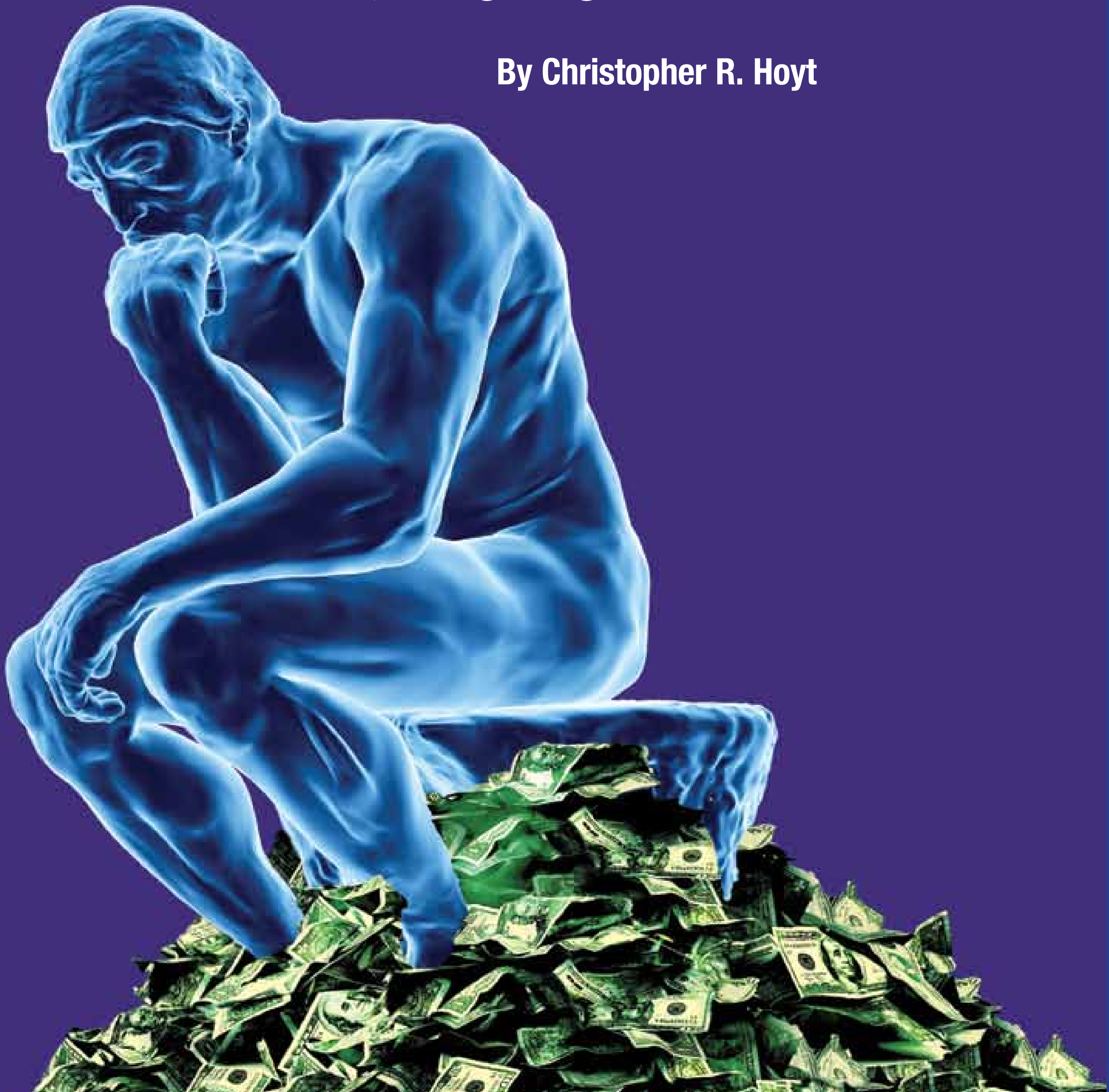
Rethinking Roth IRA Conversions in 2010

By Christopher R. Hoyt



The year 2010 is the first year that wealthy taxpayers have access to a Roth IRA. It also may prove to be the best year for taxpayers to do a Roth IRA conversion because of the scheduled tax rate increases in future years. People are reexamining the pros and cons of making a Roth IRA conversion in 2010 to lock in lower tax rates (see "Future Income Tax Increases" below). After 2012, many middle-class taxpayers will avoid a large Roth IRA conversion because it could trigger the imposition of the new health-care taxes on a person's investment income and wages (even though the retirement plan distribution will itself be exempt from the surtax).

