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The Roth IRA Conversion- A Golden Opportunity

INTRODUCTION

Many individuals have wanted to convert a Traditional IRA to a Roth IRA, but were not eligible because their modified adjusted gross income (MAGI) exceeded the income limitations for making conversions. These limits were repealed in January 2010 and high income earners now have a golden opportunity to create a vehicle which may not only generate tax-free income for all qualified distributions but which also has no required minimum distributions during the Roth IRA owner's lifetime. After the death of the Roth IRA owner, the beneficiary must generally meet the same type of required minimum distribution requirements as for a Traditional IRA. This opportunity to convert, however, may not be right for everyone. For instance, paying the taxes now may outweigh the benefit of tax-free retirement income in the future. An individual who is considering a conversion must consider their particular circumstances, including their age, to determine if a conversion is right for him or her.

This Legal & Tax Trends article examines the many factors that taxpayers and their independent tax advisors should consider in deciding whether or not to convert a Traditional IRA to a Roth IRA. It develops a two-prong analytical framework to assist individuals in making an informed decision. First, it suggests that taxpayers use a financial calculator to quantitatively determine whether the loss of the use of the money which is spent on taxes today is less than the present value of the future tax savings from distributions from the Roth IRA. Second, taxpayers will need to employ a qualitative approach by considering the many factors which cannot be easily incorporated into numbers. There may be special circumstances or factors which may override the quantitative result.

Many individuals whose modified adjusted gross income (MAGI) exceeded statutory limits were not able to contribute to a Roth IRA and many individuals whose MAGI exceeded $100,000 were not able to convert a Traditional IRA to a Roth IRA. For many taxpayers, MAGI will simply be equal to the adjusted gross income before taking into account deductible IRA contributions, and tuition and education loan expenses. Also, taxable social security benefits and the passive activity loss limitation rules are taken into account when determining MAGI and not AGI. The most important distinction is that MAGI does not include the income generated when an IRA is converted to a Roth IRA.

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), enacted on May 17, 2006, repealed the $100,000 MAGI limitation on Roth conversions, beginning in 2010.[2] Clients are now able to take advantage of all of the benefits of a Roth IRA, including potential tax-free growth and tax-free characterization of qualified distributions and no required minimum distributions during the Roth IRA owner's life. To clarify, TIPRA eliminated MAGI restrictions on conversions, but did not eliminate the MAGI restrictions on regular contributions (non-conversion and non-rollover contributions). Under current law, taxpayers whose MAGI exceeds certain limits may not make regular contributions to a Roth IRA in 2010 or years following. Background information on Traditional IRAs is provided in Appendix I and for additional information on Roth IRAs, please sees Appendix II.

II. CHANGE IN LAW PERMITS CONVERSION FROM A TRADITIONAL IRA TO A ROTH IRA

All taxpayers can now convert their Traditional IRAs (both deductible and non-deductible) to Roth IRAs. The amount converted is currently taxable to the extent of previously deducted IRA contributions and earnings (non-deductible contributions made to the IRA constitute basis and are not taxed). Taxpayers who receive (or are treated as receiving) a distribution from their non-Roth IRAs by December 31, 2010, which is converted to a Roth IRA, can take advantage of a special two-year spread (discussed below). The taxpayer incurs no pre-age 59½ withdrawal penalty on the converted amount. For conversions involving annuities, the taxable income to be reported will generally be based on the account value, but may also include an actuarial adjustment for any additional benefits (living benefits and death benefits) provided under the contract along with the addition of certain loads and charges, which were deducted from the account balance during the immediately preceding 12 months. The calculation of any potential adjustment is quite complicated and must be performed by an actuary. However, there are a number of factors that tend to impact the adjustment:

[2] TIPRA also eliminated the filing status restriction beginning in 2010 and, therefore, even if the taxpayer files as married filing separately, the taxpayer is eligible to convert from a qualified retirement plan or traditional IRA to a Roth IRA.

(i) the difference between the guarantee and the account value;
(ii) the time remaining before the guarantee can be exercised;
(iii) the age of the measuring life;
(iv) the form of the guarantee payment (annuitization, withdrawals, GPO or death benefit); and
(v) the way the withdrawals affect the value of the guarantee (pro rata or dollar for dollar).

