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DENTAL PRACTICE ADVISORS

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The Roth Ruckus—New Opportunities for 2010

With the lure of tax-free distributions, Roth IRAs have become popular retirement savings vehicles since their introduction in 1998. But if you're a high-income taxpayer, chances are you haven't been able to participate in the Roth revolution. Well, new rules apply in 2010 that may change all that.

Overview:

- Beginning in 2010, you may "convert" IRA and retirement funds to a ROTH IRA regardless of your income level.
- You will need to pay income tax on the converted amount, but you escape future taxes. This could be important since tax rates are expected to rise. This tax can be spread over 2011 and 2012 if you choose.
- Beginning in 2010, you may designate all or part of your 401(k) deferral (\$16,500) as a non-deductible ROTH 401(k) regardless of your income level.

A little refresher. Contributions to a "Regular" IRA are tax deductible, just like contributions to a 401(k), Profit Sharing Plan, SIMPLE or SEP. In addition, the investment earnings grow tax free—until you take them out. (So they are actually tax "deferred", not tax "free".) With a ROTH IRA, the contributions are not deductible, BUT (within the rules) you never pay taxes on the distributions, including the growth. And neither do your heirs. As usual, there are trade offs, so let's look further.

What are the general rules for funding Roth IRAs?

There are four ways to get money into a Roth IRA:

- Contribute directly to a ROTH IRA
- Contribute to a ROTH 401(k) if your company retirement plan permits it (all Willeford-sponsored Plans permit this)
- Convert all or part of a traditional IRA or retirement plan to a Roth IRA
- A combination of the above!

1. Direct contributions to a ROTH IRA

In general, you can contribute up to \$5,000 to an IRA (traditional, Roth, or a combination of both) in 2010. If you're age 50 or older, you can contribute up to \$6,000 in 2010. (Note, though, that your contributions can't exceed your earned income for the year.)

But your ability to contribute directly to a Roth IRA depends on your income level ("modified adjusted gross income," or MAGI), as shown in the chart below:

The low ceiling on income makes the direct contribution approach ideal for children or new dentists whose income is still low.

If your federal filing status is:	Your contribution is reduced if your MAGI is:	You can't contribute to a Roth IRA for 2010 if your MAGI is:
Single or head of household	More than \$105,000 but less than \$120,000	\$120,000 or more
Married filing jointly or qualifying widow(er)	More than \$167,000 but less than \$177,000	\$177,000 or more
Married filing separately	More than \$0 but less than \$10,000	\$10,000 or more

2. Direct contributions to ROTH 401(k)

For the first time, **you can get around** the MAGI income limitations if you are a member of a 401(k) plan! If your plan permits, you may elect to specify that some or all of your own wage deferrals (up to \$16,500 in 2010) be identified as ROTH funds—regardless of your income level!

3. Convert existing IRA to ROTH IRA

Prior to 2010, you couldn't convert a traditional IRA to a Roth IRA (or roll over non-Roth funds from an employer plan to a Roth IRA) if your MAGI exceeded \$100,000. Beginning in 2010 the \$100,000 limit was removed. What this means is that, regardless of your filing status or how much you earn, you can now convert a traditional IRA to a Roth IRA. (There's one exception--you generally can't convert an inherited IRA to a Roth. Special rules apply to spouse beneficiaries.) And don't forget your SEP IRAs and SIMPLE IRAs. They can also be converted to Roth IRAs (for SIMPLE IRAs, you'll need to participate in the plan for two years before you convert). You'll need to set up a new SEP/SIMPLE IRA to receive any additional plan contributions after you convert.

4. A combination of the above

The law changes did not repeal the MAGI income limits that may prevent you from making annual Roth contributions of "fresh" money. But if your income exceeds these limits, and you want to make annual Roth contributions, there's an easy workaround. You can make nondeductible contributions to a traditional IRA as long as you have earned income at least equal to the contribution, and you haven't yet reached age 70 1/2. You can simply make your annual contribution first to a traditional IRA, and then take advantage of the new liberal conversion rules and convert that traditional IRA to a Roth. There are no limits to the number of Roth conversions you can make. (You'll need to aggregate all of your traditional IRAs when you calculate the taxable portion of the conversion--more on that below.)

Calculating the conversion tax

When you convert a traditional IRA to a Roth IRA, you're taxed as if you received a distribution with one important difference-- the 10% early distribution tax doesn't apply, even if you're under age 59 1/2. (The IRS may recapture this penalty tax, however, if you make a nonqualified withdrawal from your Roth IRA within 5 years of your conversion.)

If you've made only nondeductible (after-tax) contributions to your traditional IRA, then only the earnings, and not your own contributions, will be subject to tax at the time you convert the IRA to a Roth. But if you've made both deductible and nondeductible IRA contributions to your traditional IRA, and you don't plan on converting the entire amount, things can get complicated.

That's because under IRS rules, you can't just convert the nondeductible contributions to a Roth and avoid paying tax at conversion. Instead, the amount you convert is deemed to consist of a pro-rata portion of the taxable and nontaxable dollars in the IRA.

For example, assume that your traditional IRA contains \$350,000 of taxable

(deductible) contributions, \$100,000 of taxable earnings, and \$50,000 of nontaxable (nondeductible) contributions. You can't convert only the \$50,000 nondeductible (nontaxable) contributions to a Roth, and have a tax-free conversion. Instead, you'll need to prorate the taxable and nontaxable portions of the account. So in the example above, 90% (\$450,000/\$500,000) of each distribution from the IRA in 2010 (including any conversion) will be taxable, and 10% will be nontaxable.

You can't escape this result by using separate IRAs. Under IRS rules, you must aggregate all of your traditional IRAs (including SEPs and SIMPLEs) when you calculate the taxable income resulting from a distribution from (or conversion of) any of the IRAs.

Special deferral rule for 2010 conversions only

But even if you have to pay tax at conversion, the law change contains more good news--if you make a conversion in 2010, you can take advantage of a special deferral rule that applies only to 2010 conversions. You can report half the income from the conversion on your 2011 tax return and the other half on your 2012 return. Or you can instead elect to report all of the income from the conversion on your 2010 tax return.

Should you use the special 2010 deferral rule? The answer depends in part on your tax rate in 2010 versus what you think your tax rates will be in 2011 and 2012. Keep in mind that tax rates are scheduled to increase in 2011, if the Bush tax cuts are allowed to expire. The top tax rate will increase to 39.6% in 2011, up from 35% in 2010.

Is a ROTH right for you?

The answer to this question depends on many factors, including your current and projected future income tax rates, the length of time you can leave the funds in the Roth IRA without taking withdrawals, your state's tax laws, and how you'll pay the income taxes due at the time of the conversion.

And don't forget--if you make a Roth conversion and it turns out not to be advantageous (for example, the value of your investments declines substantially), IRS rules allow you to "undo" the conversion. You generally have until your tax return due date (including extensions) to undo, or "recharacterize," your conversion. For most taxpayers, this means you have until October 15, 2011, to undo a 2010 Roth conversion.

Ask your financial/tax advisor if a ROTH is right for you, and whether you should take advantage of the special deferral rule for 2010 conversions.

If you have any questions, please contact Rick at rickw@thewillefordgroup.com.