Retirement Savings Opportunities

BY IAN J. REDPATH, J.D., LL.M., MICHAEL J. TUCKER, PH.D., J.D., LL.M., CPA, AND ERIC M. REDPATH, J.D.

Introduction
Recent tax legislation, and particularly the Pension Protection Act of 2006 (PPA), provides new planning opportunities for those who invest in individual retirement accounts (IRAs). This paper discusses the many planning opportunities that have arisen as a result of these recent legislative developments.

Transfers to Qualifying Charities from IRAs or Roth IRAs
Pre-PPA rules provided that a donor making a gift to a qualified charity from the proceeds from his/her IRA or the proceeds of a nonqualifying distribution from a Roth IRA would have to include the amount of the distribution in income and subject it to tax. An individual donor could then claim an offsetting income tax charitable deduction for the contribution. Although it would seem that the income taken into account from the IRA and Roth IRA distribution and the offsetting charitable contribution would neutralize each other from a tax perspective, such is not always the case, particularly for higher-income individuals. The receipt of additional income from an IRA or Roth IRA by higher marginal tax rate individuals impacts the taxability of social security payments, the deductibility of medical expenses, miscellaneous itemized deductions, the phase-out of itemized deductions, and the child tax credit and the calculation of the alternative minimum tax liability in such a way that there often is a net tax cost associated with making a charitable gift with IRA or Roth IRA proceeds that are taxed.

The PPA provided an exclusion from gross income for otherwise taxable IRA and Roth IRA distributions during 2006 and 2007 of up to $100,000 per year from traditional IRAs and Roth IRAs for a “qualified charitable distribution” (QCD) made by an IRA or Roth IRA owner who has attained at least age 70½ on the date of the distribution to a qualified charity. The effect of this change is to allow qualified taxpayers to donate money to a qualified charity directly from their IRA and Roth IRA accounts. Qualifying distributions are tax-free and are not subject to the penalty on early withdrawals. Since a qualifying distribution will not be included in taxable income, individuals are not able to claim a tax deduction for the charitable contribution. For purposes of determining QCD, all traditional and Roth IRAs owned by the participant are treated as one account. This PPA change applies only to outright life-time transfers from an IRA or Roth IRA, not to testamentary transfers from such accounts or distributions from qualified plans.

The income exclusion applies to individuals who have reached age 70½ by the date of contribution. Accordingly, IRA and Roth IRA distributions are eligible for the exclusion only if made on or after the date the IRA owner attains 70½. This requirement differs somewhat from the rule that requires IRA owners to begin receiving required mandatory dis-


**“RETIREMENT SAVINGS” CONTINUED**

Distributions (RMDs) by April 1 of the year following they year in which attain 70½ years of age. Despite the differences in the 70½-year rules, a QCD can be applied in satisfaction of a plan owner’s RMD requirements for the year provided the QCD is equal to or greater than the taxpayer’s RMD for the year.

As noted, a taxpayer may exclude up to $100,000 from taxable income from an IRA’s qualifying distribution to a public charity per year for 2006 and 2007. Amounts of income distributed to such a charity in excess of $100,000 are treated under the pre-PPA rules and would be taxable. Under these new PPA rules in 2006 a married couple can donate up to $200,000 to a qualified charity provided each spouse owns at least one IRA and can each make a QCD of $100,000 from their IRAs.

The donor cannot receive any quid pro quo benefits in exchange for his or her contribution. If the donor receives any benefit of value (of other than intangible religious benefits) that would otherwise reduce his or her charitable deduction, the exclusion is not available with respect to any part of the IRA distribution.

**Record-keeping requirements**

To exclude the IRA or Roth IRA distribution from the donor’s taxable income, the charity must provide the donor with a contemporaneous written acknowledgement of the gift just as it is required to do with any other contribution. Since the payment will be direct from the IRA to the charity, the IRA account owner should ensure that the charity is expecting the payment and knows the donor’s identity. If possible the check from the IRA should identify the account owner as the donor and should indicate that the gift is not being used to fund a donor-advised fund or supporting organization, since such donees would make the donor ineligible for tax-free treatment.

Another option might be to have the donor ask the IRA custodian to mail the check payable to the charity to the donor who would then deliver the check to the charity in person.

