

Roth Conversions in 2010

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Roth Conversions in 2010

A. Key Features of the Roth IRA

1. Five year minimum for tax-free withdrawals.
 - a. A qualified distribution from a Roth IRA is not taxable and is not subject to any 10% early withdrawal tax.
 - b. A qualified distribution is one that is:
 - 1) Received after the five tax period beginning with the first tax year for which a contribution is made to any Roth IRA of the taxpayer, and
 - 2) The distribution is made either:
 - a) On or after the day the account owner turns age 59½,
 - b) To the owner's beneficiary or estate due to death,
 - c) Due to the account owner being disabled, or
 - d) Made to pay qualified first-time home purchase expenses up to a maximum of \$10,000 [IRC Sec. 408A(d)(2)].
 - c. The five tax year minimum on a Roth IRA to achieve tax-free distribution status begins on the first day of the individual's tax year for which the first regular Roth IRA contribution is made, or, if earlier, the first day of the year in which the first conversion contribution is made to any Roth IRA of the individual (Reg. 1.408A-6, Q&A 2).
 - d. **Observation:** The five year minimum requirement for tax-free Roth status is an absolute. Even if the taxpayer dies before the five year period has been completed, the estate or beneficiaries must wait for the five year period to be satisfied before tax-free withdrawals can occur. As a result, opening a Roth IRA or converting a traditional IRA to Roth status at the earliest possible date can be important. A single small Roth IRA investment establishes the five year minimum holding requirement for a taxpayer for all Roth IRA purposes.
2. No minimum distribution requirement.
 - a. A taxpayer is not required to take distributions from a Roth IRA during lifetime. Accordingly, the pre-death minimum distribution rule for traditional IRAs that requires a taxpayer to take distributions beginning with the year following the year of attaining age 70½ does not apply to Roth IRAs [IRC Sec. 408A(c)(5)].
 - b. However, the post-death minimum distribution rules for traditional IRAs also apply to Roth IRAs as though the Roth IRA owner had died before the required beginning date. Accordingly, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death, or, if payable to a designated beneficiary, it must be distributed over the life expectancy

of the designated beneficiary with the distribution commencing before the end of the calendar year following the year of death (Reg. 1.408A-6, Q&A 14).

- c. If a spouse is the sole designated beneficiary, the spouse may treat the decedent's Roth IRA as his or her own Roth IRA and avoid the post-death distribution requirement.
- d. **Practice Pointer:** For a nonspouse beneficiary, the post-death life expectancy table for a single life under Reg. 1.401(a)(9)-9, Q&A 1 is used, with the beneficiary's single life expectancy calculated in the year following the year of the owner's death. The life expectancy is reduced by one for each year thereafter.
- e. **Observation:** Taxpayers receiving social security benefits, or those who expect to begin receiving them soon, should consider the benefit of converting to a Roth IRA with respect to the taxability of their social security benefits. If social security benefits are already taxable up to the 85% limit because of a higher level of AGI, withdrawing taxable traditional IRA funds or nontaxable Roth IRA funds will have no effect on the Social Security taxable income formula. However, other taxpayers with lower levels of income may be better positioned during retirement years with a Roth account. A rollover to a Roth may cause taxable income to increase for one year, but subsequent taxable income may be less and this could avoid the phase-in and taxability of either 50% or 85% of social security benefits.

Example 1 Lower inclusion of social security benefits with Roth withdrawal.

George is a single retiree whose annual IRA minimum required distribution (MRD) is about \$10,000 per year. If George accomplished an IRA-to-Roth conversion, he would have one high income year. But subsequent years might produce significantly lower taxation, if George is able to avoid the phase-in of taxable social security benefits due to lower taxable income. The following is an illustration of George's 2009 tax return with and without a taxable \$10,000 IRA withdrawal. In Roth status, George would still withdraw \$10,000 per year to supplement household income, but it would be nontaxable, leading to a lower level of taxable social security benefits:

	<u>Taxable MRD</u>	<u>Tax-free Roth Withdrawal</u>
Interest, rent income	\$ 26,000	\$ 26,000
IRA withdrawal	10,000	0
Taxable social security (\$18,000 gross)	<u>13,850</u>	<u>5,350</u>
Total Income	<u>\$ 49,850</u>	<u>\$ 31,350</u>
Federal Tax	<u>\$ 6,313</u>	<u>\$ 2,883</u>
Decrease		<u>\$ 3,430</u>

- 3. Nonqualifying distributions: basis first.
 - a. Nonqualified distributions from a Roth IRA are taxable income to the extent they exceed basis. Further, if the taxpayer is under age 59½, the taxable portion of the nonqualifying distribution may also be subject to the 10% premature distribution tax unless an exception applies (same exceptions as apply to traditional IRA early withdrawals).