While there are no age restrictions on who can convert to a Roth IRA, older individuals should proceed with caution since they may not live long enough to personally recoup the taxes paid upon conversion. On the other hand, wealthy seniors who wish to provide maximum benefit to their heirs may wish to consider a conversion, especially if they do not anticipate taking withdrawals from the Roth IRA during their lifetime. Individuals who are age 70 ½ or older should be aware that the required minimum distribution amount cannot be converted. To avoid any adverse tax consequences, the required minimum distribution should be taken from the IRA before making a Roth IRA conversion.

If the taxpayer has made only non-deductible contributions to his or her Traditional IRAs, then upon conversion only the earnings and not the contributions will be subject to tax. What if the taxpayer made only non-deductible contributions to his Traditional IRA and because of current market conditions, the value of the IRA is now less than the original amount contributed?

> ***Example:*** *John invested $5,000 in 2007, $5,000 in 2008 and $5,000 in 2009 in a non-deductible Traditional IRA. John has no other IRAs. The value at the time John converts to the Roth IRA in January 2011 is $12,000. John could convert to a Roth IRA and pay no tax. In addition, he may be able to claim a miscellaneous itemized tax deduction for the loss incurred since the amount distributed is less than his unrecovered basis.*

Partial Conversions

The math becomes more complicated if the client has made both deductible and non-deductible IRA contributions to his or her Traditional IRAs and he or she has elected to convert only a portion of the IRA. In this situation, the taxpayer cannot just convert the non-deductible contributions to a Roth IRA and avoid paying any tax on the conversion. Instead, the amount the taxpayer converts is deemed to consist of a pro-rata portion of the taxable and nontaxable dollars in the IRA.

Even though partial conversions are permitted under the tax law, a *trustee*, custodian or insurer of a Traditional IRA may not permit a partial conversion. For example, MetLife will not permit a partial internal Roth IRA conversion of an existing MetLife annuity contract. Establishing a new contract may result in the loss of existing death benefit and living benefit guarantees, the loss of existing interest rate guarantees, and may result in an increase in fees or surrender costs to the policy holder.

Conversions where taxpayer owns Multiple IRAs

Similarly, if the taxpayer has multiple IRAs, the tax law treats all of the taxpayer's Traditional IRAs (including SEPs and SIMPLE IRAs) as one IRA when the taxpayer converts (or takes a distribution from) any one of his or her IRAs. The values of all of the taxpayer's Traditional IRAs are aggregated so that the amount converted consists of a pro-rata portion of the taxable and nontaxable value of all of the taxpayer's IRAs. To calculate the nontaxable portion of the amount converted, the taxpayer divides the total non-deductible IRA contributions made (along with any other after-tax amounts in the taxpayer's IRAs) by the combined values of all of the taxpayer's Traditional IRAs, SEPs and SIMPLE IRAs.

> ***Example:*** *Jill has two IRAs - one IRA where she has made only non-deductible contributions of $50,000, which has earnings of $50,000, and which has a current balance of $100,000 and a second IRA where she has made only deductible contributions of $100,000, which has earnings of $50,000 and which has a current balance of $150,000. If Jill wishes to convert only the IRA where she has made non-deductible contributions, then she will need to pro-rate the taxable and nontaxable portions of both accounts. In this case, 80% ($200,000/$250,000) is taxable income and 20% ($50,000/$250,000) will be nontaxable return of after-tax basis.*
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> *If Jill is able to roll the $150,000 deductible IRA into her current employer's 401(k) plan or other qualified plan she may be able to reduce the tax bite when the non-deductible IRA is later converted into a Roth IRA. Some company retirement plans permit rollovers from the IRA into a 401(k) plan. The key point is that assets in the 401(k) plan are not included in the pro rata calculations.*
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> *Other taxpayers who have outside income may be able to open an individual 401(k) plan and move IRA assets into it in an effort to trim their tax hit upon conversion. Note, however, there may be certain restrictions on the taxpayer's access to the funds once rolled into an employer-provided qualified plan (e.g., 401(k) plan), which would generally depend on such factors as the terms of the plan, the age of the taxpayer, etc . . . .*

Timing Considerations

If the conversion occurred in 2010 (i.e. where the amount being converted is distributed or treated as distributed no later than December 31, 2010), the taxpayer could include one-half of the taxable amounts in 2011 gross income and the other half in 2012 gross income. The taxpayer will pay federal income tax in those years based on the then current tax brackets and income tax rates. If the individual elects out of the two-year spread, then he or she reports the entire income in 2010. If an individual expects his or her income to increase in future years, or if the taxpayer expects a particularly large deduction in 2010, then an individual might elect to include the income in 2010. One will need to weigh whether the money which is earned by delaying the tax payment will offset the risk of a higher tax bill by waiting to pay the tax. Individuals are encouraged to confer with their independent tax advisors regarding the specifics of their tax situation as it relates to the tax implications of a Roth IRA conversion.