**Favorable income tax treatment for nondeductible contributions**

QCDs include amounts that otherwise would be taxable if distributed to the IRA participant. Some IRA owners, however, make nondeductible contributions to traditional IRAs that if withdrawn would be considered a tax-free return of nondeductible contributions. Such distributions are not deemed to be a QCD; however, with respect to IRAs with nondeductible contributions, the PPA provides special distribution rules that are very favorable to the taxpayer. The taxable distributions are considered distributed first, hence any direct distributions substantially will reduce the tax impact on future withdrawals by the IRA owners.

**Example**

Mary Smith has one IRA with a total value of $100,000 of which $80,000 consists of deductible contributions and earnings, and the remaining $20,000 of nondeductible contributions. If the IRA owner makes a QCD of $80,000, the entire $80,000 will be treated as having been distributed from deductible contributions and plan earnings. The $20,000 remaining in the plan will be considered nondeductible contributions.

If Mary donates the entire $100,000 plan balance to charity, she will be deemed to have made a QCD of $80,000 and a nonqualified charitable distribution of $20,000. Mary then will claim an itemized income tax charitable deduction for $20,000. If an IRA owner makes two different kinds of charitable gifts, such as Mary did in the example above, the question arises as to how such gifts would be substantiated from a compliance standpoint. Perhaps the IRA owner should instruct the IRA administrator to distribute $80,000 directly to a qualifying charity and thereafter withdraw the remaining $20,000 and make a separate donation. If this were the case, the donor would then receive two separate substantiation letters: one for the QCD of $80,000 and one for $20,000 that could be used to substantiate the income tax charitable deduction.

**Compliance issues**

Until the IRS issues regulations or otherwise clarifies many of the procedural questions surrounding QCDs, it is unclear who is responsible for determining if an IRA distribution is a QCD. Many financial institutions do not track a plan owner’s nondeductible contributions since they view that as the responsibility of the plan owner. Even if IRA trustees did track nondeductible contributions, it still could cause significant problems if the taxpayer has IRAs with different financial institutions. Since plan owner’s IRAs are aggregated for purposes of determining if a charitable distribution is being made from an otherwise taxable distribution, one trustee may not have all the data. At this point it also remains unclear who is responsible for performing the due diligence to determine if a charity is a qualified organization and if the gift will be put to a qualified use.

**Planning note**

Taxpayers benefiting from the new IRA charitable contribution opportunity include those who do not itemize their deductions because making a QCD eliminates the need for donors to claim an income tax charitable deduction. Accordingly those taxpayers who do not itemize their deductions in 2007 enjoy the equivalent of a charitable deduction without having to itemize their deductions. Those donors who itemized their deductions for the sole purpose of claiming charitable contribution deductions no longer need to do so if they fund their charitable contributions with QCDs from their IRAs.

Those living in states with no...
A spousal beneficiary has long deferred immediate income recognition from the inherited 401(k) plan.

Under pre-PPA rules, nonspouse beneficiaries were not permitted to rollover distributions from employer-sponsored retirement plans and so often were forced to pay tax on large distributions that the plan required should be paid out to them within a short period of time. Often the retirement plan required them to receive the lump-sum distribution immediately or within a few years of the death of an employee and accordingly the beneficiaries incurred an immediate tax when they received a distribution.

If the deceased’s retirement assets were held in an IRA as opposed to an employer-sponsored retirement plan then neither a spouse nor a nonspouse beneficiary was required to receive a lump sum. The spousal beneficiary could treat the inherited IRA as his or her own. A nonspouse beneficiary did not have an option to treat the inherited IRA as his or her own, but such a beneficiary could receive RMDs in accordance with the IRS’s actuarial tables, which generally favor younger beneficiaries in terms of minimizing RMDs.

Effective for distributions made after December 31, 2006, nonspouse beneficiaries may transfer any portion of a deceased employee’s eligible retirement plan to an IRA established for the purpose of receiving the distribution on behalf of the employee’s designated beneficiary. Such an IRA is treated as an inherited IRA and benefits must be distributed in accordance with the RMD rules that apply to inherited IRAs of nonspouse beneficiaries. Spouses can roll over an inherited 401(k) plan into their existing IRAs, but nonspouses must establish a separate IRA—the “inherited IRA.” Nonspouse beneficiaries who transfer the money to an existing IRA are liable for tax on the entire 401(k) distribution.

Those who receive a direct transfer of money from the 401(k) plan administrator will be taxed on the distribution even if in turn the distributee deposits the money in an IRA. Accordingly distributees should arrange for the 401(k) plan administrator to send the money directly to the IRA account.