- b. A nonqualified distribution is tax-free basis recovery to the extent that the distribution does not exceed the aggregate amount of Roth IRA contributions, whether regular contributions or conversion contributions [IRC Sec. 408A(d)(4)].
- c. **Observation:** The effect of this rule is a favorable first-in-first-out (FIFO) assumption, under which previously taxed amounts invested in a Roth IRA, whether directly or by taxing a conversion into a Roth, are considered the first portion of any taxable withdrawal. Accordingly, a taxpayer who funds a Roth IRA has little downside, as the amount invested (previously included in income) can be withdrawn at any time without taxation.

Example 2 Nonqualifying withdrawal from Roth IRA.

Beth creates a Roth IRA by contributing \$5,000 per year for three years. After the third year, Beth has a financial emergency and withdraws the \$15,000 of invested funds from the Roth IRA. This withdrawal is tax-free, as amounts received in a nonqualifying distribution are considered to first come from the taxpayer's contributions to the Roth IRA. Also, because there is no taxable distribution, there is no early withdrawal penalty, regardless of Beth's age.

4. Tax efficiency of a Roth IRA.

- a. In comparing a traditional (deductible) IRA to a Roth IRA, some analyses assume that the overall outcome is identical if the taxpayer's marginal tax rate applicable to the IRA deduction is the same as the marginal rate applicable to taxable withdrawals during retirement years. This form of comparison generally assumes that the Roth IRA investment is a lesser amount, because taxes must be paid prior to the investment of the funds into the Roth IRA.

Example 3 Traditional IRA versus Roth IRA (academic view).

	<u>Traditional IRA</u>		<u>Roth IRA</u>	
	<u>Tax Return</u>	<u>IRA Acct.</u>	<u>Tax Return</u>	<u>IRA Acct.</u>
Earned income	\$ 1,000		\$ 1,000	
- IRA deduction	<u>(1,000)</u>	\$ 1,000	<u>0</u>	\$ 1,000
Taxable	<u>\$ 0</u>		<u>\$ 1,000</u>	
Tax at 40%		<u>0</u>		<u>(400)</u>
Net Invested		<u>\$ 1,000</u>		<u>\$ 600</u>
Retirement: Account doubled		\$ 2,000		\$ 1,200
Less taxes at 40%		<u>(800)</u>		<u>0</u>
After-tax Cash		<u>\$ 1,200</u>		<u>\$ 1,200</u>

- b. **Observation:** Under this view, the decision is determined solely by whether the taxpayer is in a higher or lower tax bracket in retirement years. Thus, in the preceding example, if the taxpayer deducted the traditional IRA at a 40% bracket in working years and paid taxes on the withdrawal of those funds in retirement years at a 30% bracket, the traditional IRA would outperform the Roth IRA. On the other hand, if the taxpayer was in a greater tax bracket in retirement years, the Roth IRA would outperform. This approach to comparing the traditional IRA and

Roth IRA tends to favor the traditional IRA. It also ignores the more complex marginal rate impact of taxable social security benefits in retirement years.

- c. A more practical view is that taxpayers will fund the maximum permitted statutory amount into a traditional IRA or a Roth IRA, and that the difference in tax treatment will be reflected in costs or savings reflected in other assets of the taxpayer outside of the retirement account.

Example 4 Traditional IRA versus Roth IRA (practitioner’s view).

	<u>Traditional IRA</u>		<u>Roth IRA</u>	
		Tax Savings (Cost) Outside Tax- Free Acct.		Tax Savings (Cost) Outside Acct.
	<u>IRA Acct.</u>	<u>Free Acct.</u>	<u>IRA Acct.</u>	<u>Acct.</u>
Invest in IRA	\$ 1,000		\$ 1,000	
40% tax savings		<u>\$ 400</u>		<u>\$ 0</u>
Retirement: Account doubled	\$ 2,000	\$ 800	\$ 2,000	\$ 0
Less taxes at 40% tax cost on IRA		<u>(800)</u>		<u>0</u>
After-tax Cash	<u>\$ 2,000</u>	<u>\$ 0</u>	<u>\$ 2,000</u>	<u>\$ 0</u>

- d. **Observation:** This illustration again suggests that the traditional IRA and Roth IRA produce an equal result, assuming that the taxpayer is in the same tax bracket in deduction years versus retirement income years. However, the flaw in the preceding comparison is that the outside account holding the tax savings can accumulate as rapidly as the inside nontaxable IRA or Roth account. The traditional and Roth IRA investments accumulate without the burden of current taxes, whereas the outside account from the tax savings is not a deferred account, but rather one that must bear an income tax burden as it accumulates (or be invested in lower yielding tax-exempt securities).

