

# ROTH IRA CONVERSIONS

## New Rules for 2010

By Renee Goetzka, CPA and Jason Whaley, CPA

The Roth Individual Retirement Account (IRA) is a retirement account that, like the traditional IRA, allows tax-deferred growth inside the account. However, Roth IRAs differ from traditional IRAs in a number of ways. First, contributions can be made to a Roth IRA after the account owner reaches age 70½. Second, required minimum distributions are not mandatory during the Roth account owner's lifetime. Third, and most importantly, "qualified distributions" from a Roth IRA are tax-free. Tax practitioners are familiar with Roth IRAs because they have existed since 1998. There is little doubt that Roth IRAs are a powerful tool for wealth accumulation. Unfortunately, to date the Roth IRA has been inaccessible for high income taxpayers due to adjusted gross income (AGI) limitations that restrict eligibility for both contributing to a Roth and converting non-Roth accounts to a Roth. There are no significant changes

pending with regard to income limits for contributions. However, beginning in 2010, there are two major changes to the tax rules regarding conversions to Roth IRAs:

- The AGI limitations will no longer apply for taxpayers converting eligible retirement accounts, described in IRC section 402(c)(8)(B), to Roth IRAs and;
- Married taxpayers filing separate returns will be eligible to convert.

Accounts ineligible for rollover include inherited IRA accounts for non-spousal beneficiaries and the amount of a traditional IRA account representing the taxpayer's required minimum distribution for the current tax year. Taxpayers rolling over and converting traditional IRA accounts also need to remember that they can complete only one rollover per year (in which they receive the cash from the IRA) and that they must complete the rollover within a 60-day period. Alternatively, trustee-to-trustee transfers are unlimited.

### Two-year Spread

Roth conversions will generally result in taxable income. Specifically, taxable income is created for the portion of converted funds attributable to pretax contributions and earnings. For conversions taking place in 2010 only, a special rule applies. Half (50 percent) of the income from the 2010 conversion is taxable in 2011, and the remaining half is taxable in 2012. Taxpayers are permitted to elect out of the two-year spread and to include the entire taxable conversion amount in gross income on their 2010 Form 1040. The election is irrevocable and must be made by the due date of the 2010 return. The IRS has not yet issued guidance clarifying whether "due date" includes extensions. Nor is there presently any guidance regarding the mechanics of electing out of the two-year spread. Presumably this will be achieved simply by including the entire amount of taxable conversion income on



the 2010 income tax return. Practitioners should be alert for guidance in this area as the 2010 filing season approaches.

Taxpayers and their advisors also need to remember that taxpayers electing the two-year spread may inadvertently accelerate income from a 2010 conversion by taking a distribution from the converted Roth IRA account before 2012. (See below for a discussion of the potential application of the 72(t) penalty to the distribution). Also note that if a taxpayer is using the two-year spread but dies before 2012, a spousal beneficiary can continue to use the two-year spread by irrevocably electing to treat the remaining taxable conversion amount in income during the appropriate years. The two-year spread is a special rule for 2010 conversions only, so conversions in later years will be taxable during the year of conversion.

Practitioners should keep in mind that under present law tax rates in 2011 and beyond are scheduled to be higher than 2010 tax rates. The highest marginal tax rate in 2010 is 35 percent. In 2011, the top rate is scheduled to be 39.6 percent. In addition, proposed legislation could add a surtax. When advising a client who converts in 2010, tax practitioners should consider both the client's anticipated taxable income in 2010 through 2012 and how tax rate changes would impact the amount of tax payable on the conversion. Also remember that the repeal of the AGI limit for conversions is permanent. Clients can spread conversion income over multiple years simply by converting the desired amount in a given tax year.

### Traditional IRAs with Non-Deductible Contributions

When all of a taxpayer's traditional IRA accounts consist entirely of deductible contributions and earnings, the entire amount converted to a Roth IRA is taxable. However, if the taxpayer's traditional IRA accounts contain nondeductible contributions, determining the taxable conversion amount is more complex. The balances from all traditional IRA accounts are combined in determining the portion of the conversion amount that is taxable. Because of this special rule, taxpayers with tax basis in their traditional IRAs who are considering converting to a Roth IRA would be wise to avoid rolling over 401(k) funds to a traditional IRA until after the conversion. For example:

- Taxpayer has one traditional IRA account. It has a balance of \$10,000 comprised of \$9,000 of nondeductible contributions and \$1,000 of earnings. If

the taxpayer converts the entire account to a Roth IRA, only \$1,000 (the earnings portion) would be includible in income.

