Retirement Benefits Planning Update

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Retirement Benefits Planning Update provides information on developments in the field of retirement benefits law. The editors of *Probate & Property* welcome information and suggestions from readers.

Roth IRAs—The Siren Call of the Tax Free Stretch Out

Setting aside the income tax cost of getting funds into a Roth IRA account (discussed below), a Roth IRA provides an income tax free investment fund for the life of the account owner (and, potentially, the joint lives of the account owner and the account owner's spouse) because the lifetime portion of the minimum required distribution (MRD) rules of Code § 401(a)(9) do not apply to a Roth IRA. Code § 408A(c)(5). The post-death MRD rules do apply beginning in the distribution calendar year following the account owner's (or, if a surviving spouse designated beneficiary elects to treat the Roth IRA as the spouse's own, in the year following the surviving spouse's death) as if the account owner (or surviving spouse) had died before the required beginning date. Accordingly, if there is a designated beneficiary of the account owner (or of the surviving spouse) and the rule that otherwise requires the account to be fully distributed by the end of the year in which the fifth anniversary of the account owner's (or spouse's) death occurs is thus avoided, MRD payments may be made over the life expectancy of the designated beneficiary. Code § 401(a)(9). The younger the beneficiary, the longer period for tax free growth of the account continues. Code § 401(a)(9)(B).

If the Roth IRA has existed for five taxable years, all distributions made after the account owner attains age $59\frac{1}{2}$ or dies, on account of the account owner's disability or as a distribution to a first-time home buyer under Code § 72(t)(8), are qualified distributions and are not included in the distributee's gross income. Code § 408A(d)(2)(A)(iv). The five taxable year period (the non-exclusion period) begins on the first day of the account owner's taxable year for which a regular contribution is made or, if earlier, on the first day of the taxable year in which a conversion contribution is transferred to (or distributed from a traditional IRA for transfer to) any Roth IRA established by the account owner (all Roth IRAs being aggregated for purposes of the tolling of the five-year rule). Code § 408A(d)(2)(B); Treas. Reg. § 1.408A–6, A-2. For example, if an initial regular contribution is made on or before April 15, 2006, for the 2005 taxable year, the five-year period begins on January 1, 2005. If an account owner dies, the account owner's five taxable year period continues to apply except that, in the case of a surviving spouse designated beneficiary who elects to make the account his or her own account and also has an existing Roth IRA, the shorter of the account owner's or the surviving spouse's five taxable year period applies. Code § 408A(d)(2)(B); Treas. Reg. § 1.408A-6, A-7(a) and (b).

Even if distributions must be made before the five taxable year period has run (nonqualifying distributions), ordering rules soften the effect that Code § 72 would otherwise have on the taxability of the distributions. Under a set of ordering rules, the distributee is generally treated as first receiving the amount of regular contributions made to the Roth IRA and then conversion contributions (in each case, amounts already included in the account owner's gross income and not again subject to tax) before being considered to receive earnings of the Roth IRA, which would be includable in gross income. Code § 408A(d)(4)(A). Note that the 10% penalty tax for premature distributions of Code § 72(t) will be assessed if a distribution is made from a Roth IRA to a pre-age $59\frac{1}{2}$ account owner in a year that is within five years of the conversion and the distribution is allocable under the ordering rules to the conversion amount previously included in gross income. This is so even though the distributed amount is not, itself, included in gross income for the year of distribution. The five taxable year rule for this purpose begins with the first day of the taxable year in which the conversion occurred. Code § 408A(d)(3)(F).

Catch 22—The Contribution/Conversion AGI Limits

The economics that underpin the retirement benefit policy reflected in the provisions of the Code other than those for Roth IRAs are predicated on the assumption that deferring taxable income that would otherwise be subject to income tax at the presumed higher tax brackets that apply during a wage earner's productive years until retirement (when presumably lower tax brackets would apply) maximizes retirement benefits. A Roth IRA is instead designed to accelerate income tax payments by having the account owner forgo an otherwise available deductible contribution to a traditional IRA or pay income tax on the conversion of all or part of a traditional IRA into a Roth IRA. In a general way, the conversion to a Roth IRA is tax neutral if the rates of tax, rates of investment return, and distribution dates are the same. The account owner pays tax on the present value of the benefit amount as compared to paying tax on the future value of the benefit amount as it is distributed. Unless an account owner expects to be in a higher income tax bracket following retirement (a relatively infrequent expectation) or intends to leave the Roth IRA intact during his or her lifetime to obtain a stretch out distribution of the increased account value for designated beneficiaries following the account owner's death, the income tax cost of funding a Roth IRA would seem prohibitive (particularly, in the case of substantial conversions of traditional IRA accounts).

