Defined Benefit Plan Funding

The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (Pub. L. No.111-192) provides short term relief from the normal minimum funding requirements for defined benefit plans. The Service has issued Notice 2010-55, 2010-33 I.R.B. 253 (for single-employer plans), Notice 2010-56, 2010-33 I.R.B. 254 (for multiemployer plans), and Notice 2011-3, to be published in 2011-2 I.R.B.

Hybrid Pension Plans

In October, 2010, the Treasury Department issued final regulations (75 Fed. Reg. 64123) providing guidance on sections 411(a)(13) and (b)(5), enacted by the Pension Protection Act of 2006 (Pub. L. No. 109-280) and amended by the Worker, Retiree, and Employer Recovery Act of 2008 (Pub. L. No. 110-458). The regulations generally apply to plan years beginning after December 31, 2010. Treasury also released proposed regulations (75 Fed. Reg. 64197), addressing issues under section 411 that were not addressed in the final regulations.

Most hybrid pension plans must be amended to reflect the new requirements. Under Notice 2009-97, 2009-52 I.R.B. 972, the amendments are due by the end of the 2010 plan year. Notice 2010-77, 2010-51 I.R.B. 851, modified Notice 2009-97 and extended the deadline to the last day of the first plan year that begins on or after January 1, 2011.

The Small Business Jobs Act of 2010 (Pub. L. No. 111-240)

On September 27, 2010, the President signed the Small Business Jobs Act, which (1) allows 401(k) and 403(b) plans to give participants the option of transferring money from a pre-tax account to a Roth account within the plan and (2) allows governmental 457(b) plans to offer Roth accounts and Roth conversions, beginning in 2011. These changes are discussed elsewhere in this issue. *See* Scott D. McMillen, *In-Plan Roth Conversions.*

Generally, when a self-employed individual calculates net earnings for self-employment taxes, no deduction is allowed for health insurance costs. The Act permits a one-time exception to this rule for the taxable year beginning in 2010. I.R.C. § 162(l)(4).

The Act amends section 72(a) to provide rules governing the partial annuitization of an annuity, endowment, or life insurance contract, effective for amounts received in taxable years beginning after 2010.

The Act also (1) increases reporting penalties (I.R.C. §§ 6721 & 6722) for information returns required to be filed on or after January 1, 2011 (including 2010 1099s and W-2s), and (2) removes cell phones and similar telecommunication equipment from the definition of "listed property" (I.R.C. § 280F(d)(4)), effective for taxable years beginning after 2009. ■

Some Immediate and Long-Term Advantages of a Roth IRA Conversion

By William K.S. Wang*

Initial Analysis

Suppose I have three bank accounts, each with $100. The first two bank accounts are in traditional IRA accounts with a zero basis. (These traditional IRA accounts may have been converted from 401(k) accounts at a prior employer.) The third account I own outright.

For simplicity, assume the federal income tax rate is a flat 50% and will remain at that level forever. Further assume there will never be state income taxes. (This article could just as well have assumed some other rate, such as 33⅓%, but 50% requires an analogy to only three accounts, while 33⅓% requires an analogy to four accounts.)

In effect, the Service has a half ownership in my two traditional IRA $100 bank accounts. If I withdraw part or all of the money from the IRA, I must pay the Service half. The Service is like a 50% partner.

If I convert the $200 in the traditional IRA accounts to a Roth, I must pay $100 in income tax. In effect, for $100, I am buying out the Service's 50% partnership interest. In other words, if I give the Service the $100 bank account I own outright, the Service conveys to me its half ownership in the two traditional IRA $100 bank accounts.

I start out with $100 outright and $200 in a 50% partnership with the Service. I end up with $200 in a Roth IRA that I own outright. I give up $100 to get $100. From a net worth perspective, the result is a wash. My net worth remains $200.

Going forward, however, I have certain immediate and long-term advantages.

1. Interest on the $100 bank account that I owned outright was subject to income tax. Interest on the Roth IRA bank accounts is not subject to income tax, and all $200 of those accounts are now mine (versus only $100 earlier).

* Professor, University of California, Hastings College of Law. Professors Ellen Aprill, Stephen Cohen, Clark Freshman, Saul Levmore, Francine Lipman, Malcolm Morris, Stephen Schwarz, and Ahmed Taha made valuable comments on earlier drafts.