A Roth IRA, a Roth 401(k), and a Roth 403(b) account are the inverse of a traditional retirement account. There is no income tax deduction for a deposit into a Roth account, but the distribution, including the investment income earned in the account, is usually exempt from income tax. IRC § 408A (Roth IRA) and IRC § 402A (Roth 401(k) and Roth 403(b)). By comparison, a traditional retirement account is designed to defer the taxation of compensation income. With a traditional account, income tax is deducted in the year money is deposited into the account and then all withdrawals are usually fully taxable.

High-income taxpayers have been able to contribute to a Roth 401(k) or a Roth 403(b) account if an employer offered such an option, but contributions to a Roth IRA had been off limits to them until 2010. By way of background, money can get into a Roth IRA in two ways. The first is a "regular contribution" of up to $5,000 per year ($6,000 if over age 49) made by a person who has wage or self-employment income. But if a person's adjusted gross income in 2010 is over $120,000 ($177,000 on a joint return), he or she is prohibited from making such a contribution to a Roth IRA. IRS Notice 2009-94, 2009-50 I.R.B. 848. Thus, the only way a high-income taxpayer can have a Roth IRA is the second way: by making a Roth IRA conversion.

A Roth IRA conversion is a transfer of assets from a traditional IRA or other qualified retirement account into a Roth IRA. Until 2010, a Roth IRA conversion was prohibited if an individual had over $100,000 of "modified adjusted gross income," but that limit was eliminated in 2010. IRC § 408(c)(3)(B) (2009).

The main tax challenge is that a Roth IRA conversion is a taxable event. A conversion is treated as a taxable distribution from the traditional account followed by a nondeductible contribution to a Roth IRA. IRC § 408A(d)(3)(A)(i) & (ii); Treas. Reg. § 1.408A-4, Q&A-1(c) & Q&A-7. A special provision permits a taxpayer to defer the taxation of a 2010 Roth IRA conversion into the years 2011 and 2012. IRC § 408A(d)(3)(A)(iii). Many taxpayers, though, have stated that they prefer to take the tax hit in 2010 because of the relative certainty of lower income tax rates in 2010. If in hindsight a Roth IRA conversion appears to have been a bad decision, an important option is that a person can completely undo a Roth IRA conversion with a "recharacterization" (described below) by transferring the converted amount (plus the allocable investment income) to a traditional IRA.

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The Pros and Cons

A Roth IRA conversion takes taxable income that would have been spread over many years of retirement and accelerates the taxation of that income into one year (or possibly two years: 2011 and 2012). For many people this produces a bad tax result, especially when the extra income pushes a person into a higher income tax bracket. It also can be a drain on other financial resources. If a person is under age 59½, then as a practical matter he or she will have to pay the tax with cash from sources other than the proceeds from the retirement plan distribution to avoid the 10% early-withdrawal penalty. IRC § 72(t). Does the client have such resources?

Given these disadvantages, when will the benefits of a Roth IRA conversion overcome them? There are basically five situations. The best candidate for a Roth IRA conversion is:

1. *Someone that will always be in the highest income tax bracket.* Two reasons: (1) the extra income will not push that person into a higher income tax bracket and (2) the maximum 35% income tax rate in 2010 is relatively low by historical standards—it is certainly lower than the 39.6% and 43.4% rates that are scheduled to occur in 2011 and 2013, respectively.

Future Income Tax Rate Increases

Highest federal tax rates on:	2010	2011	2013
Investment income (interest, rent)	35.0%	39.6%	43.4%
Wages (1.45% health ins + 0.9%)	36.4%	41.0%	41.9%
Dividends	15.0%	39.6%	43.4%
Long-term capital gains	15.0%	20.0%	23.8%

The "Bush tax cuts" expire at the end of 2010, and the 1990s marginal income tax rates return in 2011. Beginning in 2013, wealthy taxpayers begin paying higher taxes to fund the national health program. The taxes generally apply to individuals who have over $200,000 of income ($250,000 on a joint return). First, there will be a 3.8% surtax on investment income (including long-term capital gains) for individuals who have over $200,000 of income ($250,000 on a joint return). Some income will be exempt from the surtax, including retirement plan distributions, capital gains from selling a principal residence, and partnership or Subchapter S corporation income, provided that the recipient is employed at the business. Second, there will be a 0.9% additional tax on the compensation income of individuals who have over $200,000 of income ($250,000 on a joint return). This 0.9% surtax is paid only by the individual—not by the employer. This will be in addition to the existing 1.45% Medicare/Medicaid tax that employees pay on all of their earned income and that is matched by employers. Section 1411(as modified by section 1402 of The Health Care and Education Reconciliation Act of 2010 (Pub. L. No. 111-152) (3.8% investment income surtax)) and section 9015 (as modified by section 10906 of The Patient Protection and Affordable Care Act, Pub. L. No. 111-148 (0.9% compensation surtax)).

