WITHUMSMITH+BROWN TAX BRIEF

Take Advantage of Roth IRAs in 2010

DECEMBER 31, 2009

BE IN A POSITION OF STRENGTH℠

On New Year's Eve many individuals make resolutions as the clock nears midnight. Some resolutions are to begin an exercise regimen to get in better health. Beginning in 2010, individuals can take advantage of Roth IRA conversions to better manage their future retirement needs in a tax-efficient manner.

After 2009, individuals will be able to roll over amounts in qualified employer sponsored retirement plan accounts, such as 401(k)s and profit sharing plans, and regular IRAs, into Roth IRAs, regardless of your adjusted gross income (AGI). In 2009, individuals with more than $100,000 of AGI as specially modified are barred from making such rollovers.

What's so attractive about a Roth IRA?

- Earnings within the account are tax-sheltered (as they are with a regular qualified employer plan or IRA).
- Unlike a regular qualified employer plan or IRA, withdrawals from a Roth IRA are not taxed if some relatively liberal conditions are satisfied.
- A Roth IRA owner does not have to commence lifetime required minimum distributions (RMDs) after he or she reaches age 70 1/2 as is generally the case with regular qualified employer plans or IRAs.
- Beneficiaries of Roth IRAs also enjoy tax-sheltered earnings (as with a regular qualified employer plan or IRA) and tax-free withdrawals (unlike with a regular qualified employer plan or IRA). They do, however, have to commence regular withdrawals from a Roth IRA after the account owner dies.

Here's how the Roth IRA works:
For 2010, individuals can contribute up to $5,000 to a Roth IRA (as long as they have compensation for the year at least equal to the contributed amount). The $5,000 limit will be increased when the cost-of-living index warrants it. Individuals age 50 or older can make additional contributions of $1,000. Therefore, the limit is $6,000 a year for people who will be age 50 (or older) during 2010.

MANAGE FUTURE RETIREMENT NEEDS BY TAKING ADVANTAGE OF A ROTH IRA NOW.

Questions or comments?
E-mail us at taxbriefs@withum.com

WithumSmith+Brown, PC
Certified Public Accountants and Consultants
New Jersey. New York. Pennsylvania. Maryland. Florida. Colorado.

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However, the maximum contribution allowance must be reduced by any contributions (deductible or nondeductible) made to traditional IRAs.

Unfortunately, there are some limits on Roth IRA contributions. For single taxpayers, if adjusted gross income (AGI) is $120,000 or more, no contribution can be made to a Roth IRA. If AGI is between $105,000 and $120,000, the $5,000 maximum contribution is phased out (reduced) according to a formula. For married taxpayers filing jointly, no contribution can be made if AGI is $176,000 or more, and the $5,000 maximum (per spouse) is phased out for AGIs between $167,000 and $177,000. For married taxpayers filing separately, the allowable contribution is phased out for AGIs between $0 and $10,000.

Contributions can be made to Roth IRAs even if you are a participant in a qualified plan and even after you reach age 70½. While no deduction is available for contributions made to a Roth IRA, taxpayers may be entitled to a credit (saver's credit) against tax for their contribution.

"Qualified" distributions from a Roth IRA are tax-free. Therefore, individuals can avoid tax on Roth IRA earnings forever (i.e., even at distribution). A distribution is qualified if made: once a taxpayer attains age 59½, upon death or disability, or (up to $10,000 per lifetime) for first-time homebuyer expenses. However, a distribution is not qualified if made within the five-year period beginning with the first tax year the individual made a contribution to a Roth IRA.

A nonqualified distribution is treated first as a nontaxable return of contributions. To the extent a nonqualified distribution exceeds contributions it is taxable and is also subject to a 10% penalty under the regular early withdrawal rules (i.e., the penalty will not apply if the distribution is made once you reach age 59½, or upon death or disability, or in other limited circumstances).

Conversion Opportunity

Individuals 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. Converting a regular IRA into a Roth IRA is treated as such a rollover.) Prior to 2010, individuals can roll funds over from a regular IRA to a Roth IRA only if their AGI, calculated with specified modifications, does not exceed $100,000 in the rollover year. Beginning in 2010, the $100,000 AGI ceiling on conversions from a traditional IRA to a Roth IRA will be removed. Any funds rolled over will be taxed under the regular IRA distribution rules as if there were no rollover. The 10% early withdrawal penalty will not apply to the rollover. However, if rolled over funds are withdrawn within the five year period that renders them taxable, the 10% penalty will apply to the withdrawal.

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The rollover will be fully taxed, assuming the rollover is being made with pre-tax dollars (money that was deductible when contributed to an IRA or money that wasn't taxed to an employee when contributed to the qualified employer sponsored retirement plan) and the earnings on those pre-tax dollars. For example, an individual who is in the 28% federal tax bracket and rolls over $100,000 from a regular IRA funded entirely with deductible dollars to a Roth IRA, they will owe $28,000 of federal tax. You may also incur an additional state income tax, depending on the state that you are a resident. So the individual will be paying tax now for the future privilege of tax-free withdrawals and freedom from the RMD rules.

Should you consider making the rollover to a Roth IRA? The answer may be "yes" if:

1. You have the liquidity to pay the income tax on the conversion from non-retirement plan funds.
2. You anticipate paying income taxes at a higher tax rate in the future than you are paying now.
3. You have a number of years to go before you might have to tap into the Roth IRA.
4. You are willing to pay an income tax price now for the opportunity to pass on a source of tax-free income to your beneficiaries.
5. Your IRA is depressed in value relative to its future appreciation potential.
6. Your IRA will be part of your taxable estate.

You also should know that Roth rollovers made in 2010 provide for a tax deferral opportunity and an unusual choice. If you make a rollover to a Roth IRA in 2010, the tax that you'll owe as a result of the rollover will be payable half in 2011 and half in 2012, unless you elect to pay the entire tax bill in 2010.

Why would an individual choose to pay a tax bill in 2010, instead of deferring it to 2011, and 2012? Absent Congressional action, after 2010, the tax brackets above the 15% bracket will revert to their higher pre-2001 levels. That means the top four brackets will be 39.6%, 36%, 31% and 28%, instead of the current top four brackets of 35%, 33%, 28% and 25%. The current Administration has proposed to increase taxes only for those making $250,000, but it is difficult to predict which taxpayers would be affected by higher income tax rates.

If you are considering taking advantage of this tax planning opportunity, or if you would like to discuss whether or not such a conversion would be both feasible and beneficial to you and your family given your current and future retirement needs, please call your local WS+B tax professional now to begin an analysis of a Roth IRA conversion.

If you have any questions, please contact the WS+B tax services team.

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