THE NEW CHALLENGES –

Will a Roth Conversion, Recharacterization or Reconversion Help?

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BY

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I. Back to Basics

(A) Remembering the Individual Retirement Account ("IRA") basics

1. Governed by Section 408 of the Internal Revenue Code of 1986, as amended (the "Code")

2. Maximum contribution is $5000

3. Catch-up contribution if age 50 or more is $1000

4. Deduction for contribution to IRA is allowed under Section 219 of Code, subject to income and participation under employer retirement plans

5. Deductions are eliminated when joint return adjusted gross income is $109,000 or single is $65,000

6. Amounts earned in IRA are not taxed until distributions

7. Any non-deductible after tax contributions received by taxpayer are tax free. However, if taxpayer receives both deductible and non-deductible then each distribution is prorated

8. At required beginning date ("RBD") minimum required distributions ("MRD") must be made and consequently taxed to the participant or beneficiary

Example 1

> *Bob is a single man with annual adjusted gross income of $50,000. He can contribute $5,000 to an IRA. Assume he continues to qualify and contributes the maximum amount until he reaches his RBD of 70 ½ and the value of his IRA at the RBD is $300,000. At his RBD based on the uniform lifetime table he will be required to receive the MRD of $300,000/27.4 (4-5% between age 71 and 80 and 6% between age 81-90) for which he will be taxed at his current tax rate. Assume his bracket is 25%. He will pay $2,737 in taxes and have a net benefit of $8,211. This calculation continues until his death at which time his beneficiaries will be required to take the MRD and also be taxed on those amounts.*

(B) Remembering the Roth IRA basics

1. Governed by Section 408A of the Code

2. Maximum contribution is $5,000

3. Can contribute after age 70½

4. Catch-up contribution if age 50 or more is $1,000

5. Deduction for contribution to Roth IRA is not allowed

6. Contributions eliminated after adjusted gross joint return income of $176,000 or single return income of $120,000

7. No minimum required distributions during lifetime of owner

8. Amounts earned and distributions (a “Qualified Distribution”) from Roth IRAs are NEVER taxed, assuming that the following distribution time periods are met. Note that the 10% penalty can apply if

distributions are made prior to the following time periods:

(a) A Qualified Distribution can not be made before 5 years after date of contributions

(b) A Qualified Distribution must be made either

(i) to the participant after age 59 ½;
(ii) to a beneficiary as a result of death;
(iii) to a participant as a result of disability; or
(iv) to a participant who is a qualified first time homebuyer

Example 2

☞

Bob, in example above, makes same contributions but receives no deduction. As long as he meets the 5 year requirement and the 59 ½ age he can take any money out with no tax. Thus if he wants the same $10,948 he would have the full benefit of that money. Assuming the tax rates and earnings rates are the same at the time the funds were placed in the Roth IRA and distributed from the Roth IRA the net result (because no deduction was allowed for the contribution to the Roth IRA) would be the same as the traditional IRA.

- Must have a Roth IRA for at least 5 years
- Must wait five years after conversion
- 10% penalty – taxable portion of nonqualified disbursements

II. So What is the Big Deal Now?

(A) Under the law in 2009, a taxpayer could convert his or her IRA to a Roth IRA

1. Pay income tax and no premature distribution penalty

2. Adjusted gross income can not exceed $100,000 under Section 408 A(c)(3)(B) of the Code

(B) BIG DEAL – The Tax Increase Prevention and Reconciliation Act enacted of 2005, Public Law No. 109-222, 120 Stat. 345 (2006) ("TIPRA") eliminates the income limitation

1. Applies to Traditional IRA, SEP IRA, Simple IRA, 401(k), 403(b), 457(b), Profit Sharing Plans (plan must allow in-service distribution if under retirement age – money must be 2 years old and participation for 5 years – could provide a "window" in 2010)

2. No age limit

3. Applies if you are single or married

4. Income tax payments can be ratably deferred to 2011 and 2012. *Must elect* to include in 2010. Consider tax rate changes – Display 11