> ***Example****: Jack has $100,000 in his Traditional IRA. For several years, he made after tax contributions to his IRA totaling $20,000. If Jack converted his IRA to a Roth in 2010, Jack could report $40,000 in 2011 and $40,000 in 2012 or he could elect to report the $80,000 of taxable income entirely in 2010. In either case, Jack incurs no 10% early withdrawal penalty if the entire $100,000 is converted to the Roth IRA. This spreading of income over two years may be attractive not only because Jack can spread out the payments, but also because he is more likely to avoid being pushed into a higher tax bracket.*

The ability to spread income over two years is only available for conversions which took place in the 2010 calendar year. Generally, if the amounts being converted are distributed (or treated as distributed) after 2010, the taxpayer will have to report the entire income in the year of the distribution (or deemed distribution).

Death during the Two Year Spread

> ***Example****: Bill converted his Traditional IRA in 2010 and elected to report the $50,000 of taxable income realized upon conversion over two years. Bill dies in 2011, is the remaining $25,000 includible in gross income for that year? Does Bill's estate (or does his surviving spouse, if he was married) include the untaxed amounts on its (or the spouse's) 2011 income tax return?*

On the death of the Roth IRA holder during the two-year spread period, all remaining income amounts which were deferred under the two year spread will be includible in the holder's final return. If a surviving spouse is the beneficiary of the Roth IRA, the spouse may continue the deferral by including the remaining amounts in his or her income over the remainder of the two-year spread period.

Re-characterizing the Transaction

While the taxpayer can initiate the conversion anytime during the calendar year, the client may wish to convert early in the tax year, particularly if the taxpayer expects the market will rise. If, however, the market drops (or because of unforeseen expenses or job loss, the taxpayer no longer has the funds to pay the tax) then the taxpayer may "undo" the transaction and re-characterize the converted funds.

Once the taxpayer has re-characterized the account, he or she cannot immediately reconvert the re-characterized IRA assets back to a Roth IRA. The taxpayer must wait until the later of 30 days after the re-characterization or the beginning of the next tax year to reconvert the amount to a Roth IRA. To retain the most flexibility, some commentators have suggested that the taxpayer, after converting to a Roth IRA early in the year, review his or her situation in November of that year and if the market is down at that time then re-characterize the transaction. Under this approach, maximum flexibility is retained since the taxpayer can reconvert back to a Roth IRA as early as January of the following year.

> ***Example***: *Tom converts to a Roth IRA in January 2011 and then after the market slides more than 20% during the year he elects to "undo" the transaction in November 2011. Tom must wait until January 1, 2012 before again converting amounts from the Traditional IRA to a Roth IRA.*

The re-characterization must generally be made by the due date of the taxpayer's return, plus any extension. For example, a conversion made in 2011 may be re-characterized or undone as late as October 15, 2012. A taxpayer who decides to make a re-characterization after filling the return for the affected year must file an amended return reflecting the transfer and write "Filed pursuant to Treas. Reg. Section 301.9100-2" (1997) on the amended return. Taxpayers may wish to keep the conversion proceeds separate from other Roth IRAs in order to more easily retain the option to convert the account back to a Traditional IRA.

Prior to conversion, taxpayers may also wish to establish a separate IRA for each type of asset class. By converting each of these IRAs separately, the taxpayer retains the most flexibility. In this way, the taxpayer can later re-characterize those Roth IRAs which have lost value since conversion and retain the Roth IRAs which have performed well since conversion. If all of the asset classes are commingled into one Roth IRA, then this opportunity to pick and choose based upon market performance is lost.

Preparing for the Conversion

Taxpayers who wish to convert will need to start planning to make sure that they have the cash to pay the tax with outside funds. Using the IRA funds to pay the tax could result in such amount being subject to the 10% federal income tax penalty (unless an exception applies). Clients may also wish to make an after-tax contribution to a Traditional IRA for the current tax year (subject to the annual contribution limits), so that more funds are available for conversion. Clients who are self-employed may consider increasing the amount available for conversion by contributing the maximum amount into their SEP (the lesser of 25% of earned income or $49,000 for 2010). Before clients who are self-employed increase their employer contributions to their own SEP-IRAs, they must consider the impact it would have on the amount they would have to contribute to their employees' SEP-IRAs. Finally, while there is no deadline to convert, some commentators have speculated that this opportunity to convert may not last indefinitely. Once Congress becomes aware of the large amount of lost revenue, it may decide to reinstate the income restrictions for conversions.