2. Unlike the traditional IRA, my Roth IRA has no required minimum distributions starting at age 70½. I can keep the Roth IRA until I die and leave the entire amount to my child (who may take distributions over her lifetime, and never pay any income tax).
3. By paying the $100 in income taxes, I reduce my estate by $100. Before, although my net worth was really $200 (because of the $100 income tax due on the traditional IRAs), my estate was $300. (Of course, a $300 estate is not taxable, and my estate might qualify for the spousal deduction. Nevertheless, I might leave this $300 to my child and leave a sufficient amount of other assets to my child to make this $300 subject to estate tax.)

Suppose I did *not* convert and were to die upon turning age 70. Assume I did not take any distribution from my ($200 plus interest) traditional IRA and left all my assets to my child. All three bank accounts ($300 plus interest) would be in my estate. The Service would still have a half ownership in the traditional IRA accounts ($200 plus interest) that went to my child. Interest on the third ($100 plus after-tax interest) bank account would have been taxed during my lifetime and would continue to be taxed while held by my child.

Assume instead that I convert to a Roth IRA this year (at, say, age 65) and die when turning age 70. Of the original three accounts, only the two Roth IRA accounts would be in my estate ($200 plus interest). Interest on these Roth IRA accounts would never be subject to income tax (in my remaining lifetime and my daughter's).

Alternate Analysis

Again, suppose I have three bank accounts, each with $100. The first two bank accounts are in traditional IRA accounts with a zero basis. The third account I own outright.

Again, assume the federal income tax rate is 50% and will remain 50% forever and that there will never be state income taxes. In effect, the Service has a half ownership in my two traditional IRA $100 bank accounts.

Under current law, under certain circumstances, a taxpayer whose adjusted gross income does not exceed a prescribed limit can open a Roth IRA account (and can use existing savings for that purpose). *See* I.R.C. § 408A(c)(3). What if the Code were amended to remove the income limitation and allow me to convert the third $100 bank account (the one I own outright) to a Roth IRA with no tax (and also allow me to withdraw from the Roth at any time with no tax)? Naturally, I would convert the third account to a Roth IRA.

In effect, I would have three identical bank accounts:

1. two traditional IRA $100 accounts, one "owned" by me and one "owned" by the Service.
2. one Roth IRA $100 account.

The $100 Roth IRA would cancel out the $100 account "owned" by the Service. Whenever I wanted to liquidate entirely the two traditional IRA accounts, I could also liquidate the Roth IRA and have just enough to pay the tax. The advantage of the Roth IRA over the $100 bank account I had before is that the Roth IRA would grow tax free. I would be better off.

Assume, however, that the Code does *not* allow me to convert the third bank account (the one I own outright) into a Roth IRA or even a traditional IRA. Nevertheless, I can accomplish the same result by converting my traditional IRAs into a Roth and using the third account to pay the tax on conversion. I no longer have the third account, but I also no longer have any tax liability on the traditional IRA. I have $200 that I own outright and on which I shall never owe any tax (except in very rare instances).

Of course, in both analyses above the major simplifying assumption is the constant and uniform income tax rate. In reality, rates are not constant and uniform. Conversion of a large amount to a Roth might in fact thrust me into a higher marginal income tax bracket. In addition, I do not know what my (or my child's) marginal tax rate would be at the time of withdrawal from the traditional IRA. Also unknown is the age at which I shall die. With the traditional IRA, I must start taking minimum distributions at age 70½. Nevertheless, the analysis with the simplifying assumptions demonstrates the potential advantage of a Roth IRA conversion.

Using the Opportunity to Recharacterize the Conversion When Investing in Stocks

If I convert to a Roth, the Code allows me to recharacterize (rescind) the conversion by a certain deadline the following year. *See* I.R.C. § 408A(d)(6). If my Roth IRA is invested in stocks, the opportunity to recharacterize the conversion offers a "heads I win, tails the Service loses" opportunity.

This analysis begins with the three accounts, but with another type of asset in two of the accounts. I have three accounts, each with $100. Two are traditional IRA accounts (with a zero basis) invested in *stocks*. The third is a $100 bank account that I own outright. Again, assume federal income taxes are 50% and will remain 50% forever and that there will never be state income taxes.