- Now assume that prior to completing the Roth conversion, the same taxpayer rolls \$90,000 from a 401(k) to a second traditional IRA account. Although the 401(k) is rolled over into a separate IRA account, the rollover will result in more taxable income from the Roth conversion. Regardless of which account is used to complete the Roth conversion, the taxable amount of a conversion will be 91 percent of the converted amount, calculated as  $(\$100,000 - \$9,000) / \$100,000$ . Even if the taxpayer chooses to convert the first IRA with a value of \$10,000 to a Roth IRA, the conversion would result in gross taxable income of \$9,100 since the conversion is deemed to be a pro-rata conversion of all IRAs owned by the taxpayer. Thus, this taxpayer would have received a more favorable result by waiting to roll over the 401(k) balance until after converting the first IRA to a Roth.

### Who Should Consider Converting?

Determining a prime candidate for a Roth conversion is difficult. Because of the number of variables that must be considered, there is no one-size fits all solution. Each client's individual tax situation needs to be examined before a practitioner can make a recommendation. Conceptually, however, ideal conversion candidates might include taxpayers who:

- Have the ability to pay the conversion income tax with funds outside of the IRA;
- Have NOL carryovers, charitable contribution carryovers or reduced income in the year of conversion;
- Have tax basis in their IRA(s) and would recognize minimal income upon conversion due to recent market events;
- Expect to be in a higher tax bracket when withdrawing the Roth IRA funds than in the year of conversion;
- Will not have the conversion income increase their exposure to the Alternative Minimum Tax (AMT);
- Have considered state tax implications in the conversion year and the anticipated state tax treatment of Roth distributions (keeping in mind they may live in a different state in retirement);
- Have consulted their attorney regarding differences in exposure to creditors for qualified plans vs. IRAs;

## IRS Issues Guidance on Minimum Distribution Waiver

Congress decided last year to waive required minimum distributions from retirement savings plans for 2009, but there is still some confusion about how to apply the waiver.

The Worker, Retiree, and Employer Recovery Act of 2008 waived the required minimum distributions (RMD) for 2009 from defined-contribution plans such as 401(k) and 403(b) plans, as well as IRAs. The legislation came in response to the financial crisis, which severely reduced the savings of many retirees.

Notice 2009-82 provides two sample plan amendments that sponsors of individually designed or pre-approved plans may adopt or use to amend their plans to either cease making 2009 RMDs unless a participant or beneficiary elects otherwise, or continue making 2009 RMDs unless a participant or beneficiary elects otherwise.

The IRS has granted transitional relief for plans for the period Jan. 1, 2009, to Nov. 30, 2009; therefore, if a plan's operation conflicts with the adopted sample amendment during this period, the IRS will not consider it an operational failure.

Individuals may roll over any amount they receive from a DC plan or an IRA that, in 2009, would have been an RMD for 2009 but for WRERA, if it meets the definition of an eligible rollover distribution. For plan participants and IRA owners who have already received their 2009 RMDs, but the 60-day rollover period has expired, the IRS has extended the rollover period for these distributions until Nov. 30, 2009. However, because of the special one-rollover-per-year rule for IRAs, which was not changed by WRERA, an IRA owner may be able to make only one rollover if their 2009 RMDs were paid in installments. ■

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- Have considered the effects of conversion on their exposure to federal and state estate tax;
- Have a time horizon that allows maximum Roth IRA earnings growth;
- Want the flexibility of having the option (but not the requirement) of taking tax-free IRA distributions;
- Want to pass nontaxable IRA assets to their heirs;
- Are willing to accept the risk that the United States may have a consumption-based tax (Value Added Tax (VAT), sales tax) in the future that would dilute or eliminate the tax advantage of prepaying tax now to obtain tax-free Roth earnings; and/or
- Are willing to accept the risk that favorable tax laws regarding Roth IRA distributions may change in the future.

