Opportunity may be knocking with Roth IRA rule changes

That sound you hear with the flipping of your 2010 calendar just may be opportunity knocking. The rules governing eligibility requirements for converting a traditional Individual Retirement Account (IRA) or rollover from a qualified employer plan to a Roth IRA have changed.

A Roth IRA offers certain tax benefits different from traditional IRAs or qualified retirement plans. While contributions to Roth IRAs are not tax deductible on a taxpayer's federal income tax return, Roth funds have the potential to grow income tax-free at the federal level.

Beginning Jan. 1, 2010, the $100,000 modified adjusted gross income ceiling that prevented many people from converting IRAs or rolling over qualified retirement plans like 401(k)s to Roth IRAs was repealed. Limitations related to married taxpayers who file separately also disappeared.

In addition, individuals who convert traditional IRAs or roll over qualified retirement plans to a Roth IRA in 2010 have the option to either pay taxes on all of the conversion income in 2010 or to report 50 percent of the conversion income in 2011 and 2012 income.

Conversions to a Roth IRA are not pain free. You will have to pay federal and possibly state income taxes on all of the tax-deferred money moved from your traditional IRA or qualified retirement plan. In addition, you cannot withdraw the assets that are moved into the account for five years or before reaching age 59 ½, if you take a non-qualified distribution you will be required to pay a 10 percent penalty tax.

Both traditional IRAs and qualified retirement plans are taxed upon withdrawal at ordinary income rates and require mandatory withdrawals at certain ages. Qualified Roth IRA distributions avoid both.

There are reasons why this conversion process is attractive, especially in 2010.

1. Converting "locks in" taxes at current rates. For those who think future tax rates will be greater than current rates, conversion now may make sense.
2. Earnings inside a Roth IRA are tax-free for qualified distributions. This feature makes them more efficient vehicles than many other long-term savings plans.
3. Required minimum distribution (RMD) rules (mandatory withdrawals at certain ages for traditional IRAs) do not apply to Roth IRAs. This means you aren't forced to accept income that could push more of your Social Security benefit into your taxable income.
4. The Roth IRA conversion rules apply to distributions from employer-sponsored retirement plans.
5. Converting to a Roth IRA is simple. Just notify the organization holding your traditional IRA or qualified rollover contribution that you want to convert all or part of your account to a Roth IRA. These companies then provide you the needed paperwork.

The limit for IRA contributions (not conversions) for 2009 and 2010 is $5,000 per year for individuals ($6,000 if age 50 and over) and $10,000 for married couples ($12,000 if age 50 and over). To be able to contribute the maximum IRA contribution to a Roth IRA in 2010 you must have a modified adjusted gross income of less than $105,000 (single) or $167,000 (Married, filing jointly) for 2010.

Some states have not yet adopted the federal rules, and there may be conflicts between federal and state tax treatment of a Roth IRA conversion. Consult your tax professional for your state's tax rules as well as a financial professional to determine the proper course of action for your situation.

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