5. Convert at any time

6. Convert when stock market values are substantially reduced

7. Conversion by a trustee to trustee transfer, direct rollover or withdrawal followed by a rollover (60 days period)

8. No 10% penalty under 59½ <u>if</u> taxes are not paid out of conversion funds

Example 3

☞ *Bob (age 47) has $400,000 in an IRA. In 2010 Bob rolls over the $400,000 to a Roth IRA. Assuming no other election the income tax payable by Bob can either be paid 100% in 2010 <u>or</u> 50% in 2011 and 2012.*

(C) Income tax only applies to the deductible portion of the contribution but you can not convert only non-deductible contributions

Example 4

Bob has $200,000 of deductible contributions and $200,000 in non deductible contributions. If Bob's only IRA is $400,000 then 50% is tax free and 50% is taxable. The 50% ratio will also apply if he only rolled over $200,000.

(D) TIPRA allows you to elect whether to include income in 2010, 2011or 2012. Considerations for when and how to pay income taxes include:

1. Plan for income taxes or using losses

2. Pay from "other money"; i.e. do not use converted funds to pay taxes – see Display 2 on handout

3. Partial conversions are allowable – consider different "pots to put money in" – see Display 12

4. Alternative minimum tax

5. Consider financial aid and consequences for student loans

6. Estimated income taxes

7. Consider how the extra income may affect other issues on the income tax return

   (a) How much taxpayer's social security benefits are taxed

   (b) How much certain high income retirees may pay for their Medicare part B

(c) How much medical expenses taxpayer can deduct subject to the 7.5 percent AGI floor

(d) How much limit taxpayer's itemized deductions

(E) Remember that RMDs are <u>not</u> required to be paid in the owner's lifetime so the income tax savings on the RMDs will affect the decision to convert

Example 5

Bernstein compares $500,000 under the following three scenarios using their proprietary Wealth Forecasting System:

-Traditional IRA
-Roth Conversion, paying the taxes from IRA monies
-Roth Conversion, paying the taxes from a side fund

Assume Bob has $500,000 in a traditional IRA invested in a 60/40 asset allocation and he must take RMDs at age 70½. If he converts in 2010 when he is age 60 and pays all the income tax in 2010 (assuming the current tax rate) then, if he dies at age 90 under "typical markets" the portfolio would have the following values:

-Traditional IRA- **$3.5 million**

-Roth Conversion, paying the taxes from IRA monies- **$3.6 million (if the conversion occurred when Bob was under the age of 59 ½ then there would be an early distribution penalty on those amount distributed from the IRA to pay the taxes)**

-Roth Conversion, paying the taxes from a side fund- **$5.1 million**

(F) How Do You Do It?

1. Dates

(a) 1st date conversion can take place: 1/1/10

(b) Last date conversion can take place: 12/31/10

(c) Conversion tax due if elect: 4/15/11

(d) Last date to recharacterize: 10/15/11

(e) 50% tax: 4/15/12

(f) 50% tax: 4/15/13

2. Contact IRA holder to do a trustee to trustee transfer to an existing or new ROTH account in 2010.

3. The IRA holder will issue a 1099-R by January 31, 2011. The financial institution will generally put in box 1 Gross Distributions, then in 2(a) the taxable amount will be zero and the 2(b) box of taxable amount not determined will be the distribution. Federal income tax withheld will also be on 1099-R.

4. Contact CPA directly to be sure that the distribution amount is correct. If not then contact financial institution within February to correct, otherwise have to correct through IRS. Each client must work with tax advisor to determine what is taxable.

5. Confirm with CPA if paying tax in 2010 or paying tax in 2011 and 2012. There is no form yet on the Form 1040 indicating how you present and calculate the deferral of tax until 2011 and 2012.

