

New Roth IRA Opportunities for Higher-Income Taxpayers

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Converting a Regular IRA to a Roth IRA may result in a future tax savings

Want to pay income tax now that could be postponed for many years? You may want to in order to substantially reduce the total taxes that you will pay over the years. The conversion of regular IRA to a Roth IRA, not previously available to higher-income taxpayers, offers that possibility.

Tax Treatment of IRAs. Contributions to a regular IRA may be deductible, in whole or in part, depending upon the contributing taxpayer's adjusted gross income, marital status and age and whether the taxpayer or the taxpayer's spouse participates in a qualified retirement plan. All amounts distributed from the IRA will be taxable, except for an amount equal to the nondeductible contributions made to the IRA. The amount which a taxpayer may contribute to a regular IRA during a taxable year, whether deductible or not, is limited.

By contrast, no contributions to a Roth IRA are deductible, so all contributions are made with after-tax dollars. The amounts distributed from a Roth IRA will generally not be subject to federal income taxation. Thus, the investment earnings for a Roth IRA might never be taxed. The amount which a taxpayer may contribute to a Roth IRA during a calendar year is limited, and may be zero, depending upon the taxpayer's adjusted gross income, marital status and age.

The favorable tax treatment for distributions from Roth IRAs will apply only to "qualified distributions". A qualified distribution is a distribution (1) made after the owner of the Roth IRA reaches age 59

½, (2) made to the owner's beneficiary or estate after the owner's death, (3) attributable to the owner's disability, or (4) not exceeding \$10,000 which is used to purchase a first home.

Conversions. For several years, lower-income taxpayers have been allowed to convert their IRAs to Roth IRAs. Conversions have been limited to taxpayers with adjusted gross incomes of \$100,000 or less (and have been prohibited for married taxpayers filing separate returns). Starting in 2010, all taxpayers will be permitted to convert to Roth IRAs.

The tradeoff for a conversion is that the taxpayer will be taxed upon the conversion in the same manner as though the regular IRA had been distributed to him instead of converted (although he will not be subject to the 10% additional tax for distributions before age 59 ½). If the conversion occurs during 2009, and the taxpayer doesn't otherwise elect, the taxes will be spread over four years. One-fourth of the taxable amount will be included in the taxpayer's gross income for 2009, 2010, 2011 and 2012. If the conversion occurs during 2010, and the taxpayer doesn't otherwise elect, the taxes will be spread over two years, with one-half of the taxable amount being included in the taxpayer's gross income in 2011 and one-half in 2012. The taxes cannot be spread over multiple years if the regular IRA is converted after 2010.

Tax Planning. An individual contemplating the conversion of a regular IRA to a Roth IRA should consider the following tax factors:

- A younger taxpayer will get more bang for his buck from a Roth IRA than will an older taxpayer. The younger taxpayer will have more years of investment earnings that will go untaxed.
- If the holder of a regular IRA expects federal income tax rates to go up in the future, a conversion would cause the amounts in the IRA to be taxed at the lower current rates, rather than the higher rates that would apply upon distribution of moneys from the regular IRA in future years. Will the advantage of lower rates in the earlier year, when combined with the future buildup of untaxed investment earnings, outweigh the benefit of deferring the payment of tax?
- Similarly, if a converting taxpayer expects federal income tax rates to rise in the near future, he may want to elect to have the entire taxable amount included in his income for the year of the conversion. For example, if a conversion occurs in 2010 and the IRA owner expects tax rates to be higher in 2011 and 2012 than they are in 2010, he may wish to have the full taxable amount included in his gross income for 2010, so that it will be taxed at a lower rate than it would have been if he chose to have it included in income for 2011 and 2012. Will the advantage of lower rates in the earlier year outweigh the benefit of deferring the payment of tax?
- The holder of a regular IRA is required to start taking his money out once he attains age 70 ½. This requirement does not apply to a Roth IRA. The owner of a Roth IRA can leave all of the money in the IRA until he dies and let it continue to build up investment earnings that will not be taxed.
- The tax resulting from a conversion should ideally be paid by the taxpayer from assets held outside the IRA, rather than from distributions from the IRA. If distributions are made from the IRA to pay the tax, there will be less money left in the IRA to generate untaxed investment income. In addition, if the taxpayer has not reached age 59 ½, the distributions may not be eligible for the favorable tax treatment accorded qualified distributions.
- If a converting taxpayer wants to spread out the tax cost of a conversion (and is not concerned about potentially higher tax rates in later years), sooner is better than later. A conversion in 2009 will spread the cost over four years for a lower-income taxpayer. A conversion in 2010 will spread the cost over two years for a lower-income taxpayer or a higher-income taxpayer.

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