



Employee Benefits Law Alert

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Retirement Planning in 2010: Changes to the Roth IRA Conversion Rules

Effective January 1, 2010, taxpayers with traditional IRAs may convert to Roth IRAs regardless of their modified adjusted gross income ("AGI") or income tax filing status. Passed as part of the Tax Increase Prevention and Reconciliation Act of 2005, this recently effective law may provide a significant retirement and estate planning opportunity, but taxpayers must remember that converting is not the best option for everyone. Before converting, taxpayers must carefully consider their particular circumstances.

Advantages to Roth IRAs

Taxation of Distributions. Unlike distributions from a traditional IRA, which are generally taxed as ordinary income, "qualified distributions" from a Roth IRA are tax-free. This means that investment earnings escape taxation if (1) the Roth account existed for at least five taxable years at distribution, and (2) the distribution is made either when the taxpayer is 59½ or older or because of death, disability, or the purchase of a home by a qualified first-time homebuyer. Income tax and a 10 percent early distribution tax penalty may apply to distributions that do not meet these requirements ("non-qualified distributions").

Required Minimum Distributions. Owners of traditional IRAs must take required minimum distributions from their retirement assets in the year after they reach age 70½ and can only make contributions before they reach age 70½. Roth IRAs have no required minimum distributions or contribution age limits, allowing taxpayers to manage assets well after retirement and earn tax-free returns on contributions.

Estate Planning. Roth IRAs can provide an effective estate-planning vehicle. Taxpayers can pass Roth IRA tax benefits on to their beneficiaries, allowing heirs to make tax-free withdrawals from inherited Roth IRA accounts. Note, however, that Roth IRA beneficiaries must take distributions from an inherited account over their life expectancies, and Roth assets are included in an estate's value. Nevertheless, this law change allows higher earning taxpayers to pass on tax-free legacies to their heirs.

Items to Consider When Deciding Whether to Convert

Tax Implications. Before converting traditional IRAs, taxpayers must consider whether they can pay the resulting income tax. Those who convert from a traditional IRA to a Roth IRA must pay income tax on all pretax contributions and earnings included in the converted sum. This could result in significant tax

liability and could change the tax bracket for those who convert a large amount from a traditional IRA.

The new conversion rules allow taxpayers who convert in 2010 to spread this tax liability evenly in 2011 and 2012. For 2010 conversions only, taxpayers can either (1) report the total amount of their converted pretax contributions and earnings on their 2010 tax returns, or (2) report half of this amount on their 2011 returns and the other half on their 2012 returns. Even with this flexibility, the potential tax liability may be a non-starter for many who otherwise wish to convert. What if poor market conditions cause the balance to decline, so that the conversion then looks like a mistake? There are certain opportunities to recharacterize back to a traditional IRA and even to implement a reconversion to a Roth IRA after that, but these must be done within specified timeframes and could be costly.

Taxpayers should pay the tax liability from non-retirement-account assets to maximize buildup of tax-free earnings in their Roth IRA. Taxpayers that cannot afford to do so may want to reconsider their decision to convert. Those who can pay for a 2010 conversion must decide whether to pay the full tax liability in 2010 or defer payment to 2011 and 2012. With tax rates expected to rise after 2010, payment in 2010 may prevent additional tax liability down the road. On the other hand, the second option may be better for those who want to convert, but who cannot afford to pay the full tax liability in 2010.

Five-Year Conversion Period. Each conversion is subject to a 5-year waiting period. If taxpayers withdraw a conversion from their Roth IRA within five years of the conversion, they must pay a 10 percent penalty on the distribution unless an exception applies (i.e. the taxpayer is over age 59½ when the withdrawal occurs). Taxpayers should evaluate their immediate financial needs to ensure they will not need converted funds within five years of conversion.

Future Earnings. When considering whether to convert, taxpayers should also examine whether they anticipate being in a higher tax bracket in the future. Owners of traditional IRAs who expect to fall in a higher tax bracket when they withdraw may want to convert now so the funds are taxed at a lower rate (and to avoid taxation of future earnings). Conversely, those who expect to fall in a lower tax bracket at withdrawal may want to forego conversion. Here, sticking with the traditional IRA will allow taxpayers to defer taxation so that withdrawals are taxed at a lower rate in the future.

Employer Plan Accounts. Taxpayers who participate in employer-sponsored plans, such as 401(k) plans, are also now eligible to move to a Roth IRA. Plan participants who are eligible to take a distribution from the plan may elect a rollover to a Roth IRA. Effective January 1, 2010, this ability to elect a direct rollover distribution to a Roth IRA is applied without any limits on a participant's modified AGI. However, participants who are not eligible to take a distribution from their plans are not able to convert their plan accounts to a Roth IRA.

Conclusion/Action Items

All taxpayers with pre-tax IRAs should consult with legal counsel or their tax advisors to:

- *Estimate the taxable portion of a potential conversion.* Taxpayers should only convert if they can pay the resulting tax. Taxpayers can calculate the non-taxable amount of the conversion using the pro rata method as follows:
 - o Step 1: Add up the balance of all IRAs.
 - o Step 2: Divide the amount of all nondeductible contributions (from Form 8606 of your old tax returns) by the balance in Step 1 to calculate the non-taxable percentage.
 - o Step 3: Multiply the non-taxable percentage by the conversion amount. The resulting amount is the portion of the conversion that is NOT subject to income tax.
- *Evaluate your immediate financial needs and future earnings potential.* The benefits of a conversion are minimized if taxpayers make early withdrawals or fall in a lower tax bracket when they withdraw. Consequently, taxpayers should analyze future earnings and income needs before converting.
- *For those who decide to convert, evaluate how much to convert.* Taxpayers can convert any portion of a traditional IRA or eligible 401(k) distribution. Those who cannot pay the income tax on a full conversion may want to convert only a portion of their traditional IRA or 401(k) distribution. Taxpayers may also want to leave some funds in a tax-deferred 401(k) or traditional IRA to maintain tax diversification in their retirement accounts.