By Richard R. Shavell, CPA, CCIFP
Chairman, ABC National Tax Advisory Group
Shavell & Company, P.A.,

Converting Retirement Funds Into a Zero-Tax Vehicle

Did the late Senator from Delaware, William V. Roth, Jr. realize that his name would have an impact on how we all look at our retirement plans? A newly passed law taking effect in 2010 will encourage us to look even closer at whether or not we should make contributions to Roth IRA or Traditional IRA plans. By planning ahead, we can take the proper steps now to prepare for when the opportunity arrives.

Traditional versus Roth IRA

The fundamental difference is that while you may receive a deduction for contributions to a traditional IRA all proceeds are taxable when later distributed. With a Roth IRA, the initial contribution is never deductible. In exchange for using after-tax dollars all amounts when distributed will never be taxed. And, unlike the traditional IRA, you are not required to take distributions from a Roth IRA so you can build tax-deferred earnings for your heirs, who will never have to pay tax when amounts are eventually distributed. Like most laws there are many limitations preventing many from utilizing Roth IRAs such as annual income limitations.

Qualified rollover contributions until 2010

From now through 2009, you may be able to roll funds over from a regular IRA into a Roth IRA so the post-rollover income can grow tax-free in the Roth IRA, but only if your adjusted gross income (AGI), calculated with specified modifications, does not exceed $100,000 in the rollover year. The income resulting from the conversion is included on the tax return for the tax year in which funds are transferred or withdrawn from the traditional IRA. However, the usual 10% premature distribution penalty does not apply.

The difference between Roth and traditional IRAs can mean as much as 25% to 35% or more in retirement funds available after-tax, depending on timing of conversion.

New law

Becoming effective for tax years beginning after Dec. 31, 2009, the "Tax Increase Prevention and Reconciliation Act" removes the $100,000 AGI ceiling on conversions from a traditional IRA to a Roth IRA.

Further, a beneficial income inclusion rule applies for conversions occurring in 2010. Unless a taxpayer elects otherwise, none of the gross income from the conversion is included in income in 2010. Instead, half of the income resulting from the conversion is includable in gross income in 2011 and the other half in 2012, providing a two-year deferral on the tax impact.

For example, Steve's regular IRA has a $12,000 balance, consisting of deductible contributions and earnings. He does not have a Roth IRA. During 2010

continued on page 39

Rich Shavell, CPA, CCIFP is President of Shavell & Company, P.A. CPAs and Consultants in Boca Raton and Stuart, FL. Rich has been an advocate for contractors over the last twenty years presenting comments before the IRS on proposed regulations and testifying before the House and Senate on behalf of ABC. Currently, Rich serves as Chair of ABC's National Tax Advisory Group. Locally he serves on our Chapter's Legislative Committee and Rich is the 2005 winner of the South FL Business Journal's Excellence in Accounting Award in Construction. For more information visit www.shavell.net or call (561) 997-7242.

Converting Retirement Funds Into a Zero-Tax Vehicle

continued from page 14

Steve converts the traditional IRA to a Roth IRA. Unless he elects to include the entire conversion in income for 2010, $6,000 of the income resulting from the conversion is included in income in 2011 and $6,000 in 2012.

What are the implications?

For the high-income taxpayer with an AGI over $100,000 who would otherwise not be able to contribute to a Roth IRA, there are several factors to consider including:

• If marginal income tax rates at time of conversion are expected to be higher or remain constant (high) then a conversion might make sense. If rates are expected to be lower at retirement a conversion may not make sense.

• Age when contributions are made and the length of time investments will be able to grow tax deferred; generally the economic benefit of the Roth conversion increases the longer the taxpayer lives;

• From what funds will the tax on conversion be paid i.e. the retirement funds or from other savings? If from retirement savings the economic benefit of the conversion will be diminished.

• Whether it is better to recognize all of the conversion income in 2010 or defer that until 2011 and 2012.

There are studies being performed and software available to compute the tax cost/investment benefit of the conversion. The factors listed above will impact the computations, as would the expected rates of tax (at time of conversion and at withdrawal) and the rates of return on investments.

What to Do?

There are many scenarios that the taxpayer should consider in making these very complex decisions. For example:

• A high-income individual can make nondeductible contributions to a traditional IRA for 2006 through 2009 and then convert the IRA to a Roth IRA in 2010. Only earnings on the traditional IRA would then be taxable on the conversion.

• Consider the contractor who is not satisfied with his company's qualified retirement plan such as a 401(k). If he were to close that plan down and distribute the funds to the participants, then he, as a participant, could roll those funds into a regular IRA that would then be available for conversion into a Roth IRA in 2010 regardless of income level.

Time to Prepare

Alongside your qualified tax advisor, your first step is to evaluate your circumstances as 2010 approaches. If the analysis is that a conversion will make sense, then you can consider certain additional steps among which might be how to:

• Maximize the potential conversion amount by making contributions to your traditional IRA. If income limitations prevent deductible contributions consider nondeductible contributions;

• Minimize taxable income in the year the conversion is included in income to mitigate impact of potentially increased marginal rates (because of the inclusion of the converted income into taxable income).

Tax Laws Change

This conversion law is anticipated to bring tax dollars into the Treasury as conversions are implemented and additional tax is paid in 2010 through 2012. But what if Congress decides to eliminate this potential benefit as we approach 2010? Perhaps the right course is to evaluate your circumstances, consider what steps should be implemented, but only facilitate the steps that are not irreversible before 2010.