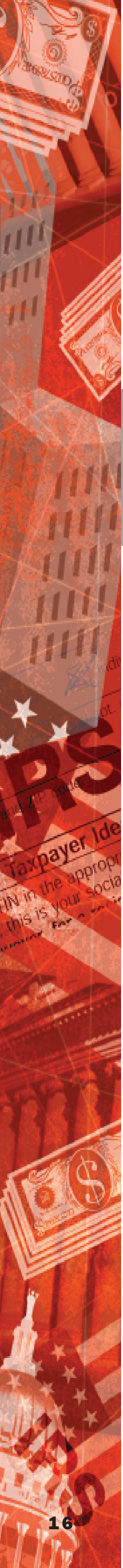
By Richard P. Freedman and Anthony P. Curatola, Editor



IRAs and Roth IRAs in 2010

Beginning in tax year 2010, an individual may convert assets in a traditional IRA to a Roth IRA without regard to his or her modified adjusted gross income.

Individual taxpayers have the flexibility to move assets from one traditional IRA to another traditional IRA or from one Roth IRA to another Roth IRA, and the Roth IRA receives assets from other IRAs. Hence, a taxpayer may transfer some or all traditional IRA holdings to a newly established or existing Roth IRA. This changes the tax properties of the earnings after the transfer and on distribution from taxable to nontaxable. Since qualified amounts withdrawn from the Roth IRA aren't subject to the income taxes, an additional benefit is that the Roth IRA isn't subject to the required minimum distribution rules.

But not everyone can transfer amounts to the Roth IRA from the traditional IRA. Pursuant to IRC §408A(c)(3)(B), this type of transfer, referred to as a conversion rollover, is permitted *only if* the following conditions exist for transfers prior to 2010:

- The owner *doesn't file* a married tax return separately for the year; and
- The modified adjusted gross income (MAGI) amount for the *year of transfer* doesn't exceed $100,000.

Beginning in tax year 2010, however, the MAGI limits for converting assets held in a traditional IRA to a Roth IRA are eliminated. Thus, taxpayers may make such conversions without regard to their MAGI. Better yet, a special allocation rule is provided for any conversions occurring in year 2010. Unless the taxpayer otherwise elects, the taxable portion of

the conversion amount is includible in gross income ratably in tax years 2011 and 2012. That means the taxpayer may make a conversion in tax year 2010 and include:

- None of the converted amount in gross income for tax year 2010,
- One-half of the converted amount in gross income for tax year 2011, and
- One-half of the converted amount in gross income for tax year 2012.

This special conversion rule comes from the Conference Agreement of the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2006 (not the House or Senate; see Act §512 of TIPRA).

The taxpayer isn't required to spread the converted amount in tax year 2010 over the following two years. The taxpayer may elect to include the entire taxable amount in tax year 2010 rather than spreading it over the following two years (see IRC §408A(d)(3)(A)(iii)), but he or she must elect to include all income in 2010. Otherwise, the allocation over 2011 and 2012 is automatic.

The following examples illustrate the above tax provision.

Example 1 Facts. Andrea has a traditional IRA with a value of $10,000, consisting of deductible contributions and earnings. Her income over the past few years has exceeded $100,000. As such, she hasn't been eligible to establish a Roth IRA, but she is advised by

ILLUSTRATION: ARTDISC

her tax accountant in 2010 that she does qualify to transfer the funds being held in her traditional IRA into a newly created Roth IRA. She makes the conversion election.

Results. If Andrea transfers the $10,000 of traditional IRA holdings into the newly established Roth IRA, she would include the $5,000 of the converted amount in gross income for 2011 and the remaining $5,000 of the converted amount in gross income for 2012. Alternatively, Andrea could elect to include the entire $10,000 conversion amount in the gross income of tax year 2010.

Unforeseen events arise in everyone's lives. If, after making a transfer to the Roth IRA in 2010, the taxpayer takes a distribution from the Roth IRA before tax year 2012, a special income inclusion rule applies (IRC §408A(d)(3)E)(i)) that stipulates:

- In the year of the distribution, the gross income is increased by the amount distributed, and
- In 2012 (or 2011 and 2012 in the case of a distribution in 2010), the amount included in gross income is the lesser of:
  - One-half of the amount includible in income as a result of the conversion or
  - The remaining portion of such amount not already included in income.

Here's an example of the application of the recapture rule.

Example 2 Facts. Andrea transfers $10,000 from her traditional IRA into the newly established Roth IRA at the start of tax year 2010. She elects to include half of the $10,000 in tax year 2011 and half in 2012. Unfortunately, an event occurs late in 2010 that forces Andrea to take a $2,000 distribution from the Roth IRA. The distribution isn't a qualified distribution, and all of it is includible in gross income as a result of the conversion.

Results. In this situation, Andrea would include the $2,000 distribution in the gross income of tax year 2010. In 2011, she would include $5,000 in gross income, which is the lesser of $5,000 (one-half of the income resulting from the conversion) or $8,000 (the remaining income from the conversion). In 2012, Andrea would include $3,000 in gross income, which is the lesser of $5,000 (one-half of the income resulting from the conversion) or $3,000 (the remaining income from the conversion ($10,000 – $7,000).

An unintended benefit may exist for those taxpayers not able to make deductible contributions to a traditional IRA or nondeductible contributions to a Roth IRA.

As a result of these tax provisions, there are several benefits in making direct rollovers to a Roth IRA. As stated above, the taxpayer will be able to make a direct rollover to his or her Roth IRA beginning in 2010 regardless of his or her modified AGI amount. The taxpayer doesn't need to make required minimum distributions from a Roth IRA.

An unintended benefit may exist for those taxpayers not able to make deductible contributions to a traditional IRA or nondeductible contributions to a Roth IRA. A case can be made for these disadvantaged taxpayers to make nondeductible IRA contributions in 2008, 2009, and even 2010 and then convert the entire amount in the traditional IRA into a newly established Roth IRA in 2010. The only amount included in gross income would be the earnings arising on the nondeductible contributions. Another benefit is that the taxpayer has established a Roth IRA. Keep in mind that the Roth IRA must be established for five years before distributions from the Roth IRA are excluded from gross income. Hence, the clock is started, and some future funds are now nontaxable and not subject to the required minimum distribution rules. **SF**

Richard P. Freedman is an associate professor of Legal Studies at Drexel University and is a partner in the firm of Angelini, Viniar & Freedman, LLP. He can be reached at (215) 895-2127 or freedmrp@drexel.edu.

Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa. You can reach Tony at (215) 895-1453 or curatola@drexel.edu.