Rollovers by Nonspouse Beneficiaries

A spousal beneficiary has long been able to roll over the deceased spouse’s 401(k) plan into his or her own IRA and thus defer immediate taxation even if the plan required that the account balance be distributed in a lump sum to the participant’s designated beneficiary in the year of death or within a short period of time following the employee’s death.

Prior to the PPA a nonspouse beneficiary of a 401(k) plan could not roll over an inherited 401(k) plan into his or her own IRA or otherwise defer income recognition if the plan mandated an immediate income distribution to the beneficiary. In many cases the result would be that the nonspousal beneficiary had to recognize significant income shortly after the death of the account owner because there was no way for a nonspousal beneficiary to

Hardship Withdrawals from a Qualified Plan

Generally, elective contributions to a qualified plan cannot be distributed before the occurrence of one of the following specific events:

1. Death, disability, or severance from employment
2. Attaining age 59½ (for a profit-sharing or stock bonus plan)
3. Hardship distribution (for a profit-sharing or a stock bonus plan)
4. Plan termination

With respect to a hardship distribution, the standard is whether the distribution is made on account of the employee’s immediate and heavy financial need and the distribution is necessary to satisfy that need. Whether the immediate and heavy financial need standard is met is a test based on all the facts and circumstances; however, distributions for the following reasons are deemed to be made on account of an immediate and heavy financial need if they are used for:

1. Paying medical expenses that were either previously incurred by, or are necessary for the medical care of, the employee, the employee’s spouse, or the employee’s dependents;
2. The costs directly related to the purchase, excluding mortgage payments, of the employee’s principal residence;
3. Paying tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee, his or her spouse, children, or dependents; and
4. Paying amounts necessary to prevent the eviction of the employee from his or her principal residence, or to prevent foreclosure on the mortgage on the employee’s principal residence. For purposes of the hardship
Emma is a beneficiary of Sarah’s pay for Ethan’s medical bills because a qualifying child or a qualifying relative meets the Section 152 definition of a dependent. Although neither Emma nor Ethan were dependent on Sarah at the time of the accident and requires a leg brace, Ethan was involved in a serious bicycling accident on her 401(k) plan. Emma’s son made her niece Emma her beneficiary. Sarah works as a computer security officer in a large corporation and has the cash available to pay for Ethan’s medical bills because Emma is a beneficiary of Sarah’s 401(k) plan.

Planning note
The effect of this change is to substantially enlarge the number of people on whose behalf a hardship distribution can be made since it includes beneficiaries of the plan who are not qualifying children or qualifying relatives.

Example
Sarah works as a computer security officer in a large corporation and made her niece Emma her beneficiary on her 401(k) plan. Emma’s son Ethan was involved in a serious bicycle accident and requires a leg brace. Although neither Emma nor Ethan meet the Section 152 definition of a qualifying child or a qualifying relative with respect to Sarah, Sarah may take a hardship distribution to pay for Ethan’s medical bills because Emma is a beneficiary of Sarah’s 401(k) plan.

Planning note
The PPA requires the IRS to issue similar rules with respect to IRC§ 403(b), 457, and 409A nonqualified deferred compensation plans.

Roth IRA Conversions
Taxpayers with a modified adjusted gross income (MAGI) of $100,000 or less may convert their traditional IRA to a Roth IRA. When the Roth conversion takes place, the individual will be taxed on his or her untaxed income in the traditional Roth IRA at the time of conversion to the Roth IRA, however. Since a conversion is treated as a distribution, withholding applies unless the IRA owners waive it. Most IRA owners will waive it because they wish to convert the entire amount and then elect to pay the applicable income taxes on the conversion from funds held outside the IRA.

Why make a Roth IRA conversion?
The question arises as to why a taxpayer would find it advantageous to make a Roth IRA conversion. An individual choosing to make a Roth conversion will elect to pay income tax in the year of conversion on the amount converted for the purpose of avoiding income tax in the future when the Roth IRA makes distributions to the account owner or his or her beneficiary.

Generally an individual making a Roth IRA conversion will find such a conversion advantageous when he or she is in a low tax bracket at the time of conversion—hence the effective rate of tax on the account balance at the time of the Roth IRA conversion would be low—and either he or she or his or her beneficiary would be in a higher tax bracket in the future when the Roth IRA would make tax-free distributions. Hence, in order for the Roth conversion to be economically attractive, the tax-free growth of the after-tax contribution to a Roth IRA would be more valuable than the current deduction resulting from making a deductible contribution to a traditional IRA from a present value, time value of money perspective.

