BAIRD

Enhanced Roth Conversion Opportunity

Roth IRAs have been a popular retirement planning tool since they were first introduced in 1998. One of the most attractive aspects of these accounts is the ability to convert an existing Traditional IRA to a Roth IRA. Unfortunately, this option has only been available to taxpayers with Adjusted Gross Income (AGI) under $100,000. However, thanks to a law change passed in 2005, that is about to change.

Roth Conversions will be Available to Everyone in 2010

Thanks to the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the $100,000 AGI limitation is scheduled to be removed, meaning that taxpayers with income at any level will be eligible to convert a Traditional IRA to a Roth IRA. The AGI limit is still in place through tax year 2009, but that doesn't mean that IRA owners can't begin evaluating whether this conversion is right for them.

Conversion Considerations

When a taxpayer elects to convert a Traditional IRA (or other type of plan, such as a 401(k)) to a Roth IRA, there are important tax considerations to be aware of:

1. The year of conversion impacts when the converted amount is considered taxable income.

The change in law that removed the AGI threshold for conversions also changed the way these converted amounts are taxed. Generally, the year in which the Traditional IRA is converted to a Roth IRA is the tax year in which the conversion amount is considered taxable income. However, if a taxpayer converts a Traditional IRA to a Roth IRA in 2010, the income recognized as a result of the conversion is not taxable that year. Instead, half the converted amount is considered taxable in 2011, and the other half is taxable in 2012. A conversion in any year other than 2010 will create taxable income in the year of conversion.

> *Example 1:* A taxpayer has an IRA worth $100,000. If the taxpayer converts the entire IRA to a Roth in 2011, he or she will recognize $100,000 of taxable income in 2011. However, if that taxpayer converts the Traditional IRA to a Roth in 2010, $50,000 will be considered taxable income in 2011, and the other $50,000 will be taxable in 2012.

2. The amount converted from the Traditional IRA to the Roth IRA must stay in the Roth for at least 5 years (beginning January 1 of the year of conversion).

Any withdrawals from the converted portion of the account (either principal or income earned) before the 5 years have ended are subject to a 10% early withdrawal penalty. This includes cases where funds are withdrawn to pay the taxes due upon conversion. In addition to the 5 year requirement, withdrawals of any income earned inside the Roth IRA must also meet one of the other penalty exceptions, including:

- The account owner is at least age 59½
- The withdrawal is part of a series of substantially equal periodic payment (aka, a 72(t) distribution)
- The withdrawal is a result of the death or disability of the account owner
- The withdrawal is used to fund higher education expenses or for a first-time home buyer

How to Determine the Taxable Portion of a Conversion

Because of the large up-front tax cost of doing a Roth conversion, it's important to understand how the taxable income from the conversion is calculated.

When converting a Traditional IRA to a Roth IRA, only the previously untaxed portion of the account is considered taxable at the time of the conversion. This would include any contributions to the account that were deducted for tax purposes, as well as any earnings in the account. If any non-deductible contributions were made to the IRA, then that

amount is considered tax-free at the time of the conversion, although any earnings on those contributions are considered taxable.

> *Example 2A*: A taxpayer has a Traditional IRA worth $100,000, which includes $15,000 of non-deductible IRA contributions. If the taxpayer coverts the entire IRA to a Roth, he or she will recognize just $85,000 of taxable income in the year of the conversion.

If the taxpayer chooses to only convert a portion of the Traditional IRA to a Roth, then the tax-free portion of the conversion is based on a pro-rata allocation of the non-deductible contribution between the converted and unconverted IRA value. In other words, you can't choose to only convert the tax-free portion of the Traditional IRA to a Roth and leave the rest in the Traditional IRA.

> *Example 2B*: Building off the previous example, assume the taxpayer only converted $20,000 of the Traditional IRA to a Roth. The non-deductible portion of the Traditional IRA is 15% of the full value of the IRA ($15,000 / $100,000), so 15% of the converted amount is considered tax-free, or $3,000 (15% x $20,000). The taxpayer would report $17,000 of taxable income in the year of conversion ($20,000 - $3,000).

This is also the case if the taxpayer has multiple IRAs. While the taxpayer may only be converting one of the two IRAs to a Roth, the taxable income is calculated based on the total value of all the IRAs in that person's name. A spouse's IRA does not impact the calculation.

> *Example 2C*: Building off Example 2A – Assume the taxpayer not only has the $100,000 IRA with a $15,000 non-deductible, tax-free portion, but they also have a $200,000 IRA that came from a 401(k) rollover and has no non-deductible portion. If the taxpayer chooses to convert the entire $100,000 IRA, all $300,000 of IRA funds are considered in the taxable income calculation. The non-deductible portion of all IRAs is 5% of the full value of the IRAs ($15,000 / $300,000), so just 5% of the converted amount is considered tax-free, or $5,000 (5% x $100,000). The taxpayer would report $95,000 of the taxable income in the year of conversion ($100,000 - $5,000). If the taxpayer's spouse also has an IRA, that IRA is ignored when computing the taxable portion of the taxpayer's Roth conversion.

How to Prepare for This Opportunity

Taxpayers considering a Roth conversion should focus on the impact of the conversion on their overall financial plan. Factors to consider include:

- **How soon will you need the money currently in the Traditional IRA?** If you intend to use these funds shortly after the conversion, the conversion will simply result in pre-paying a tax liability that you could have continued to defer until you actually needed the money. Plus, you will have to pay a 10% penalty to access that money within 5 years.
- **What is your tax rate today compared to when you plan to withdraw the money?** If you expect to be subject to a lower tax rate in the future, then the Roth conversion may not be appropriate – why create income today when you're at a higher tax rate than you will be when you actually need the income? The inverse of this is also true – a higher future tax rate might incent you to convert your Traditional IRA today and pay taxes at your lower current rate.
- **Look at the overall impact of the Roth conversion.** When you convert to a Roth IRA, the extra income is part of your AGI. That increase in AGI can impact things such as your ability to claim certain tax deductions or the taxability of Social Security benefits, among other issues. That doesn't mean a conversion may not be right, just that it's important to know the full tax cost of the conversion.

In general, the best way to determine if you should convert a Traditional IRA to a Roth IRA is to prepare a complete financial plan. Your Baird Financial Advisor can assist you with this planning by preparing one analysis with the Traditional IRA, and another with the Roth to determine which plan better allows you to meet your financial goals.

To learn more, please contact your Baird Financial Advisor.

Baird does not offer tax advice.