Roth IRA Conversions

Estate and Tax Planning Information

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Roth IRA conversions can offer many benefits, most notably the suspension of required minimum distributions, future tax-free withdrawals, and a hedge against future tax hikes. Other less-obvious benefits may include offsets to the conversion tax using carry-forwards from charitable deductions, net operating losses, and investment tax credits; as well as estate-planning opportunities.

Beginning in 2010, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) will permanently eliminate the $100,000 household modified adjusted gross income (MAGI) limitation for conversions to Roth IRAs from traditional IRAs and employer-sponsored retirement plans. Roth IRA contributions still will be subject to MAGI limits, phased out at $120,000 for singles and $176,000 for joint filers in 2009. (Married couples filing separately are ineligible to make Roth IRA contributions.)

In passing the tax-reducing components of TIPRA, Congress sought to limit federal revenue reductions to less than $70 billion over the 10-year budget period. The Joint Committee on Taxation projected a tax revenue increase during the period of some $6.4 billion (present value) resulting from Roth IRA conversions. Interestingly enough, the Tax Policy Center (www.taxpolicycenter.org) estimates that the real longer-term cost to the government will be more than double that amount, due to lower traditional IRA tax collections in future years. This alone suggests that Roth conversions may provide taxpayer benefits well beyond their initial (or deferred) tax cost.

Roth Overview

Funds contributed to Roth IRAs are not tax deductible. However, earnings accumulate tax-free and, after five years of participation and reaching age 59½, distributions are tax-free. Distributions of earnings before five years of participation and reaching age 59½ generally are subject to a 10-percent excise penalty in addition to ordinary income taxes. This means that you always can distribute your Roth contribution amounts without tax or penalty. In the case of contributions comingled with converted funds, the annual contributions are considered distributed before converted amounts, followed by converted amounts (earliest first), and finally, earnings. Converted traditional IRA amounts distributed before five years of participation or age 59½, whichever occurs first, may be subject to a 10-percent excise penalty.

Exceptions to the 10-percent excise penalty can be found under Internal Revenue Service (IRS) Section 72(t). Exceptions may include death, disability, first-time home buyers (up to a lifetime maximum of $10,000), medical insurance premiums for eligible unemployed individuals, medical expenses that exceed 7.5 percent of AGI, IRS levy, qualified education expenses, qualified reservists, and amounts taken as a series of substantially equal periodic payments. While the 10-percent early distribution excise penalty is waived on converted assets, it specifically is not waived on amounts distributed from retirement plans to pay conversion taxes.

Unlike traditional IRAs, there is no age 70½ required minimum distribution (RMD) and, so long as there is earned income, contributions can continue after age 70½ subject to MAGI phase-out limitations (discussed above). As a result, Roth IRAs can continue to grow over the life of the original owner and the surviving spouse if the spouse is the primary beneficiary. After the death of the surviving spouse, Roth distributions then can be "stretched" over the life expectancy of nonspousal beneficiaries (discussed below).

2010 Tax Deferral

For 2010 Roth conversions only, taxpayers can pay all taxes due on the conversion in 2010 or defer 2010 income recognition to 2011 and 2012. At the taxpayer’s election, half of income can be reported in 2011 (with tax due April 15, 2012, or October 15, 2012, with extension) and the other half in 2012 (with tax due April 15, 2013, or October 15, 2013, with extension). This could allow up to 28 months before the first tax payment is due and 32 months for the second tax payment for conversions made in January of 2010. Although the taxes are paid at the rates prevailing at the time of payment, the choice will be made easier because the 2011 tax rates should be available before the 2010 filing deadline.

Because conversions also can be done over multiple tax years, a potentially valuable planning opportunity will remain after 2010. The logic involved in converting in 2010 also applies to the recommendation that the conversion be done sooner in the tax year. The earlier conversion allows the assets to (presumably) grow for a longer period of time in the Roth account. Again, the taxation of the conversion will depend upon the ratio of pre-tax to after-tax contributions.
Recharacterization and Reconversions

Conversion earlier in the year also gives taxpayers more time to take advantage of an opportunity known as “recharacterization.” Recharacterization allows investors to undo a conversion and eliminate the attendant tax liability by moving the funds back into the traditional IRA.

Recharacterizations must be completed by the due date of the tax return including automatic extension. Generally, taxpayers will wish to wait at least until the end of the conversion year before deciding to recharacterize. The timeframe gives taxpayers converting in January about 21 months to reflect on the wisdom of the conversion. Reconversion is permitted after 30 days or January 1st of the year following the conversion, whichever is later. This prohibits reconversions of the same amounts from taking place in the same tax year. Note that, in the case of a partial conversion, the unconverted amount remains eligible for same-year conversion, even where a reconversion is of a different amount.