Example 5 Shortfall in traditional IRA tax accumulation.

	<u>IRA Balance</u>	<u>Outside Tax Savings (40%)</u>
Year 1	<u>\$ 10,000</u>	<u>\$ 4,000</u>
<u>After 20 years:</u>		
• IRA at 6%	\$ 32,071	
• Tax savings invested at 6% less 40% tax		<u>\$ 8,114</u>
Tax on withdrawal	x 40%	
	<u>\$ 12,828</u>	

- e. **Observation:** In the preceding example, the initial tax savings of \$4,000 from the deductible IRA investment of \$10,000 can only be accumulated subject to an annual income tax burden on the reinvested earnings. This reduces the yield on the outside tax savings fund from 6% pre-tax to 3.6% net after a 40% tax burden.

The inside IRA, however, is accumulating without current taxation. When taxation occurs 20 years later at withdrawal, the tax burden of \$12,828 is much greater than the accumulated savings in the outside tax fund of \$8,114.

B. Contributing to a Roth IRA

1. Statutory limits.

- a. Subject to income phase-out rules, each individual may contribute for 2009 to a Roth IRA up to the lesser of:
 - 1) \$5,000, or
 - 2) The individual's compensation or earned income for the year, reduced by the amount contributed to traditional IRAs for the year [IRC Sec. 408A(c)(2)].
- b. If the individual has attained age 50 by December 31, an additional \$1,000 catch-up contribution is added to the \$5,000 deductible limit.
- c. Employer contributions, including elective deferrals, made under a SEP IRA or SIMPLE IRA on behalf of an individual, including a self-employed individual, do not reduce the amount of the individual's maximum contribution to a Roth IRA [Reg. 1.480A-3, Q&A 3(c)].

2. Contribution phase-out.

- a. The nondeductible \$5,000 maximum contribution to a Roth IRA for 2009 is phased out ratably over the following range of modified AGI:

Filing Status	Modified AGI Phase-out Range
Joint	\$166,000 – \$ 176,000
Single or H of H	105,000 – 120,000
Married separate	0 – 10,000

- b. **Observation:** Participating in an employer-sponsored retirement plan has no bearing on an individual's eligibility to contribute to a Roth IRA. Only modified AGI in excess of the phase-out range makes an individual ineligible to contribute to a Roth IRA. Further, Roth contributions can be made after an individual becomes age 70½ [IRC Sec. 408A(c)(4)].
- c. Definition of modified AGI:

AGI increased (+) or decreased (-) by:

- + Foreign earned income and foreign housing cost exclusions
- + Employer-provided adoption assistance
- + Series EE bond interest income used for higher education expenses
- + Contributions to a traditional IRA
- + Interest expense on student loans
- + Qualified tuition and fee deduction
- + Section 199 production deduction
- Income from a Roth conversion [IRC Sec. 408A(c)(3)(C)].

- d. **Observation:** Modified AGI for Roth conversions, discussed later, follows the same formula, other than any required minimum distribution from a traditional IRA may be excluded in calculating a taxpayer's modified AGI for that threshold (Reg. 1.408A-3, Q&A 6).

3. Deadline for Roth IRA contributions.

- a. As with a traditional IRA, taxpayers have until the tax return due date to make a Roth IRA contribution.
- b. This due date requirement does not include extensions [IRC Secs. 408A(c)(7) and 219(f)(3)].

C. Converting a Pre-tax Retirement Plan to Roth Status

1. An individual may convert (or rollover) all or any part of a traditional IRA, qualified retirement plan, 403(b) plan or 457(b) plan into a Roth IRA. For years beginning after 2007, eligible distributions from a qualified retirement plan, as well as 403(b) or 457(b) plans, may be rolled over directly into a Roth IRA account [IRC Sec. 408A(c)(3)(B)].

- a. For distributions prior to 2008, only amounts in an IRA could be converted to a Roth IRA (Reg. 1.408A-4, Q&A 5). This required use of a conduit IRA if an individual desired to roll a qualified retirement plan distribution into a Roth IRA.
- b. **Observation:** A qualified plan distribution should be rolled into a Roth IRA using a trustee-to-trustee transfer rather than a distribution directly to the participant, in order to avoid the 20% withholding that applies to direct participant distributions [IRC Sec. 3405(c)(1)].