Even if the account owner is over age 59½ (so that there is no risk of the 10% penalty on premature distributions), withdrawing funds from the Roth IRA to pay the up-front income tax cost of a conversion or to pay estate tax caused by the inclusion of the Roth IRA in the account owner's taxable estate undercuts the stretch out aspect of the Roth IRA—the ultimate benefit of the arrangement. To make the up-front income tax cost worthwhile, the tax costs (income and estate) of the Roth IRA contributions should come from the account owner's other assets. In effect, the payment of up-front taxes from other assets makes the Roth IRA the equivalent of a capital asset with the added benefits that (1) the asset can be diversified without an income tax cost and (2) all future income and appreciation the asset generates will be income tax free. An individual whose income is below the adjusted gross income caps for Roth contributions described below may not have sufficient net worth to finance the cost of a conversion or to systematically forgo income tax deductions. For the wealthy account owner who has the financial ability to prime the pump, two statutory provisions, one phasing in for 2006 and future years and a second already in effect for 2005, widen the eye of the needle.

Regular Roth IRA Contributions

Regular contributions to Roth IRAs at the levels permitted for IRAs generally are available, in whole or in part, only to those account owners whose "modified" adjusted gross income (MAGI) falls below the phase-out levels for the account owner's filing status. For individual account owners, a full contribution may be made if MAGI is $95,000 or less (and a partial contribution until MAGI reaches $110,000). For a married account owner, the full contribution limit is $150,000 and the phase-out amount is $160,000. For a married account owner filing separately, the phase-out spread is from $0 to $10,000, preventing a manipulation of the restrictions otherwise applicable to a married account owner. Code § 408A(c)(3). MAGI is the amount of AGI under Code § 62, computed with the adjustments made in Code § 219(g)(3), the Code section that determines the income limits that apply to calculate permissible contributions to a traditional IRA by an account owner who is an active participant in a qualified employer-sponsored plan. In the case of Roth IRAs, MAGI is then reduced further by the amount of any conversion distribution.

In contrast to the rules for contributions to traditional IRAs, an account owner who is an active participant in a qualified retirement plan is not required to scale back contributions to a Roth IRA, and contributions may be made for and after the year in which age 70½ is attained. Code § 408A(c)(4). Note that the dollar income caps that apply to limit deductible contributions to traditional IRAs for those pre-age 70½ account owners who are participants in qualified employer plans are significantly less than the Roth IRA income limits, so that contributions to a Roth IRA may be available for individuals who cannot make deductible contributions to traditional IRAs. For example, in 2005 a single individual who is an active qualified plan participant may make a full contribution to a traditional IRA only if MAGI is under $50,000 (and a partial contribution until MAGI reaches $60,000). For a married account owner, the full contribution limit is $70,000 in 2005 (increasing to $80,000 for 2007 and after) and the phase out amount is $100,000 ($120,000 for 2007 and after). For those who are not eligible to make deductible contributions to an IRA, contributions to a Roth IRA are clearly superior to nondeductible contributions to a traditional IRA, the earnings from which will ultimately be subject to tax.

Roth 401(k) Accounts

Under Code § 402A, effective for years after 2005, employers sponsoring Code § 401(k) or 403(b) plans may permit employees to divert any part or all of the elective deferrals that may otherwise be made in

Tax Years	Roth IRA	Age 50 Catch Up	Roth 401(k)	Age 50 Catch Up
2005	$3,000	$500	$14,000	$4,000
2006–07	4,000	1,000	15,000	5,000
2008 and after	5,000	1,000	15,000	5,000

reduction of salary (that is, on a pretax basis) to designated Roth accounts established under the plan. Designated Roth contributions are not excluded from the employee's taxable income, but qualified distributions from the Roth 401(k) accounts are excluded from the distributee's taxable income. Code § 402A(a)(1), (d)(1). Compared to regular Roth IRA contributions, a Roth 401(k) account permits greater deferrals (see table above). There are no designated Roth account AGI limits so that higher income employees who could not participate (or fully participate) in a Roth IRA can potentially take full advantage of designated Roth contributions if employers adopt this feature. The maximum amount that may be deferred by a highly compensated employee is, however, subject to the usual Code § 401(k) rules, including the actual deferral percentage (ADP) limitations, and may be less than the maximum elective deferral dollar amount. Code § 408A(c)(3)(A) and (C)(ii).