2. *Someone that will likely be subject to the estate tax.* If a taxable estate includes a traditional retirement account, then federal and state estate taxes are inflated because they are imposed on the deferred income taxes in the account. Beneficiaries are entitled to claim an itemized income tax deduction for the federal (but not the state) estate taxes imposed on a traditional retirement account in the years that they report retirement plan distributions as taxable income. IRC § 691(c). In most cases, though, they would have been better served if the traditional account had been converted into a Roth IRA so that no estate tax would have been levied on the deferred income taxes.
3. *Someone that is currently in a low income tax bracket but will likely be in a higher income tax bracket in retirement.* An example is a graduate student who has a traditional retirement account from a prior job or who converts an inherited qualified plan account (inherited 401(k) accounts are eligible for a Roth IRA conversion but inherited IRAs are not). IRS Notice 2008-30, Q&A-7, 2008-12 I.R.B. 638, 639; Natalie Choate, *Nonspouse Beneficiary Roth IRA Conversions*, LISI Emp. Benefits & Retirement Plan. Newsl. No. 514 (Feb.18, 2010), at www.leimbergservices.com. A similar scenario exists for individuals that live in one of the nine states that has no state income tax (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming) and that either intend to move to another state that has a state income tax or to leave the accounts as an inheritance to beneficiaries who live in such a state.
4. *Someone with tax deduction carryforwards.* For example, an individual that has a charitable deduction carryforward that expires in 2010 should consider making a Roth IRA conversion. The charitable carryforward will produce an offsetting 50% (or 30% or 20%, depending on the type of charitable deduction) income tax deduction that could significantly reduce the cost of the conversion. IRC § 170(b).
5. *Someone that wants to take advantage of a Roth IRA's exemption from making lifetime required distributions.* An important advantage of a Roth IRA is that the account owner is not required to receive a required minimum distribution (RMD) from a Roth IRA during his or her lifetime. IRC § 408A(c)(5). This permits a greater accumulation of resources for major expenses that may occur in retirement. By comparison, traditional IRAs, qualified retirement plans, Roth 401(k) plans, and Roth 403(b) plans must make RMDs after the required beginning date (the "RBD," which is April 1 following the year that the individual attains age 70½). IRC §§ 408(a)(6) (an IRA), 401(a)(9) (a qualified retirement plan), 402A(e)(1)(B) (a Roth 401(k) and a Roth 403(b)). The annual RMD ranges between 4% and 5% of the account balance between ages 71 and 80 and between 5% and 8% of the account balance between ages 81 and 90 (see "Roth IRAs Are Exempt from Lifetime RMDs" below). Although individuals who have a Roth 401(k) or Roth 403(b) account do not have this advantage, they can easily obtain it by making a tax-free rollover from the Roth 401(k) or Roth 403(b) to a Roth IRA. Treas. Reg. §§ 1.402A-1, Q&A-1, and 1.408A-4, Q&A-5.

The exemption from lifetime RMDs applies only to the original Roth IRA account owner. After the account owner's death, a Roth IRA must be liquidated under rules similar to the rules that apply to liquidating a traditional IRA. A "stretch" arrangement is possible. This means that a Roth IRA can be liquidated over a designated beneficiary's life expectancy (typically until the beneficiary attains age 83, 84, or 85). Treas. Reg. § 1.408A-6, Q&A-14(b) (Roth IRA) and Treas. Reg. § 1.401(a)(9)-5, Q&A-5(a) through (c) and Q&A-6 (traditional accounts). Such stretch treatment is possible with both traditional and Roth accounts only if all of the beneficiaries of the account are either "designated beneficiaries" (that is, human beings) or certain types of trusts that only benefit designated beneficiaries. Treas. Reg. § 1.401(a)(9)-4, Q&A-5 and -6 (trusts). Stretch treatment, however, is generally not permitted if one of the beneficiaries

Roth IRAs Are Exempt From Lifetime RMDs

Traditional IRAs, qualified retirement plans, Roth 401(k) plans, and Roth 403(b) plans must make required minimum distributions (RMDs) after the required beginning date (usually April 1 following the year that the individual attains age 70½). A Roth IRA is exempt from this requirement. IRC § 408A(c)(5).