How to Effect the Change from a Traditional IRA to a Roth IRA

A taxpayer can take advantage of the change in the law in one of three ways. First, an individual can make a conversion without actually taking a distribution. For instance, if the IRA custodian/trustee/insurer permits, an individual may make a conversion by simply notifying the IRA custodian/trustee/insurer to re-designate the Traditional IRA as a Roth IRA. A re-designation is not considered a change of ownership and therefore, any living or death benefit riders that were on the contract will remain in effect after the conversion. Second, a Traditional IRA may be changed to a Roth IRA by the taxpayer directing a trustee-to-trustee transfer from the Traditional IRA to a new Roth IRA. Finally, a taxpayer can convert the Traditional IRA by taking a distribution from the Traditional IRA and rolling over or depositing the funds into a new Roth IRA account.

Regardless of the method employed (including the re-designation and trustee-to-trustee transfer methods), the converted amount is treated as a distribution from the IRA and a qualified rollover contribution to the Roth IRA, so the conversion must satisfy the general rollover rules (other than the one IRA-to-IRA rollover per 12 month period rule). For example, if the taxpayer receives the rollover amount, a rollover contribution must be made within 60 days to avoid adverse tax consequences. Since 2008, it is also possible for an eligible rollover distribution from certain qualified plans to be transferred, by direct or 60 day rollover, to a Roth IRA if the taxpayer otherwise qualifies. In this article conversion refers to any one of these methods of effecting the change from a Traditional IRA to a Roth IRA.

The general rule is that an individual is not permitted to do more than one rollover from or to the same IRA with a twelve-month period. This rule applies to Roth IRAs also. However, there is a special exception with respect to a conversion. In this situation, the taxpayer is permitted to disregard a conversion from a Traditional IRA to a Roth IRA.

> ***For example,*** *Tom takes a distribution from his Traditional IRA in November 2010 and rolls it to a separate Traditional IRA within sixty days. In March, 2011, Tom decides to roll this Traditional IRA to a Roth IRA. This rollover is permitted provided that Tom meets all the requirements for a rollover.*

In the case of a rollover from a Traditional IRA to a Roth IRA, the Roth IRA's five-tax-year holding period (which determines whether later distributions from the Roth IRA will be qualified) begins with the tax year in which the rollover contribution was made (assuming this is the taxpayer's only Roth IRA and the taxpayer did not make a regular contribution for an earlier year, or a conversion/rollover contribution in an earlier year). In this instance, the five-tax-year holding period for the 10% penalty tax also begins with the tax year in which the rollover contribution was made. Distributions of these converted amounts prior to the expiration of the five-tax-year holding period or prior to the attainment of age 59 ½ are subject to a 10% penalty unless one of the following exceptions applies: distributions due to the Roth IRA owner's death or disability, substantially equal periodic payments for life, eligible medical expenses, certain unemployed individual's health insurance premiums, limited "first time" home purchase, qualified higher education expenses or IRS levy. Each conversion has its own five-tax-year holding period for purposes of the 10% penalty tax.

Any distributions of earnings are both tax-free and penalty free if received after the qualified distribution five-tax-year holding period and the attainment of age 59 ½ (or one of the other requirements). Earnings distributed before the five-tax-year holding period has expired or before the attainment of age of age 59 ½ are subject to ordinary income taxes and may be subject to a 10% penalty. The 10% penalty would not apply if one of the following exceptions applies: distributions due to the Roth IRA owner's death or disability, substantially equal periodic payments for life, eligible medical expenses, certain unemployed individual's health insurance premiums, limited "first time" home purchase, qualified higher education expenses or IRS levy.

Rollover of Non-Cash Property

If the rollover distribution from your Traditional IRA is entirely in cash, then the property rolled into the Roth IRA must also be in cash. While the taxpayer does not need to show that it is the same cash, he or she will not be permitted to use the cash to purchase property and then roll the property into the Roth IRA. If the taxpayer received a property distribution from a Traditional IRA, then the taxpayer must roll the same property to the Roth IRA. A rollover or conversion is the only time one is permitted to contribute property to a Roth IRA.