In determining whether to make a Roth conversion the taxpayer also should consider whether he or she has the cash available to pay the tax on conversion and whether the avoidance of taxable RMDs is a desirable objective when balanced against the tax applicable at the time of the conversion. All of these factors and others can be input into mathematical calculators that can determine quantitatively whether the taxpayer can convert advantageously. Of course such calculators employ certain assumptions about interest rates and the taxpayer’s intentions and circumstances that may not be accurate.

At times, a taxpayer may conclude that the decision to convert a traditional IRA to a Roth IRA was a mistake and, accordingly, he or she may desire to undo the conversion and essentially redeposit the converted balance back into the traditional IRA. Undoing a Roth IRA conversion is possible; however, an individual cannot convert to a Roth IRA, transfer the amount back to a traditional IRA, and then reconvert to another Roth IRA during the same taxable year or, if later, during the 30-day period beginning on the day of the recharacterization of the Roth IRA back to the traditional IRA.

Example
In 2007, Mary Lincoln converted an amount from a traditional IRA to a Roth IRA and then later in 2007 transferred that amount back to a traditional IRA. Mary may not reconvert that amount from the traditional IRA to a Roth IRA before the beginning of the year following the year in which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on which she transferred the amount from the Roth IRA back to a traditional IRA.

Elimination of the MAGI Limit in 2010
As noted, prior to 2010, a taxpayer with a MAGI of $100,000 or less can convert all or a portion of his or her traditional IRA account balance to a Roth IRA. The amount converted is treated as a distribution from the traditional IRA for income tax purposes and accordingly is subject to income tax though it is not subject to the additional 10-percent tax on early withdrawals.

For years beginning after 2009, there are no MAGI limits on conversions of traditional IRAs to Roth IRAs.
IRAs. Thus, after 2009, taxpayers may make Roth IRA conversions without regard to their MAGI. For conversions occurring in 2010 only, unless a taxpayer elects otherwise, the amount includible in gross income as a result of the conversion is included ratably in 2011 and 2012. Apparently the federal government anticipates that the year 2010 will see an enormous number of Roth IRA conversions by those whose MAGI’s in the past precluded them from making such conversions. Unless a taxpayer elects otherwise, none of the amount includible in gross income as a result of a Roth IRA conversion occurring in 2010 is included in income in 2010. Half of the income resulting from the conversion is includible in gross income in 2011 and half in 2012.

Planning point
Taxpayers with MAGIs above $100,000 might consider making nondeductible contributions to traditional IRAs for 2007, 2008, and 2009 in anticipation of converting these traditional IRAs to Roth IRAs in 2010. If the taxpayer makes contributions to a nondeductible IRA in these three years, he or she then can convert this account to a Roth IRA in 2010 without any income tax on the amounts contributed, though of course, the earnings on the contributed amounts will be subject to income tax.

The year 2010 is the last year for the current low marginal income tax rates since these tax rates sunset in 2011 and higher rates will apply. Hence individuals making a Roth IRA conversion in 2010 should consider recognizing the income in 2010 despite the option to defer the tax on the converted amount to 2011 and 2012.

Roth conversion accelerations of income
An income inclusion related to Roth conversions in 2010 that is recognized in 2011 and 2012 is accelerated to 2010 if converted amounts are distributed before 2012. In that case, the amount included in income in the year of the distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: 1) half of the amount includible in income as a result of the conversion; and 2) the remaining portion of such amount not already included in income.

Example
Joan has a traditional IRA with a value of $100, consisting of deductible contributions and earnings. Joan does not have a Roth IRA. Joan converts the traditional IRA to a Roth IRA in 2010 and, as a result of the conversion, $100 is includible in gross income. Unless Joan elects otherwise, $50 of the income resulting from the conversion is included in income in 2011 and $50 in 2012.

Later in 2010, Joan takes a $20 distribution, which is not a qualified distribution and all of which, under the ordering rules, is attributable to amounts includible in gross income as a result of the conversion. Under the accelerated inclusion rule, $20 is included in income in 2010. The amount included in income in 2011 is the lesser of: (1) $50 (half of the income resulting from the conversion), or (2) $80 (the remaining income from the conversion). The amount included in income in 2012 is the lesser of: (1) $50 (half of the income resulting from the conversion) or (2) $30 (the remaining income from the conversion, i.e., $100 – $70 ($20 included in income in 2010 and $50 included in income in 2011)).