2. Modified AGI limit.

- a. For 2009 and prior, taxpayers may convert a pre-tax retirement plan to a Roth IRA only if the taxpayer's modified AGI does not exceed \$100,000.
- b. Modified AGI is the same definition as discussed above at paragraph B.2.c. for the income phase-out for the annual contribution limit to a Roth IRA, except that required minimum distributions from a traditional IRA are excluded in calculating modified AGI for Roth conversion purposes (Reg. 1.408A-3, Q&A 6).
- c. **Observation:** In view of the recessionary economy, some taxpayers with substantial retirement plans may have their modified AGI decline to within reach of the \$100,000 modified AGI threshold for their 2009 tax return. This opportunity needs to be identified by December 31, 2009 if a Roth conversion during 2009 is to be accomplished. In some cases, planning actions would be appropriate to reduce AGI in order to qualify for a Roth conversion.

Example 6 Creating deductions to qualify for a Roth conversion.

Helen is a self-employed consultant whose income has suffered because of the poor economy in 2008 and 2009. Near the end of 2009, Helen's CPA prepares a tax projection that indicates that she will have modified AGI of \$110,000 for the year. Helen normally makes an annual SEP contribution. But in view of her significantly decreased income, she had not intended to fund the SEP for 2009. If Helen has traditional IRA accounts that could be rolled over to a Roth IRA in a conversion transaction, Helen should consider tax planning actions such as funding the SEP, or possibly claiming Section 179 or 50% bonus depreciation on business asset additions, in order to decrease modified AGI below the \$100,000 limit for 2009. This would allow Helen to convert some or all of her traditional IRA accounts to Roth status, while increasing taxable income in what is otherwise a low taxable income year for her situation.

3. The conversion of a traditional IRA or retirement plan into a Roth IRA causes the value of the account to be included in the taxpayer's gross income for the year of the conversion as if it were distributed to the taxpayer [IRC Sec. 408A(d)(3)(A)(i)]. However, the 10% early withdrawal penalty does not apply to these rollover/conversions [IRC Sec. 408A(d)(3)(A)(ii)].

Example 7 Converting a deductible account to a Roth IRA.

Al, who has only made deductible IRA contributions, elects to convert \$50,000 from a traditional IRA into a Roth IRA. The \$50,000 amount is fully subject to income tax in the year of conversion. However, even if Al is less than age 59½ at the time of the conversion, the 10% early withdrawal penalty does not apply.

- a. When an individual has a traditional IRA or other qualified retirement plan with both deductible and nondeductible contributions, taxable income from a conversion into a Roth IRA is determined under the general distribution rules. Accordingly, all of the individual's IRAs and all of the basis in those IRAs are aggregated to determine the taxable amount of the distribution [IRC Sec. 408(d)(2)].

Example 8 Converting to a Roth IRA using nondeductible contributions.

Ted has two IRA accounts, each with a value of \$50,000. One account has zero tax basis, as it originated in a rollover from a former employer's deductible 401(k) plan. The other IRA has \$22,000 of basis, attributable to a number of nondeductible contributions that Ted made over the years.

If Ted chooses to convert only one IRA into Roth status, his basis must be spread among all IRA accounts, to determine the proper ratio of his current Roth conversion income. Accordingly, Ted must recognize \$39,000 of income from the conversion (\$50,000 value of IRA less \$11,000 of basis, equal to one-half of his total IRA basis).

4. Special Roth conversion rules.
 - a. Military death gratuities and service members' group life insurance (SGLI) payments may be contributed and treated as a qualified rollover to a Roth IRA, regardless of the otherwise applicable Roth contribution limits [IRC Sec. 408A(e)(2)].

- 1) The rollover must be completed within one year of the date the payment was received.
 - 2) However, if the military death gratuity or SGLI payment was received with respect to a death from an injury occurring after October 6, 2001 and before June 17, 2008, the rollover must be made by June 17, 2009.
- b. Qualified airline employees may contribute any portion of an airline payment received from a commercial airline carrier involved in bankruptcy proceedings to a Roth IRA, effective for contributions made after December 23, 2008 (Sec. 125 of the 2008 Worker, Retiree and Employer Recovery Act).
- 1) The contribution must be made within 180 days from the date the payment is received, or before June 23, 2009, whichever is later.
 - 2) The contribution is treated as a qualified rollover contribution and the modified AGI limits do not apply. However, the rollover contribution is included in income to the extent it would be included in income if not part of the rollover contribution.