### Recharacterizing Conversions to Roth IRAs

The ability to recharacterize (undo) a Roth IRA conversion has been available for a number of years. Tax practitioners should be familiar with the following rules:

- Taxpayers have until Oct. 15 of the year following the year of conversion to recharacterize the conversion (as long as either an extension was filed or the tax return was timely filed);
- The taxpayer must contact their IRA custodian to make a trustee-to-trustee transfer from the Roth IRA to a traditional IRA (either back to the original traditional IRA or to a new traditional IRA); and
- Earnings/loss must be included in the recharacterization transfer.

Likewise, taxpayers have long had the ability to reconvert previously recharacterized funds back to a Roth IRA. However, in order to reconvert a taxpayer must wait until the later of the tax year following the original conversion or 30 days after the recharacterization.

### Basket Strategy for Locking-in Tax-Free Growth

Tax practitioners should be aware of a planning opportunity using the recharacterization rules. Earnings within a Roth IRA account are calculated on a pro-rata basis, so a client cannot specifically identify individual assets within an IRA to recharacterize. Because of this, a client may want to consider setting up

separate Roth IRA accounts (baskets) when converting to a Roth IRA to isolate individual investments. In the event that one or more Roth accounts falls while the others rise within the recharacterization window, the client can choose to recharacterize only the account(s) that have depreciated. In effect, this would achieve the desired cherry picking result of only converting (and paying tax on) the asset class(es) that exhibited growth during the window of opportunity to recharacterize. An exaggerated example of how this might work is as follows:

- Client has a traditional IRA worth \$200,000 with zero tax basis consisting of \$100,000 of stocks and \$100,000 of bonds.
- The client instructs the trustee to convert the stocks into Roth IRA 1 and the bonds into Roth IRA 2.
- The client timely files a 2010 income tax return and elects out of the two-year spread (reporting \$200,000 of conversion income on the 2010 return).
- Assume that by mid-2011, Roth 1 has declined by 50 percent and is now worth \$50,000. Roth 2 has increased by 50 percent and is now worth \$150,000.
- By Oct. 15, 2011, the client instructs the trustee to recharacterize Roth 1 (the stock account) back to a traditional IRA. Roth 2 (the bond account) is left intact, thereby securing tax-free growth of \$50,000.
- The client amends the 2010 tax return to report only \$100,000 of gross income from the 2010 Roth 2 conversion (versus \$200,000 of gross income as reported on the originally filed return).
- The client may later choose to reconvert the amount that's left in Roth 1. In this case, the client will need to make it past the 30-day period before reconverting.

Clients concerned about the possibility of another market meltdown may be comforted to know that they have this option available to manage their Roth conversions.

### Five Year Holding Period for Premature Distributions attributable to Conversions

Most practitioners are aware that in order for Roth earnings to be eligible for tax-free distribution, a five-year rule must be met. However, a lesser-known five-year rule exists specifically with regard to the portion of a distribution allocable to a Roth conversion contribution. The purpose of this second five-year rule is to prevent taxpayers from avoiding the 10 percent Section 72(t) penalty by converting to a Roth IRA shortly before taking a distribution. The five-year holding period applies separately to each Roth IRA conversion; holding periods for subsequent conversions are not tacked on to the holding period of the previous conversion. The holding period for a Roth IRA conversion in 2010 begins on Jan. 1, 2010. If the same taxpayer made another Roth IRA conversion in 2012, the holding period for that conversion would begin on Jan. 1, 2012.

The practitioner should calculate the taxable amount of the distribution, interview the client regarding plans for taking distributions, and then examine the client's exposure to the premature distribution penalty. The application of the second five-year rule to conversions can be an unwanted trap for the unwary.

### Conclusion

The media has already begun publishing articles regarding Roth IRAs. Clients have started making inquiries. Practitioners need to be familiar with the details, traps and tricks surrounding Roth IRA conversions and have some "talking points" prepared. The decision whether to convert will need to be analyzed on an individual basis for each interested client. It is likely that many situations may surface in which the detailed economic analysis indicates that a conversion makes sense, but the client is reluctant or unwilling to convert due to the associated income tax liability. Before spending hours preparing what-if scenarios for a client, the tax practitioner might estimate the client's projected tax upon conversion and ask: Are you willing to write the check? ■

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