6. If you recharacterize (see below) you MUST check the 1099-R that was issued to determine if correct and you will receive a Form 5498 to reflect the “rollover” from the Roth back to the traditional IRA. The boxes on the 1099-R and the 5498 must match to avoid paying taxes on the distribution. Further the IRA owners must report recharacterizations on their federal income tax return by attaching a statement and the taxpayer may have to file a Form 8606.

III. What if You Change Your Mind After You Convert? Recharacterize! (Include in DPOA ability to convert, recharacterize, and reconvert)

(A) If stock values decline after conversion then income tax may be incurred in the year you converted on “phantom” appreciation

(B) You can recharacterize until the due date of the tax return for the tax year in question <u>including</u> extensions

Example 6

☞ *Bob has converted his $200,000 from a IRA to a Roth IRA in 2010. In 2011 the stocks he converted are now worth only $100,000. He can roll the $100,000, adjusted for any gains or losses <u>back</u> to the original IRA by April 15, 2011 or October 15, 2011 if on extension and not pay income taxes. If he has already paid the income taxes on his 2010 income tax return (didn’t defer) he will get a refund. File amended return “Filed pursuant to Section 301.9100-2”.*

Example 7
(from Treas. Reg § 1.408A-6)

☞ Bob contributes $2,000 to a traditional IRA on 1/1/07 for 2006. April 15, 2007 amount has increased to $ 2,500. He recharacterizes this contribution by transferring $2,500 to a Roth IRA. Contribution is only of $2,000. Earnings are not included and gains and losses do <u>not</u> change original contribution.

(C) Will Internal Revenue Service (the “Service”) Grant Extensions of Time to Recharacterize?

1. Relief granted under Treas. Reg. § 301.9100-3 to 89 year old widow whose income, after corrected 1099 was issued, was over the threshold for conversion. The Service determined that she discovered error before Service; didn’t make election because of events beyond her control, after exercise of

reasonable diligence was unaware of need for election and she relied upon qualified tax professionals. PLR 200905039

2. Relief granted under Treas. Reg. § 301.9100-3 for taxpayer who discovered that he was not able to convert because his adjusted gross income was too high. The Service determined that the taxpayer acted reasonably and in good faith because his request was filed before the failure was discovered by the Service and the taxpayer, after exercising reasonable diligence, was unaware of the necessity of the election. PLR 200905034

3. Relief granted under Treas. Reg. § 301.9100-1 and 301.9100-3 when enrolled agent advised taxpayers to convert when the gross income was above maximum amount. PLR 200839039

4. Relief granted under Treas. Reg. § 301.9100-1 and 301.9100-3 for taxpayer who obtained information from the Service which was incomplete. PLR 200628032

IV. Not Only a Woman's Prerogative – You Can Change Your Mind Again!

(A) Timing to Reconvert– the <u>later</u> of the:

1. tax year following the tax year in which the amount was converted to a Roth IRA or

2. the end of the 30 day period beginning on the day on which IRA owner transfers the amount from the Roth IRA back to traditional IRA

Example 8

Bob first converts $200,000 from the traditional IRA to Roth IRA in January of 2010. Bob then recharacterizes the $200,000 back to the traditional IRA on December 11, 2010 because the $200,000 had declined to $100,000. He *avoids paying income taxes on $200,000. The reconversion from the traditional IRA back to the Roth must occur the later of the end of 2011 or January 11, 2011.*

V. Why Convert from an IRA to Roth?

(A) Don’t expect significant decline in tax rate in retirement

(B) Use favorable tax attributes such as carry forward losses and charitable deductions to offset income

(C) No income tax to beneficiaries when distributions are taken from the Roth

(D) Possible lowest income tax right now – only convert when the tax rate is the lowest, but consider there are other ways to tax that may not require an increase in income tax, such as national sales tax, value added tax, payroll tax, etc.

