if your traditional IRA has dropped in value (meaning less taxes payable upon conversion) and/or you expect to pay higher federal income taxes in future years. However, converting to a Roth IRA requires the individual to pay ordinary income taxes immediately on the amount converted.

Andrew: Can I convert my 401(k) to a Roth IRA?

The Advisor: Before 2008, you had to go through the two-step conversion – a rollover from an employer plan to a traditional IRA followed by a conversion to a Roth IRA. Now you can do a direct conversion from an employer plan to a Roth IRA (as long as you are eligible under the two-step conversion described above).

Andrew: I have heard some things about eligibility – what are the requirements?

The Advisor: In 2009, if your adjusted gross income (AGI) is greater than \$100,000 you cannot do a Roth IRA conversion. However, TIPRA 2005, the Tax Increase Prevention and Reconciliation Act of 2005, eliminated the AGI limit for 2010. Furthermore, if you convert to a Roth IRA in 2010, the IRS will allow half the tax owed to be paid in 2010 and the remaining half of the tax in 2011. A Roth conversion in any other year but 2010 would require that the full amount of tax be paid in the year of conversion.

Andrew: A friend of mine reversed his ill-advised Roth conversion. What does this mean?

The Advisor: It is true that the IRS allows you a 'do over' should you decide to want to reverse a Roth conversion. Let's say for example, you convert your traditional IRA to a Roth IRA in 2009. Then in 2010 you noticed the value of your Roth IRA has dropped even more than when you did the conversion. You have until October 15, 2010 to recharacterize your converted Roth IRA back to a traditional IRA status. It is as if the conversion never happened and you will not owe any 2009 federal income taxes on the original conversion. Keep in mind that you can only reconvert once per calendar year.

Andrew: How much will I be taxed when I convert my traditional IRA to a Roth IRA?

The Advisor: Any amount you convert will trigger ordinary income tax, but the amount will depend on your contributions to the traditional IRA. If all of your contributions have been tax-deductible, or a rollover from another retirement plan such as a 401(k) or 403(b), then the full amount of the conversion is taxable as ordinary income. If you have made nondeductible contributions, then part of the conversion will be nontaxable. You cannot convert only the nontaxable part and leave the taxable part in your IRA. Keep in mind your tax bracket can change when converting an IRA to a Roth IRA because you must include the conversion amount in your taxable income. It is always a good idea to consult your tax advisor before proceeding.

Andrew: Will I be penalized if I convert my traditional IRA to a Roth IRA before I turn age 59 ½?

The Advisor: No, a special exception has been created where you will not incur a penalty on your conversion from an IRA to a Roth IRA even if you are under the age of 59 ½. However, Congress imposed a special rule that if you take a distribution from the newly converted Roth IRA within five years after the conversion, the early distribution penalty of 10% will apply (unless you qualify for one of the exceptions) even though the distribution itself will not be considered taxable.

If you are thinking about converting your traditional IRA to a Roth IRA or wondering if it makes sense for you, please feel free to contact a Consultant in The Wealth Office for assistance.