Partial Conversions and Recharacterizations

Because future tax rates are unknown until published, a partial conversion may be an attractive choice that also allows flexibility for future conversions. In the case of full reconversions, no gain/loss calculation is needed. However, for partial recharacterizations the amount recharacterized must take into account the gain or loss experienced while the converted funds were in the Roth account.

For example, if $100,000 was converted to a Roth and earned 10 percent, recharacterizing half ($50,000) of the original conversion will require a transfer back to the traditional IRA of $55,000. Similarly, if the performance while in the Roth was negative, the amount of the partial recharacterization would be less than the pro rata portion of the original conversion. The IRS, in T.D. 9056 (Earnings Calculation for Returned or Recharacterized IRA Contributions), provides the following formula for determining gain/loss:

\[
\text{Net Income} = \frac{\text{Contribution} \times (\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}
\]

Receipt of negotiable funds by the taxpayer, even temporarily, may trigger disallowance of the recharacterization or a failed conversion. Care therefore should be taken to assure trustee-to-trustee transfers for conversions and recharacterizations. A failed conversion is considered a traditional IRA distribution and can trigger both income tax and a potential 10-percent excise penalty. A failed reconversion can be treated as an excess Roth contribution and may trigger the 6-percent penalty tax assessed on excess Roth contributions that remain in the Roth following the tax-return due date (including extensions).

The penalty for excess Roth contributions is assessed each year that the excess amount remains in the Roth. To keep the audit trail “clean” in a recharacterization, it may be helpful to establish a separate Roth account, at least temporarily, to avoid comingling converted assets with prior Roth investments. The partially converted account also contains nondeductible contributions, but the unconverted remainder will keep the same ratio of deductible versus nondeductible assets that existed before the partial conversion in aggregate in an all-traditional IRA, simplified employee pension individual retirement account (SEP IRA), and/or savings incentive match plan for employees (SIMPLE IRA) plans.

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Bracket Creep, Phase Outs, and Social Security

Distributions from traditional IRAs, including conversions to a Roth IRA, are taxable events. The additional income from a distribution may push the taxpayer into a higher marginal tax bracket. With the higher income level attributable to conversion proceeds, there may also be a phase-out of certain otherwise allowable deductions, resulting in additional tax costs and the so-called “stealth tax.” To avoid surprises, do the math first.

A Roth conversion may mean a lower tax on future Social Security benefits because Roth distributions are not included in income. On the other hand, because the taxable portion of traditional IRA distributions (and Roth conversions) is considered income, Roth conversions may have unintended tax consequences for those already collecting Social Security. The amount of a Social Security benefit that is subject to taxes may increase if MAGI exceeds the base amount. In 2009, the base amounts are $32,000 for married couples filing jointly and $25,000 for single filers.

Estate Planning Opportunity

Original owners of Roth IRAs and their surviving spouses are not required to take RMDs. Nonspousal beneficiaries of Roth IRAs should begin RMDs the year following the year of the IRA owner’s death to take advantage of the stretch IRA
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strategy, which allows distributions to be “stretched” over their (presumably longer) life expectancy. As a result, significant accumulations may be transferred to future generations.

In contrast, owners of traditional IRAs must begin taking annual RMDs by April 1st of the year following the year they reach age 70½. If the first year’s RMD is delayed until April 1st of the following tax year, it effectively defers the tax for 12 months, but it also means that two RMDs are due in the same year. Taxation of traditional IRA distributions will depend upon the ratio of pre-tax and after-tax contributions, which is known as the Pro-Rata Rule.

Regardless of whether the traditional IRAs original owner had begun RMDs, a spousal beneficiary stands in a unique position compared to a nonspousal beneficiary. A spousal beneficiary may roll the traditional IRA into his/her name and is required to take RMDs only upon reaching age 70½. In addition, spousal beneficiaries can use the IRS Uniform Table to determine each year’s applicable divisor, which may result in a longer distribution period than the single-life table.

If the traditional IRA owner died before beginning RMDs, a nonspousal beneficiary planning to take advantage of the stretch IRA strategy must begin distributions in the year following the year of the IRA owner’s death. Using the stretch strategy, a nonspousal beneficiary will take RMDs each year using his/her age and the single-life table (term certain). Missing the stretch opportunity subjects nonspousal beneficiaries to the “five-year rule,” which requires the inherited IRA to be completely distributed within five years.

The five-year rule is not available when the traditional IRA owner dies after commencing RMDs; instead, the nonspousal beneficiary continues RMDs on the owner’s previous schedule. Because these are minimum distributions, a larger distribution always is allowable. The stretch IRA strategy is available whether the owner of the traditional IRA died before or after beginning RMDs.

Pay Taxes from Nonretirement Plan Assets
The economic merit of a Roth conversion usually requires the present value of the tax-free growth in the Roth to offset and exceed income tax paid for the conversion opportunity. Generally, the longer funds can remain in the Roth, the greater

the benefit. Additional factors influencing the Roth decision include the expected investment returns and the tax rate at conversion versus the tax rate at distribution. It will generally be best to pay the Roth conversion taxes from non-IRA assets. This allows a larger amount to benefit from long-term tax-free growth potential.

