

Advisory

TRUSTS AND ESTATES DEPARTMENT | FEBRUARY 2010

WIGGIN AND DANA

Counsellors at Law

Should You Convert Your Traditional IRA into a Roth IRA?

Prior to 2010, an individual could convert a traditional IRA into a Roth IRA provided his or her modified adjusted gross income did not exceed \$100,000. Starting in 2010, an individual may make such a conversion regardless of his or her annual income. In this edition of the *Advisory*, we discuss factors to consider in deciding whether or not you should convert your traditional IRA into a Roth IRA.

DO THE BENEFITS OF CONVERSION OUTWEIGH THE COSTS?

A conversion is treated as a taxable distribution from the traditional IRA followed by a contribution to a Roth IRA. Because conversion accelerates income tax, you should not convert a traditional IRA into a Roth IRA unless there is a good chance that the potential benefits of conversion will outweigh the up-front costs.

Generally speaking, if you can meet three out of the following four criteria, you should consider conversion.

1. You can pay the income tax generated by the conversion with assets outside of the IRA. One of the primary benefits of conversion to a Roth IRA is the opportunity to shift assets to a “tax-free” savings vehicle. Distributions from your Roth IRA are excludable from your gross income provided that the distributions are made (i) at least five years after your first contribution to any Roth IRA and (ii) after you have attained 59 ½ years of age, while you are disabled, or after your death.^[1] If you have to pay the income tax resulting from conversion out of your IRA, the advantages of conversion will be diminished because a smaller amount will be available for “tax-free” growth in the Roth account. In contrast, if you can pay the income taxes resulting from conversion out of assets other than your IRA, you will increase the amount of assets that can grow tax-free in the Roth IRA and reduce the value of your estate, all without generating any gift tax liability.

2. You will not need to make withdrawals from the IRA until late in your retirement, if at all. Another advantage of a Roth IRA is its potential for long-term growth. The owner of a traditional IRA is required to withdraw a minimum amount each year once the owner passes his or her “required beginning date” (April 1 following the year in which the owner attains 70 ½ years of age). In contrast, the owner of a Roth IRA is usually not required to receive any distributions from the Roth IRA during the owner’s lifetime, thereby permitting an accumulation of tax-advantaged assets over time.^[2] If you will be relying on IRA distributions in order to support your lifestyle in retirement, the potential for growth will be reduced — in this situation you might as well be subject to the minimum distribution requirements.

3. You expect to remain in the same tax bracket or move to a higher tax bracket in the future. As mentioned above, distributions from a Roth IRA are not subject to income tax provided certain conditions are met. Therefore, if all other factors are disregarded, a taxpayer who expects to remain in the same tax bracket or move to a higher tax bracket in the future has more to gain from conversion than a taxpayer who expects to move to a lower tax bracket. For example, a young professional may wish to pay the income taxes resulting from conversion now, at her present tax rate, because she expects to move into a higher tax bracket as her earnings increase. In contrast, an individual who is about to move into a lower tax bracket due to retirement should carefully consider whether it would be advisable to incur significant additional income taxes while he is in his present, higher tax bracket.

4. You have not yet reached the traditional age of retirement and plan to continue working. The disadvantages of paying the income taxes resulting from conversion

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out of the converted IRA may be mitigated if you have not yet reached the traditional retirement age and are planning to work for the foreseeable future. In this situation, the assets in the IRA will have a longer period in which to grow assuming that you continue to live off of your earnings and meet your life expectancy.

ADDITIONAL CONSIDERATIONS

Special rules for conversion in 2010.

You may have heard that special rules apply to IRA conversions made in 2010. Usually, the amount converted is recognized as taxable income in the year of conversion. However, if you convert from a traditional IRA to a Roth IRA in 2010, you will have an opportunity to defer the taxes resulting from the conversion. Unless you elect otherwise, the amount converted in 2010 will be included in your income ratably in 2011 and 2012. But there is a catch: the top marginal federal income tax rate is set to increase from 35% in 2010 to 39.6% in 2011.

Conversions can be retracted.

You can reverse your Roth IRA conversion through a process called “recharacterization” provided the recharacterization is completed before the due date for filing your federal income tax return, taking into account any extensions. In most cases, if you make a Roth IRA conversion in 2010, you can recharacterize the conversion as late as Oct. 15, 2011. Please keep in mind, however, that if you recharacterize a conversion you will not be eligible to make another Roth IRA conversion until the first day of the following taxable year or, if later, 30 days after the recharacterization process is complete.

Conversions can be partial and gradual.

If converting your entire traditional IRA in one year will push you into a higher tax bracket, you may wish to spread out the conversion over a period of years instead. Likewise, if you are uncertain of your future tax bracket, you can “hedge” by converting part of your IRA to a Roth account and retaining the remainder of your account as a traditional IRA.

Estate tax considerations.

Conversion may be an attractive option if you would like to reduce the size of your estate in the near term. The payment of income tax resulting from the conversion will decrease the value of your estate while transferring a portion of your estate to an income-tax-free savings vehicle that can pass to your beneficiaries. Furthermore, by paying the income taxes from the conversion, you will essentially make a gift that will not be subject to gift tax. If the value of your estate is just over the threshold of taxability, conversion could, at least temporarily, bring your estate within your applicable estate tax exemptions.

CONCLUDING THOUGHTS

The decision to convert should be made after careful analysis of the risks and potential benefits. If you are thinking about converting to a Roth IRA, attorneys in Wiggin and Dana’s Trusts and Estates Department would be happy to discuss with you the role that conversion could play in your estate plan.

[1] The distribution may also be excludable if it is no more than \$10,000 and will be used for the purchase of a “first home.”

[2] The owner of a non-spousal inherited Roth IRA is required to receive minimum distributions.

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