Roth IRA Conversions Offer Tax Free Distributions: Companies with Net Operating Losses Benefit

By Craig Phillips, CFP™

In 2010, the limitation on income was lifted and all investors, including high income individuals, became eligible for the opportunity to convert traditional individual retirement accounts (IRAs) and qualified retirement accounts to Roth IRAs. This presents an unprecedented retirement planning opportunity as this conversion was once limited only to those taxpayers with less than $100,000 adjusted gross incomes.

Conversion from an IRA or 401(k) to a Roth IRA is usually taxed as ordinary income for the year in which the account was converted. However, if the conversion occurs in 2010, the person can elect to defer this income until 2011 and 2012 (claim only 50 percent of the income per year). This is a one-time opportunity that only applies to conversions made in 2010. Any Roth IRA distributions made in the future after the age of 59 1/2 will then be tax free as long as distributions are not taken within five years of the first contribution. This tax advantage can often make a Roth IRA a better retirement option than a 401(k) or traditional IRA, especially since it looks likely that taxes will rise in the near future, perhaps significantly.

A Roth IRA's primary advantage is that withdrawals from a Roth IRA are generally tax-free and come with fewer withdrawal restrictions and requirements than a traditional IRA. Like traditional IRAs, transactions inside the Roth IRA account do not incur a current tax liability.

One of the greatest advantages of the Roth conversion is for companies with a Net Operating Loss (NOL) where the corporate structure is a tax pass through (Sub-S, partnership, etc.). The conversion to a Roth IRA can offset the total cost of converting the IRA or 401(k). Known as the "NOL Deduction," losses from a previous year are shown as deductions for the current year's tax return.

In this financial downturn, owners in a number of industries are well suited to take advantage of this conversion opportunity. For example, construction companies that have been battered in the past couple of years, are one of several sectors where owners of IRAs, 401(k)s and pension funds are converting to Roth IRA accounts, often on a tax-free basis.

Roth IRA conversion tax benefits to business owners include:

- Roth IRA owners may withdraw up to the total of the converted amount without penalty, five years after the first contribution.

- In the event Roth IRA owner dies, the surviving spouse is permitted to merge the inherited Roth IRA with his/her Roth IRA account without penalty.
- Roth IRA assets can be passed on to heirs. Minimum distribution rules may apply.
- Distributions in a Roth IRA are not age-dependent. This is a great way to accumulate income tax-free and keep assets protected for heirs to the account.
- Roth IRAs offer creditor protection in Florida.

Roth IRA conversions have been made with the understanding that the transaction can be undone by re-characterizing it back to a traditional IRA prior to the clients' tax filing deadline if it makes sense to do so (i.e., market value drops significantly between the conversion and tax filing deadline).

Many more advantages of a Roth conversion exist including tax diversification, no required minimum distribution at age 70 1/2 and a hedge against future tax increases, which may occur if the Bush tax cuts, also known as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRAA), expire in tax year 2011 if Congress does not renew them.

Converting to a Roth IRA is a great retirement and tax planning alternative to traditional retirement accounts. With restrictions lifted, now is a prime time for everyone with an IRA or 401(k) to consider conversion to a Roth IRA, especially those with companies suffering net operating losses.

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