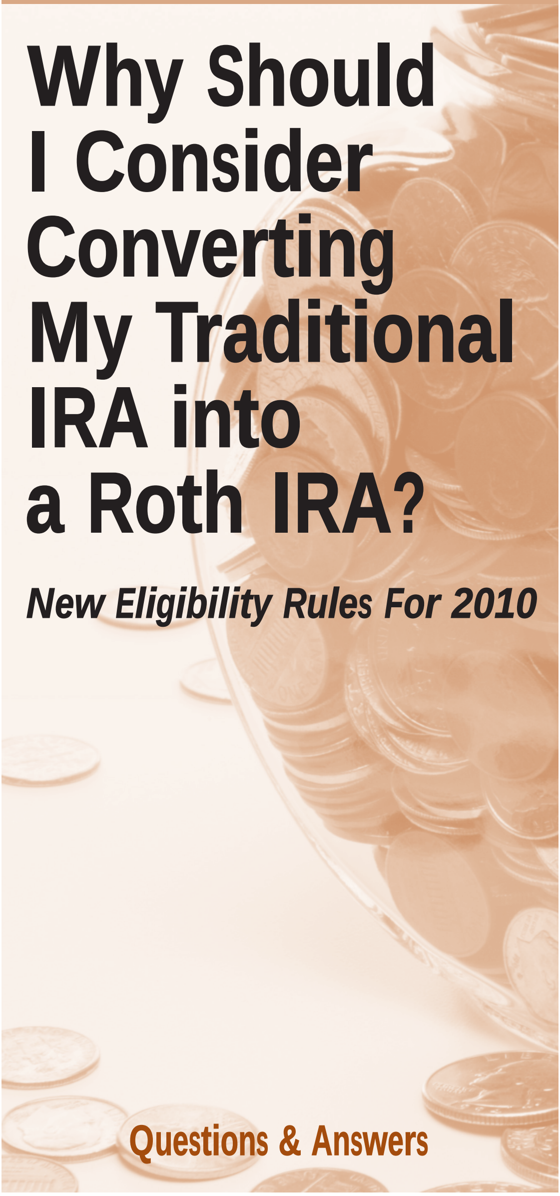
Roth IRAs

Why Should I Consider Converting My Traditional IRA into a Roth IRA?

New Eligibility Rules For 2010



Questions & Answers

Purpose of a Roth IRA Conversion Contribution

If a person has a traditional IRA, federal income tax laws allow you to move all, or a portion, of your traditional IRA funds via "conversion" to a Roth IRA. This brochure discusses the benefits of converting traditional IRA funds to a Roth IRA, and the proper procedures for doing so.

Why convert my traditional IRA to a Roth IRA?

The income earned by the funds within a Roth IRA will be tax free to you or your beneficiaries when withdrawn as a qualified distribution. The income earned within your traditional IRA is always taxable when withdrawn.

Example: You have $10,000 in your traditional IRA as of January 2009. You can certainly leave the funds within your traditional IRA and allow them to grow. Assume this $10,000 grows in value to $50,000 over the next 18 years.

The $40,000 of income will be taxable whenever it is withdrawn from a traditional IRA. However, if you had converted or moved this $10,000 to a Roth IRA, the $40,000 of income will never be taxed if the funds are withdrawn as a qualified distribution.

No matter how great the income or how wealthy you are, it will be tax free if the distribution from the Roth IRA is a qualified distribution. As discussed below, you are generally required to pay income tax with respect to the $10,000 for the year the conversion occurred.

Who was eligible to do a conversion for 2009?

If your Modified Adjusted Gross Income (MAGI) did not exceed $100,000, and if you were married, you filed a joint income tax return, you were eligible to do a conversion for 2009. However, a special rule provided that you were eligible for a conversion, even though you filed a separate return, if you did not live with your spouse at any time during the year.

What distributions from a Roth IRA will be tax free?

"Qualified distributions" will be tax free. To be a qualified distribution, the distribution must occur after you have met the five-year holding requirement, and the distribution is made to you (1) after you have attained age 59½ , (2) after you have become disabled, (3) because of a first-time home purchase, or (4) to your beneficiary after your death.

When will I have met the 5-year rule?

