To Roth or Not to Roth?  
In 2010, That Is the Question

By Marc Horner, CIMA®, CPWA®

If your income level has made the Roth individual retirement account (IRA) unavailable, then 2010 is your year. Beginning in 2010, virtually anyone may be able to convert to a Roth IRA some or all of a traditional IRA and/or company-sponsored retirement plan. But the time to start taking action is now. Here is how:

1. Fund traditional IRAs with after-tax contributions. Because traditional IRAs have no income eligibility limits for after-tax-contributions, even high-income investors can contribute. Anyone with earned income can contribute, on an after-tax basis, up to $5,000 in 2009 (may be periodically adjusted for inflation) with an additional annual $1,000 in a catch-up contribution for those age 50 or older. You then can convert your traditional IRA to a Roth IRA in 2010.

2. Fund company-sponsored retirement plans with pre-tax and after-tax contributions. If you are able to participate in your company retirement plan, consider making the maximum annual pre-tax and after-tax contributions (many people are unaware of the ability to contribute as much as $49,000 per year to company-sponsored retirement plans—see the IRS 415 Limit). In 2010, if you are retiring or leaving your employer, or if your plan allows for in-service nonhardship withdrawals, you will be allowed to convert the plan distribution directly to your Roth IRA.

3. Continue contributing beyond 2010. Although income limits for Roth IRA contributions are scheduled to continue, under current legislation you can continue to make annual after-tax contributions to both your traditional IRA and your company retirement plan and then convert those contributions to a Roth IRA (provided your plan allows for after-tax contributions and in-service withdrawals).

Taxes—Can’t Avoid ‘Em, but You Have Choices

A conversion to a Roth IRA likely will generate an income tax liability. It is important to understand the calculation and planning options associated with that liability.

A. Defer tax payment. As a one-time 2010 benefit, the tax liability associated with assets converted to a Roth IRA may be stretched over the subsequent two tax years. Caveat: Actual taxes due will be determined according to the prevailing tax rates in the year the income is recognized. Therefore, if tax rates rise in the future, stretching the tax liability may result in a larger overall tax bill.

B. Convert early. Taxes due are calculated on the converted amount, not the year-end account value. For example, $250,000 converted to a Roth IRA in January that subsequently grows to $350,000 has effectively protected the incremental $100,000 from future income taxes (for both you and your heirs). Conversions early in the year are more powerful because they give converted assets more time to grow and, therefore, potentially offer more protection from future income taxes.

C. Tax mulligan. Should your converted Roth IRA decline in value or you decide the Roth is not for you, the IRS gives us a mulligan. Called “recharacterization,” the original conversion to the Roth is undone and the associated tax liability is eliminated. Caveat: Recharacterizations must be completed by your tax-return due date, with extensions. In the case of a recharacterization because of decline in value, you then can reconvert (after satisfaction of certain waiting periods), and begin the whole process again but now with a potentially smaller tax liability.

D. Plan to pay. To maximize the tax-deferred growth of your traditional IRA and the tax-free growth of your Roth IRA, it is best to plan to pay for the tax liability with non-IRA assets.

The Pro-Rata Rule—Be Aware

If your combined total IRA assets contain both pre-tax and after-tax assets, you need to be aware of the pro-rata rule. The taxable portion of your conversion will be determined by the ratio of pre-tax to after-tax assets. For example, let’s say your total IRA assets are worth $500,000 and $450,000 (90 percent) is pre-tax and the remaining $50,000 (10 percent) is after-tax. If you convert 20 percent or $100,000 to a Roth IRA, the conversion amount will be taxed as follows:

- $90,000 (90 percent) converts and is taxed
- $10,000 (10 percent) converts tax-free

If you have multiple IRA accounts (traditional IRA, SEP-IRA, SIMPLE IRA, and/or rollover IRA), this ratio will be based on the combined pre-tax and after-tax assets from all of your IRAs.

Roth Wrap-Up

In 2010 and going forward, income limits are eliminated on conversions to Roth IRAs. Taxes due on conversions are determined by your personal income tax bracket and the pro rata rule. 2010...
is the one-time opportunity to stretch this income tax liability over multiple tax years. Satisfying this tax liability with non-IRA assets is generally best.

Conversions early in the year are best. We all have a tax mulligan called recharacterization. Roth conversions are not all-or-nothing decisions; you can convert some or all of your eligible assets. The opportunity to convert continues beyond 2010. To maximize the conversion opportunity, consider a coordinated savings plan including your traditional IRA as well as your company-sponsored retirement plan (provided the plan contains certain provisions).

Finally, and most importantly, the Roth IRA conversion decision and ongoing management is complicated and not for everyone. To make an informed decision, it is critical to include in the process your financial advisory team. Together, you can evaluate whether a Roth conversion should be a part of your overall financial plan.

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