

New Roth IRA Opportunities for Higher Income Taxpayers

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First established in 1996, Roth IRAs have become a widely used tool in planning and saving for retirement. Unlike traditional IRAs, which provide tax advantages when an individual contributes to the account, Roth IRAs provide tax advantages when the funds are withdrawn at retirement. Because Roth IRA contributions are nondeductible, distributions from such accounts are typically not included in taxable income when received. Whereas, withdrawals from traditional IRAs are generally taxable as ordinary income.

For tax year 2009:

- The maximum contribution allowed to a Roth IRA for individuals under the age of 50 is \$5,000 annually, with an additional \$1,000 “catch-up” contribution allowed for individuals who are age 50 or above.
- The maximum contributions are limited to “earned” income (for example, wages or other income from self-employment).
- The ability to contribute to a Roth IRA phases out for single filers with an adjusted gross income between \$105,000 and \$120,000 and for individuals who are married filing jointly, with an adjusted gross income between \$166,000 and \$176,000.
- Individuals wishing to convert a traditional IRA to a Roth IRA may do so if income (determined with certain adjustments) does not exceed \$100,000 for the year. The amount converted is treated as a distribution from the traditional IRA without penalty and a contribution to the Roth IRA. The taxable portion of the amount converted is treated as taxable income in the year of the conversion.

Effective for tax years 2010 and beyond, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) eliminates the income limitations noted above. Additionally, for conversions made in 2010, unless a taxpayer elects otherwise, none of the gross income from the conversion is included in income in 2010; half of the income resulting from the conversion is includible in gross income in 2011 and the other half in 2012. A taxpayer may elect to pay the tax in 2010 if the tax rates for 2011 and 2012 increase significantly. Even though current income taxes are generally payable on the amount converted to a Roth IRA, such a conversion may produce an overall tax benefit for individuals who will be in the same or a higher tax bracket when the funds are withdrawn and can pay the tax from sources other than the IRA itself.

To maximize tax savings on conversion to a Roth IRA, individuals should contribute the maximum allowable amount to their IRA in 2009. Even for those not allowed to make deductible IRA contributions because of participation in an employer-sponsored retirement plan, tax benefits can be realized by making nondeductible IRA contributions. The income portion of such contribution will be subject to income tax upon conversion to a Roth IRA. Contributions to SEP and SIMPLE IRA accounts should also be maximized, as these balances can also be converted to a Roth IRA beginning in 2010.

However, if the account contains both deductible and nondeductible contributions, the distribution is deemed to consist of a pro rata portion of the taxable and nontaxable funds. Thus, so long as an IRA account contains both deductible and nondeductible contributions, it will not be possible to completely avoid income tax on a conversion. Said another way, it is not possible for a taxpayer to

decide that the portion of the account converted is only attributable to nondeductible contributions (which would be tax-free) if the taxpayer's IRA or aggregate of IRA accounts contain both deductible and nondeductible contributions.

Taxpayers can avoid the proration of distributions between taxable and nontaxable by transferring all of the funds that would otherwise be taxable out of the traditional IRA before enacting the conversion. This can be accomplished tax-free by rolling that portion that would be taxable (i.e., all of the previously deducted contributions and account earnings) to a qualified plan, such as an employer-sponsored 401(k). As a result, only the nondeductible contributions will remain in the IRA, and that amount can then be converted to a Roth IRA with no income tax consequences. The money that is rolled into the employer plan can then be rolled back to a traditional IRA after the conversion takes place (subject to the distribution provisions of the plan), or simply left in the new plan. Individuals without access to a qualified plan, such as a 401(k), should consider taking steps to become eligible under such a plan. This can be accomplished by establishing a new plan that allows for rollovers or amending those plans currently in existence.

Taxpayers who do not have any IRA accounts and are phased out of Roth contributions due to the AGI limits could contribute to a regular IRA account for 2009 as a non-deductible contribution. This contribution could then be converted to a Roth IRA in 2010 thereby circumventing the Roth contribution rules.

Taxpayers with taxable estates need to consider the estate tax implications of converting to a Roth IRA and paying the related taxes.