The five-year period is considered to start on January 1 of the year for which the first contribution to a Roth IRA is made. All Roth IRA contributions, including rollovers and conversions, are aggregated for purposes of satisfying the 5-year rule. Exception: a distinct five-year period applies to inherited Roth IRAs.

Does the law define the order for distributions?

Yes. The law mandates the following order for distributions: (1) from regular/annual contributions; (2) from conversion contributions on a first-in-first-out basis and (3) from earnings. The order is determined as of the end of the taxable year, and each category must be exhausted before the next is used. With respect to a conversion contribution, it is treated as being made first from the portion, if any, that was includible in gross income as a result of the conversion.

How do I determine my MAGI?

You should refer to IRS publication 590. In general, you start with your adjusted gross income on line 35 of Form 1040 or line 22 of Form 1040A, subtract the amount of income attributable to the conversion, subtract the amount of income attributable to a required distribution, subtract the income relating to a Roth IRA rollover from a qualified retirement plan, and then add certain amounts such as the amount of your traditional IRA deduction, any student loan interest deduction, any tuition and fees deduction and certain other deduction and exclusion amounts.

Who is eligible to do a conversion for years 2010 and subsequent years?

Beginning January 1, 2010, the conversion requirements, will be repealed, and anyone having a traditional IRA may convert funds from their traditional IRA to a Roth IRA.

How much may I convert from my traditional IRA?

There is no dollar limit on the amount which you may convert from your traditional IRA to a Roth IRA.

You must decide whether or not it is in your best interest to incur taxes on the conversion amount now, in order to receive the benefit of tax-free earnings, when the funds are converted to the Roth IRA.

Note that you are not required to convert the total amount of your traditional IRA in one year. It may be possible, depending on your income, to lessen the tax burden by converting only a portion of your traditional IRA balance over a period of a years.

Example: If you have $50,000 in a traditional IRA, you may wish to convert $10,000 a year for a period of 5 years, or $5,000 a year for a period of 10 years.

When may I do a conversion during the year?

You may do it at any time. A conversion can be done for a given tax year as soon as January 1 of such year. For example, a person could convert his or her traditional IRA on January 1, 2010, for 2010. The last day to convert funds for a given year is December 31.

How do I convert my traditional IRA?

You can convert amounts from your traditional IRA to a Roth IRA by using any of the following three methods. The first method is the standard rollover. You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days of the distribution. The second method is a trustee-to-trustee transfer. If permissible, you may direct the custodian/trustee of your traditional IRA to transfer an amount from the traditional IRA to the custodian/trustee of your Roth IRA. The third method is an internal movement. You direct the custodian/trustee of your traditional IRA to transfer an amount from your traditional IRA to your Roth IRA.

Whatever conversion method is used, the custodian/trustee of the traditional IRA will prepare a Form 1099-R to report the distribution, and the custodian/trustee of the Roth IRA will prepare a 5498 to report the conversion contribution.

How do I convert my SEP-IRA or SIMPLE-IRA?

You would follow the same procedures which apply to converting funds from a traditional IRA. However, in the case of a SIMPLE IRA, you may convert such funds only after a 2-year period has expired since you first participated in your employer's SIMPLE IRA plan.

Do I need to execute a new Roth IRA plan agreement to receive the conversion contribution?

No. You could establish a new Roth IRA plan agreement if you wanted, but this is not required. If you already have an existing Roth IRA, you could add the conversion funds to your existing Roth IRA.

Must I or should I establish a Roth Conversion IRA?

No. A conversion contribution may be made to the same Roth IRA to which regular annual Roth IRA contributions have been or will be made. In 1998 when Roth IRAs were first available, the IRS initially recommended that an individual set up a separate Roth Conversion IRA for a conversion contribution. However, Congress enacted a law change in 1998 and the IRS quit recommending the establishment of a separate Roth Conversion IRA. You will maintain the proper records for the distribution ordering rules by completing the Form 8606 (Nondeductible Contributions).

What income tax will I owe because of a conversion made in 2010?

As discussed above, you will still owe the applicable tax on the distribution from the traditional IRA. However, there is a special rule for conversions made in 2010.

