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ROTH IRA ALERT

What is a Roth IRA?

A Roth IRA is a special type of IRA. There are several significant differences between IRAs and Roth IRAs. For example, one's eligibility to contribute to a Roth IRA is subject to special gross income limits; contributions to a Roth IRA are never deductible; qualified distributions from a Roth IRA to the owner or to the owner's beneficiaries are not taxable; the required minimum distribution (RMD) rules do not apply to a Roth IRA during the lifetime of the owner; and contributions to a Roth IRA can be made even after the owner has attained age 70½.

Are distributions from a Roth IRA taxable?

Qualified distributions from a Roth IRA are not taxable. A qualified distribution is a distribution that satisfies a five-year holding period requirement and that is made (1) when the owner is age 59½ or older, (2) on account of the owner's death or disability, or (3) as a qualified first-time homebuyer distribution.

If a distribution from a Roth IRA is not a qualified distribution, then, subject to an ordering rule, only the portion of the distribution allocable to earnings on the contributions made to the Roth IRA will be taxable. Under the ordering rule, distributions from a Roth IRA are treated as made from contributions first. Thus, no portion of a nonqualified distribution from a Roth IRA is treated as attributable to earnings (and therefore taxable) until the total of all distributions from all the individual's Roth IRAs exceeds the aggregate amount of the Roth IRA contributions.

Do the RMD rules apply to a Roth IRA?

Unlike an IRA, the RMD rules do not apply during the lifetime of the Roth IRA owner. Thus, the Roth IRA owner can delay indefinitely when distributions will commence. However, the after-death minimum distribution requirements do apply to the Roth IRA owner's beneficiaries.

If the surviving spouse is the sole beneficiary of the Roth IRA, then, upon the death of the Roth IRA owner, the surviving spouse is treated as the Roth IRA owner. Because the lifetime RMD rules will not apply to the surviving spouse, the surviving spouse can also delay indefinitely when distributions will commence.

If a non-spouse is the beneficiary of the Roth IRA, then, upon the death of the Roth IRA owner, the Roth IRA must be distributed either (1) by December 31 of the year containing the fifth anniversary of the Roth IRA owner's death, or (2) over the life expectancy of the designated beneficiary, with distributions starting no later than December 31 of the year following the year of the Roth IRA owner's death.

May an individual convert an IRA into a Roth IRA?

Before 2010, an individual may convert an IRA into a Roth IRA only (1) if the individual's gross income for the taxable year does not exceed $100,000, and (2) if the individual is married, the individual does not file a separate federal income tax return for the taxable year.

Beginning in 2010, the $100,000 gross income limit is eliminated. Thus, all individuals, including married persons filing separate returns, are permitted to make such conversions without regard to their gross income.

What are the income tax consequences of the conversion of an IRA into a Roth IRA?

A conversion of an IRA to a Roth IRA is taxable to the same extent as if the amount in the IRA was distributed to the owner.

If a conversion to a Roth IRA occurs after 2010, the taxable portion of the conversion amount will be includible in income for the year of the conversion. *However*, if the conversion occurs in 2010, then, unless the individual elects otherwise, the income from the conversion will not be taxable in 2010; instead, one-half of the income resulting from the conversion will be taxable in 2011 and the other one-half in 2012.

May an individual reverse a conversion of an IRA into a Roth IRA?

Yes; an individual can change his or her mind and undo the Roth IRA conversion. This is called a "recharacterization."

An individual may choose to recharacterize a Roth IRA conversion if the converted IRA assets decrease in value. As noted, the conversion of an IRA into a Roth IRA is a taxable event; and, if the converted IRA assets decrease in value, the individual would be subjected to a greater income tax than necessary. By recharacterizing the Roth IRA conversion back to an IRA, the income tax on the converted amount will be avoided. Thereafter, the individual may again convert the IRA to a Roth IRA.

This recharacterization election must be made on or before the due date (including extensions) for filing the individual's federal income tax return for the taxable year for which the conversion was made. If an individual makes a Roth IRA conversion in 2010, the individual may recharacterize the conversion on or before April 15, 2011, or, with an extension to file, as late as October 17, 2011.

Can multiple recharacterizations be made?

Yes; but an IRA owner who converts an amount from an IRA to a Roth IRA and then makes a recharacterization election may not reconvert that amount from the IRA to a Roth IRA before the beginning of the year following the year in which the conversion occurred or, if later, 31 days after the IRA owner made the recharacterization.

May a qualified retirement plan (QRP) distribution be rolled over to a Roth IRA?

Yes; QRP benefits may be directly rolled over to a Roth IRA. The rules that apply to a conversion of an IRA into a Roth IRA also apply to a rollover from a QRP to a Roth IRA.

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The conversion of an IRA into a Roth IRA offers significant income tax and estate tax planning opportunities, and it may be a planning strategy you should consider. We will work closely with your accountant and investment advisor to help you make this decision; and, if you make the conversion, we can help you integrate your new Roth IRA into your estate plan.

For more information, call Stephen J. Krass at (212) 683-3636 (ext. 200) or Lee A. Snow at (212) 683-3636 (ext. 230).

For more about our firm, visit our website at ksslaw.net.

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