



2009 Roth IRA Rollover Opportunities and Challenges

There is an interesting new rollover opportunity that's coming up in a few months. After 2009, you will be able to roll over amounts in qualified employer sponsored retirement plan accounts, such as 401(k)s and profit sharing plans, and regular IRAs, into Roth IRAs, regardless of your adjusted gross income (AGI). Currently, individuals with more than \$100,000 of adjusted gross income as specially modified are barred from making such rollovers.

What's so attractive about a Roth IRA? Here's a summary:

- Earnings within the account are tax-sheltered (as they are with a regular qualified employer plan or IRA).
- Unlike a regular qualified employer plan or IRA, withdrawals from a Roth IRA aren't taxed if some relatively liberal conditions are satisfied.
- A Roth IRA owner does not have to commence lifetime required minimum distributions (RMDs) after he or she reaches age 70 1/2 as is generally the case with regular qualified employer plans or IRAs. (For 2009, there's a moratorium on RMDs.)
- Beneficiaries of Roth IRAs also enjoy tax-sheltered earnings (as with a regular qualified employer plan or IRA) and tax-free withdrawals (unlike with a regular qualified employer plan or IRA). They do, however, have to commence regular withdrawals from a Roth IRA after the account owner dies.

The catch, and it's a big one, is that the rollover will be fully taxed, assuming the rollover is being made with pre-tax dollars (money that was deductible when contributed to an IRA, or money that wasn't taxed to an employee when contributed to the qualified employer sponsored retirement plan) and the earnings on those pre-tax dollars. For example, if you are in the 28% federal tax bracket and roll over \$100,000 from a regular IRA funded entirely with deductible dollars to a Roth IRA, you'll owe \$28,000 of tax. So you'll be paying tax now for the future privilege of tax-free withdrawals, and freedom from the RMD rules.

Should you consider making the rollover to a Roth IRA? The answer may be "yes" if:

... You can pay the tax hit on the rollover with non-retirement-plan funds. Keep in mind that if you use retirement plan funds to pay the tax on the rollover, you'll have less money building up tax-free within the account.

... You anticipate paying taxes at a higher tax rate in the future than you are paying now. Many observers believe that tax rates for upper middle income and high income individuals will trend higher in future years.

... You have a number of years to go before you might have to tap into the Roth IRA. This will give you a chance to recoup (via tax-deferred earnings and tax-deferred payouts) the tax hit you absorb on the rollover.

... You are willing to pay a tax price now for the opportunity to pass on a source of tax-free income to your beneficiaries.

You also should know that Roth rollovers made in 2010 represent a novel tax deferral opportunity and a novel choice. If you make a rollover to a Roth IRA in 2010, the tax that you'll owe as a result of the rollover will be payable half in 2011 and half in 2012, unless you elect to pay the entire tax bill in 2010.

Why on earth would you choose to pay a tax bill in 2010 instead of deferring it to 2011 and 2012? Keep in mind that absent Congressional action, after 2010 the tax brackets above the 15% bracket will revert to their higher pre-2001 levels. That means the top four brackets will be 39.6%, 36%, 31%, and 28%, instead of the current top four brackets of 35%, 33%, 28%, and 25%. The Administration has proposed to increase taxes only for those making \$250,000, but it is difficult to predict who will get hit by higher rates. What's more, there's a health reform proposal before the House of Representatives right now that would help finance healthcare reform with a surtax on higher-income individuals.

So if you believe there's a strong chance your tax rates will go up after 2010, you may want to consider paying the tax on the Roth rollover in 2010.

Here are some ways individuals can prepare now for next year's rollover opportunity.

- (1) Non-high-income individuals who are able to make deductible IRA contributions this year should do so. They'll reduce their 2009 tax bill and, if they make the conversion to Roth IRA next year, they won't have to pay back the tax savings until 2011 and 2012.
- (2) Individuals who have never opened a traditional IRA because they weren't able to make deductible contributions (and who never rolled over pre-tax dollars to a regular IRA) should consider opening such an IRA this year and making the biggest allowable nondeductible contribution they can afford. If they convert the traditional IRA to a Roth IRA next year they will have to include in gross income only that part of the amount converted that is attributable to income earned after the IRA was opened, presumably a small amount. In 2010 and later years, they could continue to make nondeductible contributions to a traditional IRA and then roll the contributed amount over into a Roth IRA. However, note that if an individual previously made deductible IRA contributions, or rolled over qualified plan funds to an IRA, complex rules determine the taxable amount.
- (3) Some high-income individuals may plan to make large conversions in 2010 but to opt out of the deferral of tax until 2011 and 2012 because they fear they will be in a higher tax bracket in those years than in 2010. These individuals 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 in 2010. These individuals should be considering ways to defer deductions to 2010, and accelerate income from next year into 2009.

We should discuss your and your family's entire financial situation before you plan for a large rollover to a Roth IRA after 2009. There also are many details that we should go over, such as whether the amounts you are thinking of switching to a Roth IRA are eligible for the rollover (technically, they are called "eligible rollover distributions"), whether you can make rollovers from your employer sponsored plan (for example, there are restrictions on rollovers from 401(k) plans), and the tax impact of rolling over amounts that represent nondeductible as well as deductible contributions.

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