Converting Other Assets
Tax Consequences of Conversion with Large Rollover Accumulation
Beware of a potential conversion trap arising from same-year employer plan rollovers. As with non-Roth distributions, conversion taxation is based upon the proportional share of deductible contributions, nondeductible contributions, and account earnings.

For example: Assume an investor has a traditional IRA balance of $100,000 that includes $50,000 in nondeductible contributions. The investor wants to convert during the year and believes that taxes will be owed on only $50,000. However, after the conversion but in the same tax year, that investor also has a $400,000 401(k) rollover into a traditional IRA. Suddenly, the taxable portion of a $100,000 conversion is 90 percent ($90,000). If the 401(k) rollover is delayed until the following year, the taxable portion of the current-year traditional IRA conversion indeed would be only 50 percent ($50,000). This is because the Pro-Rata Rule aggregates all SEP, SIMPLE, and/or traditional IRAs to determine the taxable versus nontaxable ratio of a conversion.

Waiting to roll over employer-sponsored retirement plans until a year after the Roth conversion solves the problem. If an employer-plan rollover has already been made, depending upon the terms of the plan, it may be possible to transfer it back before December 31st of the rollover year. Refer to the plan administrator for full details and to confirm availability.

401(k) or 403(b) Conversion to Roth IRA
Employer-sponsored plans have different rules than IRAs for keeping track of after-tax amounts. The plan administrator is responsible for keeping track of the assets and can distribute them without using the Pro-Rata Rule. This means that a distribution of pre-tax money can be made separately from after-tax amounts. Beginning in 2008, the Pension Protection Act of 2006 allows company-plan balances to be converted directly to Roth IRAs. (MAGI conversion eligibility limits are still in effect for 2009.)

Conversions from employer-sponsored plans can be made by direct rollover of before-tax and/or after-tax money from the plan to the Roth IRA. In addition, amounts can be distributed from the plan and rolled over to the Roth IRA within 60 days of the distribution date. Pre-tax amounts that are converted will be included in the IRA holder’s gross income for the year, but Roth conversion of after-tax amounts will not
be taxable income. In each case, the amount rolled over must be an eligible rollover distribution.

Keep in mind that when receiving a direct distribution (not a rollover) from an employer plan, the plan is required to withhold 20 percent for federal taxes. Applicable taxes and penalties on the amount of the rollover contribution can be avoided if the entire amount of the lump-sum distribution is deposited into an eligible retirement account within 60 days of receipt. If the 60-day deadline is missed, the entire taxable portion of the distribution will be included as income and there also may be a 10-percent tax penalty, depending on age and the reason for the distribution.

In rolling over the total distribution amount (including withholding) the investor must personally deposit (out of pocket) the 20-percent tax withholding that was deducted from the distribution. Any taxable portion not rolled over (including the 20-percent tax withholding) will be considered a taxable distribution and income tax will be owed (on the taxable portion of the distribution) plus a 10-percent penalty, if under age 55. Some states may require withholding of taxes as well.

**Roth Conversion of Annuities**

The Entire Interest Regulation requires that the actuarial present value of an annuity’s “additional benefits” be added to the end-of-year account value for determining the fair market value of the contract on the date the annuity is converted. The IRS ruling includes contracts with a living benefit feature, on a dollar-for-dollar basis for distributions, where the actuarial present value of the guarantee is 20 percent greater than the contract value. Also included are death benefits excluding premium guarantee death benefits on contracts with a death benefit feature, on a dollar-for-dollar basis for withdrawals, where the actuarial present value of the guarantee is 20 percent greater than the contract value. In these instances, the actuarial present value of the benefit will be added to the account value for purposes of calculating the fair market value. Death benefits that guarantee a return of premium, benefits (death or living) that adjust on a pro-rata basis when a distribution is taken, or benefits that have an actuarial present value of less than 20 percent of contract value are not included for purposes of this calculation.

**Takeaways**

The Roth conversion MAGI limits will be eliminated beginning in 2010. Conversions are most effective when taxes are taken from outside sources, future tax brackets are higher, and distributions are delayed as long as possible. Conversions may cause bracket-creep and can impact both itemized deductions and Social Security income. The 10-percent early distribution penalty is waived on converted amounts but not on amounts taken from traditional IRAs to pay conversion taxes.

Conversions are best made early in the year and must be completed by December 31st of the converting tax year. Early-year conversions offer recharacterization opportunities including the opportunity to respond to miscalculations and changes in income, or to take advantage of market declines before tax-filing deadlines. Special issues may arise in the case of concurrent employer retirement plan rollovers and qualified annuity conversion valuation. Conversion decisions should be based upon careful calculations; conversion may not be the best alternative for everyone.

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**Endnote**

1 IRS REG-119097-05 published on June 7, 2007.

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