Uniform Lifetime Distribution Table

Age	Payout	Age	Payout	Age	Payout
70	3.65%	80	5.35%	90	8.78%
71	3.78%	81	5.59%	91	9.26%
72	3.91%	82	5.85%	92	9.81%
73	4.05%	83	6.14%	93	10.42%
74	4.21%	84	6.46%	94	10.99%
75	4.37%	85	6.76%	95	11.63%
76	4.55%	86	7.10%	96	12.35%
77	4.72%	87	7.47%	97	13.16%
78	4.93%	88	7.88%	98	14.09%
79	5.13%	89	8.33%	99	14.93%

Computed from Table A-2 of Treas. Reg. § 1.401(a)(9)-9 for all taxpayers over age 70½, except for individuals who are married to a spouse who is more than 10 years younger. RMDs apply to IRAs (IRC § 408(a)(6)), qualified retirement plans (IRC § 401(a)(9)), and Roth 401(k) & Roth 403(b) plans (IRC § 402A(e)(1)(B)).

of the account is not a human being (for example, the beneficiary is the decedent's probate estate). Treas. Reg. § 1.401(a)(9)-5, Q&A-5(a)(2) and -5(c)(3). If a Roth IRA fails to qualify for stretch treatment, then the Roth IRA must be liquidated within five years after the owner's death. Treas. Reg. § 1.408A-6, Q&A-14(b).

A surviving spouse has an important advantage over any other beneficiary: the ability to do a rollover to a new Roth IRA. This can be done most easily by "electing to treat the decedent's Roth IRA as his or her own," thereby qualifying the surviving spouse for a lifetime exemption from RMDs. Treas. Reg. § 1.408A-2, Q&A-4.

Other Technical Rules

Conversions

- The mechanics: There are three ways to do a Roth IRA conversion. The easiest is to contact the administrator of a traditional IRA and to have the entire account transferred to a Roth IRA with the same administrator. Treas. Reg. § 1.408A-4, Q&A-1(b)(3). Another alternative is a trustee-to-trustee transfer from a traditional retirement plan to a Roth IRA. Treas. Reg. § 1.408A-4, Q&A-1(b)(2). The least desirable method is the "60-day rollover," in which the individual receives a distribution from a traditional retirement plan and has up to 60 days to deposit the amount into a Roth IRA. Treas. Reg. § 1.408A-4, Q&A-1(b)(1). The 60-day method, unlike a trustee-to-trustee transfer, may require income tax withholding by the distributing plan. Treas. Reg. § 1.408A-6, Q&A-13. Furthermore, in many situations people failed to complete the transaction within 60 days, creating potentially huge tax liabilities and numerous pleas to the IRS for relief.
- There is no 10% penalty for a Roth IRA conversion before age 59½, but a 10% penalty can apply if a converted amount is distributed within five years of the conversion to an owner of a Roth IRA who is under age 59½. There are a few exceptions (for example, disability, and so on). IRC § 408A(d)(3)(F); Treas. Reg. § 1.408A-6, Q&A-5(b) & (c) and Q&A-10, exs. (4) and (6), applying the IRC § 72(t) penalty standards.
- If a person over age 70½ does a Roth IRA conversion, he or she will not be able to convert the portion of the distribution that represents the RMD from the traditional retirement account for that year. IRC §§ 402(c)(4)(B) and 408(d)(3)(E).

After the account owner's death, a Roth IRA must be liquidated under rules similar to the rules that apply to liquidating a traditional IRA.

- A taxpayer should make sufficient federal and state tax payments through withholding taxes and estimated tax payments to avoid an underpayment penalty for the year in which the income from the Roth IRA conversion is recognized.