D. Elimination of Income Limit in 2010

1. For tax years beginning after 2009, the \$100,000 modified AGI limit on converting IRAs and qualified retirement plans to Roth IRA status is eliminated. Also, the requirement that a married taxpayer filing separately does not qualify for a Roth IRA conversion is eliminated [IRC Sec. 408A(c)(3), amended by P.L. 109-222, TIPRA of 2005].
2. The income resulting from a conversion to Roth status in the year 2010 is reported equally in each of the subsequent two tax years, 2011 and 2012 [IRC Sec. 408A(d)(3)(A)(iii)].
 - a. This forward spread of income to the two tax years following the conversion to Roth IRA status is available only for conversions occurring in the year 2010.
 - b. However, a taxpayer may elect not to have the two year forward spread apply, and as a result include the entire taxable portion of the rollover in taxable income for the year 2010.
3. The two year forward spread of the Roth conversion income triggered in 2010 is accelerated, to the extent the taxpayer takes a distribution from the Roth IRA in 2010 or 2011 [IRC Sec. 408A(d)(3)(E)(i)]. Specifically, the taxpayer must include in income in 2010 or 2011:
 - a. The distribution from the Roth IRA for the year which is allocable to the rollover that was includable as conversion income, plus
 - b. The lesser of:
 - 1) Half of the amount includable in income as a result of the conversion under the two year spread, or
 - 2) The total amount that must be included in income as a result of the conversion under the two year spread, reduced by amounts reported for preceding tax years.

Example 9 Roth conversion in 2010 with distribution before 2012.

Len has a traditional IRA with a value of \$100,000 as of February 2010 when he converts the entire IRA to Roth status. Len does not elect out of the two year forward spread, and accordingly is required to report \$50,000 of conversion income in 2011 and \$50,000 in 2012. However, in December of 2010, Len withdraws \$20,000 from the Roth IRA. Len must include the following amounts in taxable income each year:

<u>Year</u>	<u>Includable Income</u>	
2010	\$ 20,000	Actual distribution
2011	50,000	Lesser of half of conversion income or \$80,000 (total conversion income less prior reported income)
2012	<u>30,000</u>	Lesser of half of conversion income or remaining unreported income
	<u>\$ 100,000</u>	

Variation: If Len had withdrawn the \$20,000 in 2011, he would have been required to report \$70,000 in 2011 and \$30,000 in 2012.

4. The 10% premature withdrawal tax of IRC Sec. 72(t) does not apply to a qualified rollover contribution to a Roth IRA. However, if a taxable amount rolled into a Roth IRA from an eligible retirement plan is subsequently distributed within five years, the 10% penalty will apply [IRC Sec. 408A(d)(3)(F)].
5. **Observation:** The President's proposed budget for 2010 indicates that there will be substantial tax increases facing upper income individuals beginning in 2011. The U.S. Department of the Treasury, in its *General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals*, also referred to as the Green Book, issued May 11, 2009, indicated that the upper two individual tax brackets of 33% and 35% would be increased to 36% and 39.6%. These rates would be imposed on taxpayers with income over \$200,000 for single filers and \$250,000 for joint filers, although a footnote in the Green Book suggests that those income levels may be adjusted by personal exemptions and standard deduction amounts, so that the actual thresholds would be approximately \$190,000 for single filers and \$230,000 for joint filers. In addition, the phase-out of personal exemptions and itemized deductions would be restored, each effectively adding about 1% to the marginal tax rate of upper income taxpayers. These changes are all proposed to be effective in 2011. As a result, upper income filers will likely find their federal tax rate increasing from 35% in 2010 to approximately 42% in 2011. This suggests that those converting an IRA to Roth in 2010 should consider electively declining the two year forward spread, and instead report the entire Roth conversion income in 2010. The deadline for that decision will be with the filing of the 2010 tax return, which should be at a point in time when the actual 2011 tax rate increases have been enacted.

Example 10 Electing out of two year spread on 2010 Roth conversion.

Ed and Edna, both age 50, have IRA accounts with a current value of approximately \$100,000 as of January 2010. Previously, at the peak of the financial markets in 2008, those accounts had a market value of \$180,000. Ed and Edna both work in the real estate industry, and their joint income tax return is normally at the upper tax brackets. However, they anticipate that their income in 2010 will remain at a lower level because of current economic conditions. Ed and Edna accomplish the conversion of their IRA accounts to Roth status early in 2010, expecting that the value of those accounts will increase throughout the year if they defer the conversion. Also, when preparing their 2010 Form 1040, they electively decline the two year deferral and report the entire \$100,000 of conversion income in 2010. They make this election recognizing that the deferral would spread the income ahead to 2011 and 2012 when their taxable income will be greater and the upper tier tax rates will also have increased.