If you make a conversion in 2010, you will include 50% of the conversion amount in income for income tax purposes in 2011, and the other 50% in 2012. No taxes will be owing in 2010 for conversions made in 2010. You do not have to use this special rule. If you desire, you may include all of a 2010 conversion amount in your income for 2010.

If the distribution includes any basis (i.e. nondeductible contributions), you do not include such after-tax amounts in your gross income.

What income tax will I owe because of a conversion made in a year after 2010?

You must include in your gross income (at your applicable marginal tax rate) distributions from a traditional IRA that you would have had to include in income if you had not converted them into a Roth IRA. That is, you are deemed to have received a distribution and you are required to pay tax on such amount. For example, assume your marginal tax rate is 15%. If you convert $10,000 from your traditional IRA to a Roth IRA, you will pay tax of $1,500 with respect to the $10,000.

If the distribution includes any basis (i.e. nondeductible contributions), you do not include such after-tax amounts in your gross income.

Will I owe the 10% additional tax for my conversion if I am under the age of 59½?

No.

Are there amounts in my traditional IRA which I am not eligible to convert?

Yes. You cannot convert any required distribution amount. You cannot convert amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you attain age 70½) under the required distribution rules.

Can I convert an IRA which I inherit from my spouse?

Yes. If you roll over your deceased spouse's IRA into your own traditional IRA, then you may convert it to a Roth IRA. In the same way, if you are eligible to elect to treat your deceased spouse's IRA as your own, then you may so elect and then convert it to a Roth IRA.

May I convert an IRA which I inherit from someone who is not my spouse?

No. If you inherited a traditional IRA from someone other than your spouse, then you are ineligible to convert such an IRA to a Roth IRA.

If I have set up a substantially equal periodic payment with respect to a traditional IRA, am I eligible to convert some or all of this IRA?

Yes, but you must continue the periodic payments. The 10% additional tax on early distributions will not apply even if the distributions are not qualified distributions, as long as they continue to comply with the substantially equal periodic payment rules.

What tax reporting forms will be prepared by the one or two IRA custodians/trustees?

Regardless which of the three conversion methods is used, there is either an actual distribution which occurs or a deemed distribution which is deemed to have occurred. The custodian/trustee of the traditional IRA is to prepare a Form 1099-R to report the distribution. The IRS instructs the custodian/trustee to use a reason code "2" if you are not yet age 59½ or older and a "7" if you are age 59½ or older. The custodian/trustee of the Roth IRA is to report the amount of the conversion contribution in box 3 of the Form 5498 for the year during which the conversion was made.

What income tax forms will I need to complete to properly reflect a conversion on my federal income tax return?

You will need to complete Form 1040 and Part II of Form 8606 (Nondeductible IRAs). Part II is titled, "Conversions from Traditional, SEP or SIMPLE-IRAs to Roth IRAs".

Is there an age limit imposed for doing a conversion?

No, a person is eligible to do a conversion at any age. However, as discussed previously, you are not eligible to convert any required distribution.

Is there any limit on the number of conversions I may do?

No. There is no limit as to how many conversions you may do.

If I convert some or all of my traditional IRA, do I have the right to change my mind and undo the conversion, or can I only undo it if I become ineligible?

You have the right to change your mind. You can undo it even though you were eligible to do the conversion. As discussed above, you must move the funds from the Roth IRA, by a recharacterization, into a traditional IRA, by the due date for your tax return for the year during which the conversion was made, including extensions. You may either recharacterize the entire conversion amount, or you may recharacterize only a portion of the conversion amount. You must also include the related earnings, from the date of the conversion. You will need to report the recharacterization on your tax return, but no portion will be required to be included in income. The net effect of a conversion and subsequent recharacterization is that a conversion never occurred.

What is a reconversion?

A reconversion is when you do a conversion, recharacterize it and then wish to do another conversion.

Is there a limit applying to reconversions?

Yes. You cannot reconvert an amount during the same taxable year or, if later, during the 30-day period following a recharacterization.

If I withdraw money from my Roth IRA a number of years after the conversion, will I have to pay a special 10% additional tax if I am younger than age 59½?

