

Roth Conversions and Their Tax Consequences

With the upcoming 2010 law changes that will liberalize conversions to Roth IRAs, our ERISA consultants on the Columbia Management Resource Desk have been answering an increasing number of calls from financial advisors who have specific questions about Roth IRA conversions and the tax implications for their clients.

In 2010, significant changes to Roth IRA conversions will occur. First, the \$100,000 modified adjusted gross income (MAGI) limit for conversion eligibility will be eliminated. Second, the joint filing requirement for married individuals will be eliminated, and third, individuals who convert assets to Roth IRAs in 2010 may choose to spread the taxable amount of the conversion—pro rata—over 2011 and 2012. Alternatively, they may choose to include the taxable amount as income for 2010. (Note: Individuals who convert before and after 2010 must include the taxable amount of the conversion in income in the year of the conversion.)

Through our relationship with the Columbia Management Learning Center, we regularly guide Columbia Management's financial advisor partners through the rules and regulations that apply to Roth IRA conversions. A recent call with an Ameriprise advisor in Virginia is representative of a typical question on this subject. The advisor queried: How does a taxpayer determine the taxable amount of a Roth IRA conversion?

Highlights of Recommendations

- If an individual converts an IRA or qualified plan to a Roth IRA, he/she must pay taxes on any pre-tax assets that are converted.
- If an individual has both pre-tax and after-tax IRA or qualified plan assets, the IRS requires him/her to treat a conversion amount as consisting of a pro rata share of pre-tax and after-tax dollars.
- A taxpayer, with the assistance of his/her tax professional, calculates the taxable portion of an IRA-to-Roth IRA conversion by completing IRS Form 8606, *Nondeductible IRAs*. This calculation takes into consideration the pre-tax and after-tax contributions in all of the taxpayer's non-Roth IRAs to determine the taxable portion.
- A plan participant who converts his/her 401(k) to a Roth IRA does not use IRS Form 8606 to determine the taxable portion of a conversion but, instead, is subject to the basis recovery rules applicable to qualified retirement plans for post-1986 after-tax assets. (Pre-1987 after-tax assets may be distributed without associated pre-tax earnings.) The plan administrator is responsible for reporting the taxable and nontaxable portion of a qualified plan-to-Roth IRA conversion on IRS Form 1099-R.

Conclusion

Determining the taxable portion of a Roth IRA conversion is a complicated matter, and clients should consult their tax professionals for precise information. Nevertheless, it is important for financial advisors to have a general understanding of the rules. That's why having a reliable source available, such as the Columbia Management Resource Desk, to guide advisors through the Roth conversion rules can turn a difficult client question into an opportunity to differentiate the advisor and build relationships.