Planning note
An important consideration in determining whether it makes economic sense to make a Roth conversion is whether the conversion can be funded by using funds from outside the converted IRA account or whether the account owner must take proceeds from the IRA itself to pay the tax. Withdrawals made to pay the conversion tax would be subject to both income tax and the 10 percent early withdrawal penalty and significantly would reduce the economic advantage of making the conversion.

An individual with an interest in a qualified retirement plan now can convert that interest into a Roth IRA directly. Until 2010, however, the $100,000 AGI limit applies.

Advantages of a Roth conversion:
Those considering converting an IRA to a Roth IRA might consider the following factors:
1. If a taxpayer expects to be in a higher income tax bracket during retirement the income triggered by the conversion will be taxed at a lower rate. The reverse often is the case and an individual might consider that regular IRA distributions, though taxable, would be taxed at a lower rate than the amount converted to a Roth IRA if the taxpayer had less income during retirement years.
2. Those whose IRAs contain predominately after-tax amounts will not have much tax to pay on the conversion. This factor alone should motivate taxpayers to consider opening nondeductible IRA accounts in the years prior to 2010 since they will be able to move significant nontaxed amounts into Roth IRAs when they convert their regular IRAs to Roth IRAs in 2010.
3. Those who wish to avoid required minimum distributions (RMDs) for themselves might consider a Roth conversion in 2010, as the Roth account has no RMDs for the account owner. Additionally the account holder may wish to pay the entire nontaxable account balance to children or grandchildren over time without taking RMDs himself or herself by making them the beneficiaries of his or her Roth IRA. Beneficiaries of Roth IRA accounts must take RMDs, but these RMDs are not taxable.
For purposes of comparison, Table 1 sets forth a comparison of traditional IRAs and Roth IRAs.

**Roth 401(k) Plans**

A 401(k) plan or a 403(b) plan may permit employees who are eligible to make salary-deferral contributions to designate some or all of their contributions as Roth 401(k) contributions. 401(k) plans with a Roth component have been available since 2006, but the Roth component is not a required part of a 401(k) plan; it is optional with the employer. Unlike regular salary-deferral contributions, which are made on a tax-deferred basis, Roth 401(k) contributions are made on an after-tax basis, and therefore are not tax deductible. Unless the employer has amended its 401(k) plan or 403(b) plan to permit the Roth contributions, employees will not be allowed to designate their salary-deferral contributions as Roth 401(k) contributions.

Unlike the regular Roth IRA, which allows only individuals with income below certain limits to contribute to a Roth IRA, there are no income limits barring eligible employees from making contributions to a Roth 401(k) account. The contribution limit to an individual’s Roth 401(k) account is identical to the regular salary-deferral limit for 401(k) plans. Thus, in 2007, an individual may contribute up to $15,500 to his or her Roth 401(k) account or $20,500 if the individual is eligible to make catch-up contributions to the plan. Eligible employees may make catch-up contributions to 401(k) or 403(b) plans only if permitted by the plan.

Designated Roth 401(k) contributions must meet the following requirements:

- The employee must make an irrevocable election to designate the contributions as Roth account contributions.
- The employer must ensure that the amounts are not treated as pre-tax contributions.
- The employer must maintain separate records for the contributions. Separate accounts must be maintained for the life of the Roth 401(k) account to ensure that an employee’s contributions to his or her Roth 401(k) can be clearly distinguished from the plan’s other assets. The separate accounting requirement applies to contributions, withdrawals, gains and losses, and other credits and charges that relate to the Roth account.