(E) Lower stock values now

(F) No need for any required minimum distribution so can benefit future generations – see Display 7

(G) You have outside funds to pay income taxes

(H) Convert when married rather than single (i.e. in year of death of spouse) because tax rates will be lower

(I) Reduce size of estate by paying income taxes on the conversion

Example 9

Bob has an estate of 5 million and a 1 million IRA. Estate tax on 6 million less 3.5 million or 2.5 million at 45% equals $1,125,000 in estate taxes. Assume conversion. He pays $350,000 in income taxes on the distribution of the

IRA and estate is now reduced to $5,650,000 million. After exemption estate tax is $967,500 or a savings of $157,000. However, IRD deduction is available if he kept money in the IRA and paid estate taxes on the IRD.

(J) Convert at younger age; don't spend from conversion – see Displays 4, 5, and 6

(K) Reduce the amount of income for purposes of calculating the new 3.8% "surtax" investment tax under the new Health Care Bill which applies for years beginning after 12/31/2012. The 3.85 surtax does not apply to Roth distributions. While the surtax also does not apply to IRA distributions, regular IRA distributions ARE included in calculating the modified adjusted gross income, the threshold requirement for the applicability of the tax.

Example 10

☞ For example, if Bob has investment income of $200,000, then he is not subject to the surtax (the threshold for a single person is $200,000 and for a married person is $250,000). However, if he has a required minimum distribution of $130,000, the total income would be $330,000 and the surtax would apply to the amount of investment income in the amount of $130,000 (the lesser of the investment income or the amount over the threshold), the so-called surtax bubble. If however, the distribution was taken from a ROTH IRA, then there would be no surtax, as Roth distributions are not included in the modified adjusted gross income and do not increase the amount over the threshold over $200,000.

(L) Credit shelter funding more tax efficient with a Roth IRA

VI. Why Not Convert?

(A) You know you will be in lower tax bracket in future – although see Display 5

(B) Family members who are beneficiaries will be in lower tax bracket

Example 11

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> Bob is currently in the 35% income tax bracket and has $400,000 in his IRA. Assume his bracket at age 70½ is 18%. If he converts now he will pay an additional $68,000 in unnecessary taxes.

(C) If beneficiary is a charity why pay <u>any</u> income taxes?

(D) Do you <u>know</u> what the tax rates will be in 2011 or 2012?

(E) Are these assets still exempt under Florida law and federal bankruptcy law? Section 222.21 of the Florida Statutes specifically refer to Section 408 and 408A of the Code and Section 222.21(2)(c) specifically states that “money or other assets that are exempt from claims of creditors under paragraph (a) do not cease to quality for exemption by reason of a direct transfer or eligible rollover that is excluded from gross income under s. 401(c) of the Code.

(F) You may not have the money to pay the income taxes. If you use the IRA dollars to pay the taxes then the 10% penalty applies.

(G) Individuals who will need the distributions in the future. Why pay tax early?

VII. Factors to Consider – see Display 8 and 9 – conversion questions

(A) Client’s spending habits

(B) Health status of parents

(C) Long term care obligations

(D) Stability of future income

(E) Income tax rates now and in future

(F) Inflation rate

(G) Interest rate earned inside IRA or Roth

(H) Time value of money

(I) Deferral of distributions

(J) No distributions

(K) Time period

(L) Growth of “side fund” with which to pay the taxes

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Resources:

Christopher Hoyt, *Want To Convert To a Roth IRA?* Trusts & Estates, September, 2009 at 29

Steven E. Trytten, *Show Me the Money*, Trusts & Estates, September 2009 at 34

Marcia Chadwick Holt, *Roth IRAs and Roth Accounts*, Heckerling Institute on Estate Planning, 2009 at 10-1

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Lauren Y. Detzel and Eric N. Bonnett, Roth IRA Conversions: *Benefits and Planning Opportunities*, June 2009, Fla. Bar J., Volume 86 No. 6 at 83

Michael E. Kitces, *To Roth or Not to Roth*, The Kitces Report, May 2009

Tax and Accounting Center, *Converting From Any Traditional IRA Into a Roth IRA,* 2009