E. Roth Conversion Considerations

1. Taxpayers will generally benefit from converting IRA funds to Roth status if all of the following conditions are met:
 - a. The taxpayer or beneficiary will not need to take withdrawals from the IRA for at least 15 to 20 years,
 - b. The taxpayer's or beneficiary's income tax rates when withdrawals are taken are comparable or not significantly less than at the time the conversion occurs, and
 - c. The taxpayer can pay the tax at conversion with funds outside of the Roth IRA.
2. **Observations** regarding Roth IRA conversions:
 - a. The availability of funds outside of the IRA to pay the tax from the conversion is generally essential to make the Roth IRA conversion economically beneficial. If a taxpayer uses the IRA or qualified retirement plan funds to pay the tax on conversion, those funds will be subject to current income taxes and may be subject to the 10% early withdrawal penalty. Through the year 2009, when a taxpayer must have AGI under \$100,000 in order to accomplish a Roth conversion, the availability of sufficient outside funds to pay the tax is an impediment. When the \$100,000 threshold is eliminated in 2010 and after, taxpayers with greater resources will have access to the Roth conversion strategy.
 - b. The extra taxable income generated from the Roth conversion may create unexpected tax costs, due to the many phase-outs integrated into the current income tax system for upper income filers. Accordingly, taxpayers should have a detailed tax projection prepared that reflects the extra Roth conversion income, in order to accurately assess its current income tax cost.
 - c. Roth conversions are generally more beneficial for wealthier taxpayers who can avoid withdrawals of the Roth IRA during retirement years and continue to allow the funds to accumulate without taxes for a greater period of time, including the possibility of an extended payout to beneficiaries. Those taxpayers, however, are generally unable to accomplish a Roth conversion prior to 2010, because of the \$100,000 modified AGI limit that is in place through 2009.

- d. Younger taxpayers who accomplish an IRA-to-Roth conversion gain the added advantage of the ability to withdraw the converted amount tax-free and penalty-free after the funds have been within the Roth IRA for at least five years. Roth withdrawals are considered to come first from the contributed portion, including converted amounts that have tax basis, and this has the effect of allowing tax-free and penalty-free access to retirement plan funds before age 59½.
- e. Taxpayers considering a Roth conversion must recognize that predicting future income tax rates into retirement years is very difficult, particularly when that time frame might include 20 or 30 years into the future. While many taxpayers might reasonably project that under our current income tax system their marginal rates in retirement will be comparable to their current income tax rate at the time of conversion, this is premised on continuation of our present income tax system. There is always a possibility that a future Congress might convert our tax system to a value-added or national sales tax system, in which case conversion today could be a strategic error.
- f. The ideal point in time for conversion of an IRA or qualified retirement plan to Roth status is when the value of that account is economically depressed. The significant devaluation that has occurred in many IRAs and qualified retirement plans during 2008 and early 2009 is helpful to a near-term Roth conversion strategy.

F. Roth Conversion Software and Analysis

1. Many financial institution websites, as well as tax research and financial planning software packages, contain Roth conversion analyzers. The software programs attempt to compare the tax results of maintaining a traditional IRA into retirement years versus a current conversion to Roth status.
2. Vanguard Roth analyzer.
 - a. Vanguard is one of the largest no-load mutual fund families. On its website, it provides a Roth analyzer that calculates the result from converting an IRA to Roth status.
 - b. The Vanguard analyzer compares the Roth IRA to maintaining a traditional IRA plus a side fund (or “balancing account,” in their terminology). The balancing account is a mechanism for measuring the accumulation of the outside tax costs that would have been triggered if the IRA had been converted to Roth status.
3. Illustration of Vanguard Roth analyzer.
 - a. Assumptions:
 - 1) \$100,000 converted from IRA to Roth status today, followed by 30-year growth at 6% before withdrawal.
 - 2) Traditional IRA and Roth IRA both grow at 6%; side fund for tax costs also grows at 6%, but bears annual 28% tax rate.
 - 3) Taxpayer is in a 28% tax rate at the time of converting the IRA to Roth, and is in a 28% bracket 30 years later at withdrawal.

b. Roth results:

	<u>Convert to Roth IRA</u>	<u>Maintain IRA</u>	
		<u>IRA</u>	<u>Tax Side Fund</u>
2009	<u>\$ 100,000</u>	<u>\$ 100,000</u>	<u>\$ 28,000</u>
<u>Growth: 30 years</u>			
IRA @ 6%	\$ 574,349	\$ 574,349	
Side funds @ 4.32% (6% less 28% tax cost)			\$ 99,583
Less: 28% tax at withdrawal	_____	<u>(160,818)</u>	
Net Funds: 30 years	<u>\$ 574,349</u>		<u>\$ 513,114</u>

c. Comments about Vanguard software assumptions.

- 1) The Vanguard software only allows selection of today's specific tax rates (e.g., 15%, 25%, 28%, etc.) The taxpayer cannot select either a blended rate or a projected future tax rate.
- 2) The Vanguard Roth analyzer applies the same tax rate through all stages of the transaction. That rate is used to compute tax initially at the time of conversion, for the tax burden on the growth of the side fund, and for the extraction of the traditional IRA at retirement.
- 3) The Vanguard product assumes a single point in time for withdrawal of both the Roth IRA and traditional IRA in a lump sum transaction. It does not select the MRD payout requirements affecting a traditional IRA, or allow a staggered withdrawal over a period of retirement years.

d. Path to Vanguard software:

www.vanguard.com → Personal Investors → Planning & Education
 → Retirement Planning → Retirement Planning Tools
 → Should I Convert My IRA to a Roth?