**Taxation of distributions**

The income taxation of a distribution from a Roth 401(k) depends on whether or not the distribution is

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**TABLE 1 Comparison of Traditional IRAs and Roth IRAs**

<table>
<thead>
<tr>
<th></th>
<th>TRADITIONAL IRA</th>
<th>ROTH IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility to open the account</td>
<td>Individual age 70 or less with earned income. Also available to at-home spouses. Contributions must be made in cash.</td>
<td>No age restrictions as long as individual has earned income and meets income limits. Also available to at-home spouses. Contributions must be made in cash.</td>
</tr>
<tr>
<td>Taxpayer’s investment goal</td>
<td>Tax-deferred growth</td>
<td>Tax-free growth</td>
</tr>
<tr>
<td>Maximum annual contribution (2008)</td>
<td>$5,000 $6,000 if individual is age 50 or older Certain rules apply with regard to the ability to make contributions on behalf of lesser-compensated spouse.</td>
<td>$5,000 $6,000 if individual age 50 or older Same rules apply with regard to ability to make contributions on behalf of lesser-compensated spouse as apply to traditional IRAs.</td>
</tr>
<tr>
<td>Treatment of contributions</td>
<td>Deductible, subject to retirement plan participation status and modified adjusted gross income limits. Investment options limited</td>
<td>Contributions not deductible Same investment options as for traditional IRAs</td>
</tr>
<tr>
<td>Tax treatment of withdrawals</td>
<td>Earnings and deductible contributions taxable as ordinary income upon withdrawal.</td>
<td>Distributions of earnings on contributions are tax-free if held 5 years and account owner age 59.</td>
</tr>
<tr>
<td>10% early-withdrawal penalty</td>
<td>May apply to distributions of earnings taken prior to age 59, subject to certain exceptions (e.g., due to death or disability).</td>
<td>Same exceptions as for traditional IRA.</td>
</tr>
<tr>
<td>Mandatory distribution</td>
<td>RMDs must begin by April 1 of the year following the year in which the individual reaches age 70.</td>
<td>No RMD requirement for account owner, however after the death of the Roth IRA owner, the RMD rules will apply to the beneficiary. The distributions themselves will not be taxable.</td>
</tr>
<tr>
<td>Contribution deadlines</td>
<td>Due date for filing the IRA owner’s tax return, not including extensions.</td>
<td>Same as traditional IRA</td>
</tr>
</tbody>
</table>
a qualified distribution. A qualified distribution from a Roth 401(k) is not taxable but a nonqualified distribution is. A qualified distribution is a distribution that is made after a five-taxable-year period of participation and that either 1) is made on or after the date the employee attains age 59½; 2) is made after the employee’s death; or 3) is made because the employee is disabled.

Final regulations in 2007

The IRS issued final regulations in TD 9324, which apply for tax years beginning on or after January 1, 2007, that provide comprehensive guidance on taxing distributions from Roth IRA accounts. These regulations provide that a designated Roth account is a separate account under either a 401(k) plan or 403(b) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses are maintained. Any transaction or accounting methodology involving an employee’s designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement.

Qualified distributions. How a Roth distribution is taxed depends on whether or not the distribution is a qualified distribution. A qualified distribution from a designated Roth account is not includible in the employee’s gross income. A qualified distribution generally is a distribution that is made after a five-taxable-year period of participation and that either: 1) is made on or after the date the employee attains age 59½; 2) is made after the employee’s death; or 3) is attributable to the employee’s being disabled.

In the case of distribution to an alternate payee or beneficiary, the age, death, or disability of the participant are used to determine whether the distribution is qualified.

In order for a distribution from a designated Roth account to be a qualified distribution and thus not includible in gross income, a five-taxable-year requirement must be satisfied. The five-taxable-year period during which a distribution is not a qualified distribution begins on the first day of the employee’s tax year for which the employee first had designated Roth contributions made to the plan and ends when five consecutive tax years have been completed. However, if a direct rollover is made from a designated Roth account under another plan, the five-taxable-year period for the recipient plan begins on the first day of the employee’s taxable year for which the employee first had designated Roth contributions made to the other plan, if earlier.

Certain contributions do not start the five-taxable-year period of participation. For example, a year in which the only contributions consist of excess deferrals will not start the five-taxable-year period of participation. Further, excess contributions that are distributed to prevent an actual deferral percentage (ADP) failure also do not begin the five-taxable-year period of participation. Finally, contributions returned to the employee relating to erroneous automatic contributions also do not start the five-taxable-year period of participation.

Taxation of nonqualified distributions. Unlike the special ordering rules for Roth IRA distributions, which provide that the first distributions from a Roth IRA are a return of basis until the owner’s contributions have been returned, distributions from Roth 401(k) plans employ a pro rata basis recovery rule. This rule provides that an allocable share of each nonqualified distribution from a Roth component of a Roth 401(k) plan is a recovery of capital and an allocable portion of the distribution is taxable.