Unless you are exempt from the 10% special tax because you qualify for one of the exceptions, you will have to pay the 10% tax if, after applying the special tax-ordering rules, you are considered to have withdrawn your "conversion" funds, and you have not satisfied a special five-year rule. For this special rule, the five-year period starts on January 1 of the year during which you made the conversion contribution. A separate five-year period applies to each conversion you make.

You will NOT have to pay the 10% tax even if, after applying the special tax-ordering rules, you are considered to have withdrawn your "conversion" funds after you have satisfied a special five-year rule. Once you attain age 59½ or older, you may withdraw these conversion funds and not owe the special 10% tax.

Are there any other tax situations of which to be aware?

There is a situation in which an individual may have to pay additional taxes that they may not be aware of when making a conversion to a Roth IRA.

Example: You are age 48 and you withdraw $10,000 from your traditional IRA and convert it to a Roth IRA. Because the $10,000 is taxable to you, it is calculated that you owe $800 of income tax on this $10,000. You do not have resources to cover this income tax amount, so, instead of converting the entire $10,000, you only convert $9,200, and use the additional $800 to pay the income tax on the conversion amount. This is certainly permissible. The law expressly provides that the 10% additional tax does not apply to any conversion amount. However, only $9,200 was converted. The $800 which was used to pay the income taxes was not converted and must be included in your income for income tax purposes. In addition, you will owe an additional $80 ($800 x 10%) in taxes which you probably had not planned on owing because the 10% does apply to the $800 which was not converted.

Must I take a required minimum distribution from my conversion Roth IRA?

No. A Roth IRA accountholder is not subject to any required distribution rules.

Might an income acceleration rule apply to certain 2010-2011 distributions?

Yes. In order to discourage an individual from making a conversion and then taking a distribution soon thereafter, the law has been written to include an income acceleration rule. The individual will use the standard Roth IRA ordering distribution rules. If an individual takes a NONQUALIFIED distribution from his or her Roth IRA during 2010-2011 which is comprised of the taxable portion of a conversion, then he or she will need to include that portion in income earlier than it would have been under the 2-year pro-rata rule. The income deferred to 2012 will be accelerated first and then the income deferred to 2011 will be accelerated next.

In what Roth IRA distribution situations will the income acceleration rule not apply?

An individual taking a qualified Roth IRA distribution will not be subject to the income acceleration rule. Also, the income acceleration will not apply to the extent that the individual withdraws “basis” due to annual contributions.

What happens if I make a Roth conversion in 2010 and then die in 2010 or 2011?

If you elected to use the 2-year rule in 2010 and then die during 2010 or 2011, any amount which has not yet been included in income must generally be included in your income for the year of your death. This income will need to be reported on your final income tax return.

The law appears to be unsettled whether or not your executor may un-do the conversion by recharacterizing. The IRS generally adopts the position that the making of a conversion and recharacterization are personal tax rights and end when the individual dies.

Does a special rule apply if I have designated my spouse as my Roth IRA beneficiary and he or she is my sole beneficiary?

Yes. A spouse beneficiary who is the sole beneficiary can elect to continue to ratable include the amounts in income over the remaining years in the 2-year period.

Example #1 If a person converts $24,000 in 2010 and then dies on October 15, 2010, his or her spouse beneficiary will be able to continue the 2-year schedule. He or she would include $12,000 in his or her income in 2011 and the remaining $12,000 in income for 2012.

Example #2. If a person converts $24,000 in 2010 and then dies on December 5, 2011, his or her spouse beneficiary will be able to continue the 2-year schedule. He or she would include $12,000 in his or her income in 2011 and the remaining $12,000 in income or 2012.

Will my beneficiary(ies) be required to take required distributions after I die?

Yes. Your beneficiary will be required to take required distributions. However, if your spouse is your beneficiary, and he/she decides to treat the Roth IRA as their own, or rolls it over distributions are not required. In general, an inheriting nonspouse beneficiary must withdraw an annual required distribution commencing by December 31 of the year after your passing. A beneficiary will use the life distribution rule to calculate his or her required distribution unless he or she elects the five-year rules. a beneficiary may generally take distributions larger than the required distribution. Your beneficiary(ies) will want to discuss their options with their tax advisor.

The information provided in this brochure is not intended to be legal or tax advice. You should consult your attorney or tax advisor for information that relates to your specific circumstances.