4. The RIA Checkpoint tax research product has a Roth analyzer that is more sophisticated than the Vanguard product.

a. The path within IRA Checkpoint for locating the software is as follows:

Select the Tools tab, then Retirement, then Roth IRA Conversion.

b. The RIA analyzer allows three different tax rates to be selected.

- 1) The current tax rate for calculating the cost of converting the IRA to Roth status.
 - 2) An “investment tax rate” for annually paying taxes on the earnings of the side fund that is accumulated to assist with the tax costs at withdrawal of the traditional IRA.
 - 3) A tax rate at retirement that is applied to the traditional IRA.
- c. Using the same assumptions as above (\$100,000 conversion today with 30 years of growth at 6%) but applying a 28% current tax rate, a 25% investment tax rate, and a 25% tax rate at retirement, the results, per the attached Exhibit from the RIA Roth IRA conversion analyzer are as follows:

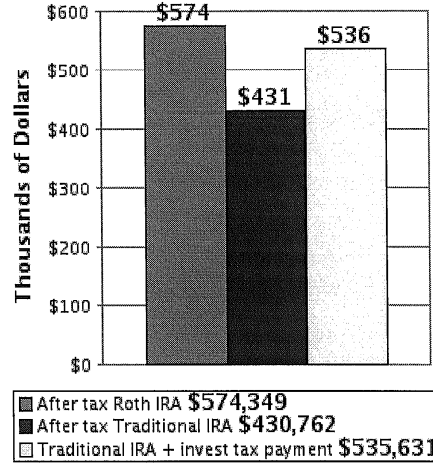
	<u>Roth IRA Account</u>	<u>Traditional IRA Account after Taxes</u>
Net funds after 30 years	\$574,349	\$535,631

5. Other illustrations (using RIA Checkpoint software), all using \$100,000 current IRA-to-Roth conversion and 6% growth rate:

<u>No. of Yrs. Until Payout</u>	<u>Tax Rate</u>			<u>Results after Tax</u>	
	<u>Convert</u>	<u>On Side Fund</u>	<u>Payout</u>	<u>Roth IRA</u>	<u>Traditional IRA</u>
25	28%	25%	25%	\$429,187	\$406,042
20	28%	25%	25%	320,714	308,063
15	28%	25%	25%	239,656	233,930
10	28%	25%	25%	179,085	177,797
25	33%	25%	25%	429,187	421,070
20	33%	25%	25%	320,714	320,122
15	33%	25%	25%	239,656	243,606
25	35%	30%	40%	429,187	355,407
20	35%	30%	40%	320,714	272,122
15	35%	30%	40%	239,656	208,669

Your retirement savings would increase \$38,718 at retirement.

Your retirement total savings, after taxes, would increase \$38,718 by converting your existing IRA to a Roth IRA. That equals a 7% difference. How much is this worth today? You would have to invest \$10,338 today to match the returns produced by the tax savings built into the Roth IRA.



Compare Your Results

Traditional IRA at Retirement

IRA before taxes: + \$574,349
 Tax liability: - \$143,587
 Return on "tax investment": + \$104,869

Total portfolio value= \$535,631

Roth IRA at Retirement

Roth IRA balance: + \$574,349
 Tax liability: - \$0
 Return on "tax investment": + \$0

Total portfolio value= \$574,349

Total difference at retirement: \$38,718
Percentage difference: 7%

Your Input Values

Input Values

Amount to convert:	\$100,000
Non-deductible contributions:	\$0
Current tax rate:	28%
Tax rate at retirement:	25.00%
Investment tax rate:	25.00%
Current age:	49
Age at retirement:	79
Rate of return:	6.00%
Roth tax liability:	\$28,000
Roth tax payment:	\$28,000