Rollover of designated Roth contributions. To roll over any portion of the basis in a designated Roth account of a Roth 401(k) plan into a designated Roth account in another Roth 401(k) plan, the rollover must be accomplished through a direct rollover (i.e., a rollover to another designated Roth account is not available for the portion of the distribution not includible in gross income if the distribution is made directly to the employee). However, the receiving plan need not separately account for designated Roth contributions that are rolled over because such contributions are independently subject to the separate account requirement. A distribution from a designated Roth account only may be rolled over to a 401(k) plan or 403(b) plan if that plan has a designated Roth program.

When the entire amount of a distribution from a designated Roth account is rolled over to another designated Roth account, the amount of the rollover contribution allocated to investment in the contract in the recipient-designated Roth account is the amount that would not have been includible in gross income if the distribution had not been rolled over. Thus, if an amount that is a qualified distribution is rolled over, the entire amount of the rollover contribution is allocated to investment in the contract. If the entire account balance of a designated Roth account is rolled over to another designated Roth account, and, at the time of the distribution, the investment in the contract exceeds the balance in the designated Roth account, the investment in the contract in the distributing plan is included in the investment in the contract of the recipient plan.

If an employee receives a distribution from a designated Roth account, the portion of the distribution that would be includible in gross income is permitted to be rolled over into a designated Roth account under another plan. The employee’s period of participation under the distributing plan is not...
>> “RETIREMENT SAVINGS” CONTINUED

carried over to the recipient plan for purposes of satisfying the five-taxable-year period of participation requirement under the recipient plan. Generally, the taxable year in which the recipient plan accepts such rollover contribution is the taxable year that begins the participant’s new five-taxable-year period of participation. However, if the participant is rolling over to a plan in which the participant already has a pre-existing designated Roth account with a longer period of participation, the starting date of the recipient account is used to measure the participant’s five-taxable-year period of participation.

Planning notes
The Bankruptcy Abuse Prevention and Consumer Protect Act of 2005 provides that a contributory IRA, regardless of whether it is a regular IRA or a Roth IRA, is exempt from the bankruptcy estate up to $1 million. If an IRA is a rollover from a qualified plan, the exemption amount applies without regard to the amount. An IRA that consists of both contributory and rollover funds has two sets of applicable rules. The $1 million will apply to the contributory funds and earnings attributed to those funds, but not to the rollover funds and to earnings attributable to the rollover funds.

In many ways, the choice is more art than science, because the answer isn’t as obvious as it may seem. The question to be addressed is: “What is it worth to me today to have tax-free income in the future?”

Conclusion
The decision whether to contribute salary deferrals as Roth 401(k) contributions is an individual choice that needs to be made based on that person’s tax status every year. In many ways, the choice is more art than science, because the answer isn’t as obvious as it may seem. The question to be addressed is: “What is it worth to me today to have tax-free income in the future?” There are calculators available to measure contributing pretax traditional versus after-tax Roth. It is very important to use these calculators so that clients can see the economic effect of their choice. However, the results may be surprising and may lead to no real answer. Most of the better calculators allow two comparisons: 1) keeping the annual contribution the same for Roth and pretax or 2) keeping take-home pay the same. Comparing both of these options is important. Since many people setting up a one-person 401(k) are seeking a current tax deduction, the Roth 401(k) may not be an advantage. Unlike most individuals when deciding between a Roth IRA and a traditional IRA, the Roth 401(k) always is a choice between after-tax and pretax. Every dollar that is contributed to a Roth 401(k) is one less dollar that can be contributed pretax. This means an immediate loss of tax savings. The higher the income level, the greater the tax savings lost.

Ian J. Redpath, J.D., LL.M., is director of graduate accounting at Canisius College. He earned a B.S. from Hillsdale College, a J.D. (honors) from the University of Detroit School of Law, and a LL.M. in tax law from the University of Wisconsin. Contact him at redpathi@canisius.edu.

Michael J. Tucker, Ph.D., J.D., LL.M., CPA, is professor of accounting at Quinnipiac University. He earned a B.A. from St. Louis University, M.B.A. and J.D. degrees from New York University, a Ph.D. from the University of Houston-Downtown, and an LL.M. from Georgetown University. Contact him at mtucker@byxbee.com.

Eric M. Redpath, J.D., is associated with the Redpath Law Offices in Buffalo, NY. He earned a B.A. from Canisius College and a J.D. from Stetson University College of Law. Contact him at ericredpath@redpathlaw.com.