Some practical questions remain after the issuance of proposed regulations for 401(k) Roth accounts issued in March 2005. Prop. Treas. Reg. §§ 1.401(k)–1(f), 1.401(k)-2, 1.401(k)-6, and 1.401(m)-2 and 5. First, the proposed regulations provide that a designated Roth account is subject to the MRD rules during the plan participant's lifetime in the same manner as pre-tax elective contributions are subject to Code § 401(a)(9)(A) and (B). Prop. Treas. Reg. § 1.401(k)–1(f)(3). As a result, MRDs must be made for distribution calendar years beginning with the year the participant attains age $70^1/_2$ and the employee would have to roll the MRD amounts over to a Roth IRA to preserve the deferral. Second, the five taxable year period, which must run before distributions from the designated Roth IRA can be qualified distributions, begins to run as of the beginning of the first taxable year for which a Roth 401(k) contribution is made to the plan or, in the case of a rollover to the plan of a designated Roth account established under another plan, from the first taxable year of a Roth 401(k) contribution to such other plan, if earlier. Code § 402A(d)(2)(B). By contrast, all of an account owner's Roth IRAs are aggregated for the purposes of measuring the five year non-exclusion period. Code § 408A(d)(2)(B); Treas. Reg. § 1.408A–6, A-2. The separate measurement of the non-exclusion period may require that a separate Roth IRA be created for rollovers of MRDs or that a method of tracking be developed if the designated Roth account funds are rolled over to an existing Roth IRA.

Finally, for the plan participant who establishes a designated Roth account to take advantage of the extended deferral of post-death distributions for younger family members, the employer sponsored plan must include extended post-death MRD payout options for designated Roth accounts. If the plan has adopted the administratively simple approach of requiring that lump sum distributions of benefits be made following a participant's death for non-Roth benefits and applies this provision to designated Roth accounts, a participant will have to implement a frequent rollover program of all elective deferrals (not merely MRDs) in favor of a Roth IRA and/or designate a surviving spouse as beneficiary to avoid the risk of having Roth benefits distributed in a lump sum to death benefit beneficiaries who, other than a surviving spouse, have no ability to roll them over to a Roth IRA.

Conversions of Traditional IRAs to Roth IRAs

An account owner whose income is below the conversion income limit may convert all or part of a traditional IRA to a Roth IRA by (1) distributing funds from a traditional IRA and rolling them over to a Roth IRA within 60 days of distribution, (2) a trustee-to-trustee transfer, or (3) redesignating a traditional IRA as a Roth IRA, all of which transfers are considered rollovers. Code § 408(d)(3)(A); Treas. Reg. § 1.408A-4, A-1(b) and (c). IRAs that are part of a savings incentive match plan for employees (SIMPLE) or simplified employee pension plan (SEP) may be converted provided, in the case of a SIMPLE, that the employee has participated for two years. Code § 408(d)(3)(G). A conversion is treated as a distribution of the converted amount from the traditional IRA to the account owner for income tax purposes and the conversion amount is included in the account owner's gross income except to the extent that the account owner has a basis in the traditional IRA. Code § 408A(d)(3)(A), (B), and (C). An account owner may have a basis in a traditional IRA because of nondeductible contributions to the IRA or nondeductible contributions to a qualified plan that have been rolled over to the IRA. The 10% premature distribution tax does not apply to the converted amounts even if the account owner is under age $59^1/_2$ at the time of the conversion except, as noted above, if distributions are made from the recipient Roth IRA within the five-year period following conversion.

If an account owner's MAGI exceeds $100,000 for the taxable year in which a conversion distribution is made from a traditional IRA, no conversion is permitted. Code § 408A(c)(3)(B). For 2005 and future years, an additional modification is made to the account owner's MAGI (determined in the same manner as MAGI is determined for purposes of regular contributions to a Roth IRA). MRDs from traditional IRAs received in the conversion year are excluded. Code § 408A(3)(C)(i)(II). Some commentators read the Code section more broadly to exclude MRDs from qualified retirement plans as well. If rollovers are available from qualified plans, the safer approach to planning for a conversion would be to roll over qualified plan benefits to a traditional IRA in a year before the conversion to assure that MRDs are excluded in computing the $100,000 MAGI limit.