If I convert the $200 in the traditional IRA accounts to Roth accounts, I must pay $100 in income tax. In effect, for $100, I am buying the Service's 50% partnership ownership. My $100

investment in stocks increases to $200 because of elimination of the tax liability.

Stocks Increase in Value

Assume that by the deadline for recharacterization, the stocks in my Roth IRA accounts double in value from $200 to $400. By effectively increasing my $100 stock investment to $200 through the Roth conversion, I gained an extra $100, as explained in the next paragraph.

Suppose I had not converted. Ignoring bank account interest, I would have a bank account of $100. My $200 in traditional IRA stock accounts would have doubled in value to $400. Taking into account the Service's 50% ownership, my interest would be worth $200. This $200 plus the $100 bank account results in a total of $300. The conversion made me $100 better off.

If I wished, after the conversion and the increase in stock value, I could balance my investments by shifting one of the $200 Roth IRA stock accounts into a bank account. I would then have a $200 Roth IRA invested in stocks and a $200 Roth IRA in a bank account.

Stocks Decrease in Value

Suppose that by the deadline for recharacterization, the stocks in my Roth IRA accounts *decline* 50%, from $200 to $100. I can then recharacterize my Roth conversion. In effect, I convey back to the Service a 50% interest in my IRA accounts (worth $50) and receive in return the $100 in taxes paid upon conversion. Ignoring bank account interest, my situation is the same as if I had never converted. I have traditional IRAs worth $100 (of which the Service owns 50%) and a $100 bank account.

In short, the opportunity to recharacterize my Roth conversion (by a certain deadline) enables me to invest some money in stocks and enjoy the gains but avoid the losses. If the stock market goes up, I enjoy the gains on $200 worth of stock. If the market goes down, I suffer the losses on only $100 worth of stock. I could even open numerous *separate* Roth IRA accounts in different asset classes. If some accounts appreciate and others depreciate, I can recharacterize the ones that decline.

After recharacterization, I can then *re*convert to a Roth IRA after waiting 30 days or until the tax year following the tax year of the initial Roth IRA conversion, whichever is later. *See* Treas. Reg. §§ 1.408A-5, 1.408A-9.

As before, I hypothesize a constant and uniform income tax rate. Throughout, I also assume that the Congress will not amend the Code to tax distributions from previously created Roth IRAs. ■

In-Plan Roth Conversions

By Scott D. McMillen*

Background

On September 27, 2010, Congress enacted the Small Business Jobs Act of 2010 (Pub. L. No. 111-240) ("the Act"). Sections 2111 through 2112 of the Act contain plan participant friendly provisions for certain types of retirement plans.

Specifically, Section 2112 of the Act amends section 402A, which allows plan participants to make Roth contributions to retirement plans. Newly enacted Act section 2112, at the most fundamental level, allows compatible plans to convert non-Roth contributions into Roth contributions within the existing retirement plan (*i.e.*, without rolling over amounts to a Roth IRA).

The Act's conversion provision was effective immediately for certain retirement plans, but did not come into effect for others (*e.g.*, section 457(b) eligible plans) until the beginning of the 2011 taxable year. However, in order to access the benefits of section 2112, most plans will need to consider and proceed upon a mixture of plan modifications to allow participants the opportunity to utilize the newly enacted provisions. This short article discusses some of the new law's nuances. It also discusses plan sponsor and plan participant considerations for Roth conversions under section 2112.

Mechanics of Conversion

In order to take advantage of the leeway afforded by the Act, a retirement plan must satisfy a number of qualifiers. First, conversion ability is limited to section 401(k), 403(b), and 457(b) plans. Thus, money purchase plans and profit sharing plans without a CODA feature are not eligible for conversion. Second, the plan must allow participants to make Roth contributions. This requires the plan to allow participants to make Roth contributions as a prerequisite before allowing participants to execute a Roth conversion. Third, upon conversion the plan must separately account for the converted pre-tax deferrals within a separate Roth conversion account. Fourth, the conversion is applicable only for amounts that are otherwise considered eligible rollover distributions under the plan. Generally, this means that distributions upon attaining age 59½, upon a separation from service, death, or disability, or that are considered

* Senior Consultant, National Tax Department – Performance & Reward, Ernst & Young LLP, Cleveland, OH.