G. Accomplishing a Roth Conversion

1. An eligible rollover amount may be converted to a Roth IRA by any of the following methods:
 - a. An eligible rollover distribution from a traditional IRA can be contributed to a Roth IRA within the 60 day regular rollover period.
 - b. An eligible rollover amount can be transferred in a trustee-to-trustee transfer from the distributing trustee to the Roth IRA trustee.
 - c. The amount in a traditional IRA can be converted to a Roth IRA maintained by the same trustee by redesignating the traditional IRA account as a Roth account [Reg. 1.408A-4, Q&A 1(b)(3)]. No new account is necessary in this form of the conversion.
2. For years beginning after 2007, eligible distributions from a qualified retirement plan, as well as a 403(b) or 457(b) plan, may be rolled over directly into a Roth IRA account [IRC Sec. 408A(e)(1)(B); Sec. 408(d)(3)].
3. For distributions prior to 2008, only amounts in an IRA could be converted to a Roth IRA. Accordingly, a participant in a employer-provided retirement plan or 403(b) or 457(b) plan was required to create a conduit IRA as an interim step in moving those funds into a Roth account.
4. **Caution:** A qualified plan distribution should be rolled into a Roth IRA using a trustee-to-trustee transfer rather than a distribution to the plan participant, in order to avoid the 20% withholding that applies to participant distributions [IRC Sec. 3405(c)(1)].
5. An individual who has attained age 70 ½ and is required to take a minimum required distribution (MRD) from an IRA or qualified plan cannot avoid a current year MRD by converting the IRA to a Roth IRA. An MRD from a traditional IRA must be taken in the year of conversion before the balance is converted to a Roth IRA [Reg. 1.408A-4, Q&A 6].
6. **Observation:** The suspension of the MRD rules for 2009 presents an opportunity to accomplish a Roth conversion in 2009 without the need to first take a MRD amount. However, in 2009, the \$100,000 modified AGI threshold for accomplishing a Roth conversion still applies.

H. Reversing a Conversion to a Roth IRA

1. If a traditional IRA or other qualified plan is converted to Roth status, there may be subsequent circumstances that motivate the taxpayer to reverse the conversion and move the funds back to traditional IRA status:
 - a. Upon finalizing the taxpayer's Form 1040 for the year of conversion, the taxpayer's modified AGI may exceed \$100,000, indicating ineligibility for the conversion (for years beginning before 2010).
 - b. The value of the account may decline significantly following the conversion, and reversing the conversion will avoid paying tax based on the higher value at the time of the conversion.

2. Consequences of an ineligible conversion for years prior to 2010.
 - a. If a taxpayer's modified AGI exceeds \$100,000 and the taxpayer is ineligible for a conversion, the transfer of funds to the Roth account is an excess contribution subject to the 6% tax on excess contributions [IRC Sec. 4973(a) and (f)].
 - b. The taxpayer has also taken a distribution from the traditional IRA that is subject to income tax, and possibly also subject to the 10% early withdrawal penalty tax of IRC Sec. 72(t).
3. A Roth IRA conversion is reversed by accomplishing a trustee-to-trustee transfer of the funds from the Roth IRA back to a traditional IRA no later than the due date, including extensions, for the income tax return for the year the conversion originally occurred. [IRC Sec. 408(A)(d)(6) and (7); Reg. 1.408A-5, Q&A 1].
 - a. The transfer back to the IRA must include the earnings allocable to the converted amount [Reg. 1.408A-5, Q&A 2].
 - b. **Observation:** The IRS refers to this transaction as a **recharacterization** of the contribution to the Roth IRA.

Example 11 Reversing an erroneous IRA conversion.

In July 2009, Tim made a qualified rollover of his traditional IRA to a Roth IRA. However, when Tim's tax practitioner prepared his 2009 tax return in March 2010, his 2009 modified AGI was \$103,000. Thus, Tim was not eligible to convert his traditional IRA to Roth status in 2009. Tim can undo the conversion by using a trustee-to-trustee transfer of the funds plus earnings from the Roth IRA to a traditional IRA no later than the due date, including the extensions, of his 2009 income tax return. If Tim does not recharacterize the conversion, he will have a taxable distribution from his traditional IRA, and also an excess contribution to a Roth IRA for 2009.

4. Reconversion after a recharacterization.
 - a. A taxpayer who converts to a Roth IRA and later recharacterizes or reverses back to IRA status may find it advantageous to reconvert back to Roth IRA status in the subsequent year. An individual who reverses a conversion (or "recharacterizes") cannot reconvert the traditional IRA to a Roth IRA until the later of the following:
 - 1) The beginning of the tax year following the tax year the amount was converted to a Roth IRA, or
 - 2) The end of the 30-day period beginning on the day the original conversion is recharacterized [Reg. 1.408A-5, Q&A 9(a)(1)]

Example 12 Accomplishing a reconversion to Roth IRA status.

Assume the same facts as in the preceding example, where Tim converted his traditional IRA to a Roth IRA in 2009. Tim later learned that his AGI exceeded the \$100,000 threshold, and he was not permitted to accomplish the conversion for 2009. Tim then recharacterized his Roth IRA back to traditional IRA status on March 25, 2010. Under the regulations, Tim cannot reconvert the traditional IRA back to a Roth IRA until April 24, 2010.