Planning with Roth IRAs

In those situations in which the changes in the access to Roth IRAs described above make the establishment of Roth IRAs viable for wealthier individuals, when would Roth IRAs be recommended? In the case of executives who have access to designated Roth accounts (particularly those who are not in the top income tax bracket), a decision to divert all or a portion of the individual's available elective deferral amounts to designated Roth accounts may provide future flexibility during retirement and the opportunity to provide deferred benefits to younger generation beneficiaries. The Roth IRA that ultimately results from the rollover of the designated Roth account would provide a source of retirement benefits that could be drawn on, if needed, without increasing the account owner's AGI (which might, inter alia, protect Social Security benefits from tax). If kept as a rainy-day fund to be passed on to children or, by allocating generation-skipping tax exemption on death, to grandchildren, the benefits of the stretch out could be achieved. But unless substantially all of the Roth IRA is available to the younger generation beneficiaries, the initial tax cost may not be recouped.

In the case of an over age 70$^1/_2$ account owner who is now able to arrange for an under $100,000 MAGI tax year that permits a conversion from a traditional IRA to a Roth IRA and who can afford to fund the payment of income and estate taxes from other assets without sacrificing financial security, a conversion potentially has maximum benefits. If the account owner dies shortly after converting to a Roth IRA, the amount of the upfront income tax cost is completely removed from the account owner's taxable estate. By contrast, in the case of a traditional IRA, the deduction under Code § 691(c) for estate tax caused by income in respect of a decedent provides no offset for state death taxes and, as an itemized deduction, may not be fully deductible by the recipient. Of course, apart from a deathbed conversion, the Roth IRA's benefits are maximized if the account owner (or the account owner's surviving spouse named as designated beneficiary) survives the creation of the account for many years. In that case, the Roth IRA's increase in value by the time estate tax, if any, is paid may well have surpassed the amount of income tax removed from the taxable estate.

A Roth IRA does not fit neatly into a typical marital, nonmarital trust plan for estate tax minimization unless the spouse will be financially secure as a result of a marital trust funded by non-Roth assets and/or the spouse's own assets. Naming a nonmarital trust as beneficiary avoids the diminishment of the applicable exclusion amount shelter that a traditional IRA causes because no income taxes are payable. But naming a trust of which the surviving spouse is the oldest beneficiary severely restricts the stretch out of distributions that are key to the economic purpose of the Roth IRA and triggers MRDs over the spouse's lifetime that could have been deferred. Compared to naming a surviving spouse, individually, as designated beneficiary (with the expectation that the spouse will make an own account election and designate younger beneficiaries on the spouse's death), naming either a marital trust or a nonmarital trust as beneficiary undercuts the Roth IRA's benefits.

An important part of the analysis of a conversion to a Roth IRA is the determination of the optimal amount to convert. If the account owner's spouse survives and is designated beneficiary, the Roth IRA will qualify for the marital deduction (because it is withdrawable). Depending on the size of a couple's combined estates, the level of the applicable exclusion amount on the account owner's and spouse's deaths, and the availability of other assets for allocation to a nonmarital trust, naming the spouse as beneficiary of too large a Roth IRA may result in estate tax that could have been avoided. The projected size of the target conversion amount as of the surviving spouse's death should be such that estate tax, if any, can be paid from other marital trust assets or the spouse's own assets. Similarly, if the Roth IRA is to pass to children or younger generation beneficiaries on the account owner's death, the projected size of the Roth IRA at the time of the account owner's death should be calculated to leave sufficient assets to fund estate tax and expenses from non-Roth IRA assets.

Depending on the age and maturity of younger beneficiaries intended to benefit following the account owner's (or surviving spouse's) death, a conduit trust (or trusts) might be named as beneficiary (or beneficiaries) to permit a trustee to have the discretion to limit distributions to the MRD amounts to preserve the Roth IRA. Because the Roth IRA will not be diminished by the payment of income tax, any allocation of GST exemption to a conduit trust for a grandchild or grandchildren will be used fully. ■