Undoing a Roth IRA Conversion with a "Recharacterization"

- If in hindsight a Roth IRA conversion was a bad decision (for example, the investment values of the converted property have collapsed and the taxpayer would therefore be paying an inflated income tax), it is possible to undo the conversion. The taxpayer should instruct the trustee of the Roth IRA to make a trustee-to-trustee transfer of the converted amount (plus the net income earned while in the Roth IRA) to the trustee of a new traditional IRA. IRC § 408A(d)(6); Treas. Reg. § 1.408A-5, Q&A-10, ex. 1. The trustee-to-trustee transfer must be completed before the due date (plus extensions) for filing the individual's federal income tax return. In most cases, this means that the transfer can be completed as late as October 15 of the year after the conversion. Treas. Reg. § 1.408A-5, Q&A-6(b).
- The price for making a recharacterization is that the taxpayer is not eligible to make another Roth IRA conversion until the first day of the following taxable year or, if later, 30 days after the trustee-to-trustee transfer. Treas. Reg. § 1.408A-5, Q&A-9.

A Roth IRA's Investment Income Is Taxable If Distributed Before Age 59½ or Within Five Years of the First Roth IRA Contribution/Conversion

- For a distribution of the investment income of a Roth IRA to be excluded from gross income, it must be made (1) after the individual attains age 59½, becomes disabled, acquires a first home, or dies (IRC §§ 408A(d)(2)(A)(iv), 408A(d)(5), and 72(t)(2)(F)) and (2) more than five years after a taxpayer makes a contribution or conversion to a Roth IRA. IRC § 408A(d)(2)(B); Treas. Reg. § 1.408A-6, Q&A-2. A similar five-year threshold applies to the investment income of a Roth 401(k) account. IRC § 402A(d)(2)(B); Treas. Reg. § 1.402A-1, Q&A-4.
- If a taxpayer receives a small distribution from a Roth IRA within the five-year period or before age 59½, it may be possible to avoid recognizing taxable income because Roth IRA distributions are deemed to come first from tax-free contributions, then from tax-free conversions, and then finally from a Roth IRA's investment

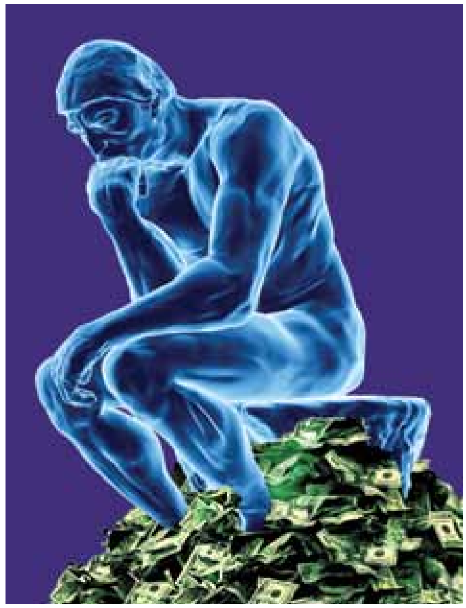
income. IRC § 408A(d)(4)(B); Treas. Reg. § 1.408A-6, Q&A-8, 9, & 10.

Defer Tax Payment Until 2011 and 2012?

If a taxpayer elects to defer the taxation of a 2010 Roth IRA conversion into 2011 and 2012, an early distribution of a converted amount (for example, a distribution in the year 2010) will trigger taxation in the year of receipt. IRC § 408A(d)(3)(E)(i) & (ii); Treas. Reg. § 1.408A-6, Q&A-6.

Conclusion

The new opportunity for higher-income individuals to have a Roth IRA in 2010, combined with the promise of higher income tax rates in future years, may make the year 2010 a banner year for Roth IRA conversions. Conversely, such conversions are likely to be less desirable in future years—especially after 2012—when the extra income triggered by a large Roth IRA conversion could



subject a taxpayer to considerably higher income tax rates on their other income. A person who does a Roth IRA conversion should consider using tax-saving strategies to reduce the tax bite from the conversion, such as making a large charitable contribution (preferably with appreciated stock). If a taxpayer can avoid the alternative minimum tax (AMT), he or she should consider fully paying the year's projected state income tax liability by December 31, 2010 (or, if applicable, 2011 and 2012) to get the benefit of an income tax deduction to offset the income from the conversion. Deductions for state taxes often can trigger the AMT. But the large amount of income from a Roth IRA conversion can change a taxpayer's normal tax paradigm. The income could cause a person to be subject to the AMT for the very first time, or conversely it could allow people who normally pay the AMT to be exempt from it for the first time in many years (for example, a person often avoids the AMT in a year when his or her income exceeds $500,000). With some thoughtful tax planning, and some help from computer tax software, people can determine whether a 2010 Roth IRA conversion is right for them. ■