Decedent or Inherited IRAs

Conversions are not permitted for an IRA which the taxpayer inherits from a person other than his or her spouse. Guidance issued in March 2008 initially appeared to permit such conversions, but a Technical Corrections law passed in December 2008 clarified that inherited IRAs cannot be converted. On the other hand, when an individual inherits a Traditional IRA from a spouse, the surviving spouse is permitted to treat this IRA as his or her own and elect to convert the IRA to a Roth IRA.

Unlike the non-spouse beneficiary of an IRA, a non-spouse beneficiary of a qualified retirement plan is eligible to make a Roth IRA conversion. This rollover to a Roth IRA by a non-spouse beneficiary must be made by a direct trustee-to-trustee transfer.

Convert SEP or SIMPLE IRAs

SEP or SIMPLE IRAs can also be converted to Roth IRAs. For SIMPLE IRAs, the taxpayer must have participated in any Simple IRA plan maintained by the same employer for at least two years prior to conversion. Before the two year period the only rollover permitted for the SIMPLE IRA is to another SIMPLE IRA. If the taxpayer re-designated the SEP-IRA or SIMPLE IRA as a Roth IRA or closed out the account or annuity, the taxpayer will need to establish a new SEP or SIMPLE IRA to receive any new SEP or SIMPLE IRA contributions after the taxpayer converts the original account to a Roth IRA.

Convert 401(k) or, 403(b) Plan from a Previous Employer

The conversion to a Roth IRA is not limited to just Traditional IRAs, SEPs or SIMPLE IRAs. An eligible rollover distribution from a qualified retirement plan may be converted to a Roth IRA also. So, if the taxpayer has a deferred vested account under an employer-sponsored deferral plan from a previous employer (i.e., a 401(k) or any other retirement plan, including a 403(b) plan or eligible governmental 457 plan), the taxpayer will be able to convert all or a portion of the account into a Roth IRA. The taxpayer will be taxed upon the value of the account at the time of conversion, less any after tax contributions he or she may have made to such an account. IRS Notice 2009-75 provides question and answer format guidance on the tax treatment of rolling over an eligible distribution from a qualified plan into a Roth IRA.[3]

For tax years before 2008 direct conversions from an employer plan to a Roth IRA were not permitted. If the taxpayer was eligible to roll a distribution from an employer plan to a Traditional IRA, and also eligible for a conversion from a Traditional IRA to a Roth IRA, then the taxpayer could accomplish this objective in two steps: first rolling to a Traditional IRA, then converting to a Roth IRA.

[3] Note, however, the tax treatment of the amount being converted from a qualified employer plan to a Roth IRA will not benefit from the special rules relating to net unrealized appreciation and the optional methods for calculating tax available to participants born on or before January 1, 1936.

Beginning in 2008 such a conversion is now permitted, but only in the circumstance where the taxpayer would be eligible for both of the steps. It still, however, may be preferable in certain situations to roll the employer plan to a Traditional IRA first and then convert to a Roth IRA. (e.g., where there have been substantial non-deductible contributions made to a Traditional IRA).

Employee salary deferral to a 401(k) or 403(b) plan and certain employer contributions and its earnings thereon are treated as elective contributions so distributions of such from a current employer's 401(k) or 403(b) plan are restricted and, generally, may only be made upon severance from employment, death, disability, hardship, retirement, or if permitted under the plan, attainment of age 59½.

A final consideration before converting a qualified plan to a Roth IRA is the fact that the qualified plans will generally offer a greater degree of creditor protection than an IRA. While Bankruptcy Act of 2005 provides protection for up to $1 million of IRAs plus any amounts which are rolled over to an IRA from a qualified plan, this protection does not apply outside of bankruptcy. To determine if an IRA can be attached outside of bankruptcy, one needs to determine the level of creditor protection given to Roth IRAs by the state in which the client resides. Some states provide broad creditor protection to Roth IRAs, but other states offer limited Roth IRA protection and still other states do not provide any creditor protection at all to Roth IRAs.

New Law Permits Roth Conversions within Qualified Plans

In September 2010 President Obama signed into law the Small Business Jobs Act of 2010 which allows (but does not require) 401(k) and 403(b) plans that offer designated Roth accounts to permit in-plan Roth conversions provided the non-Roth assets are distributable under the plan and otherwise eligible for rollover.. This new law also extends to governmental 457(b) plans starting in 2011, which is the first year a governmental 457(b) plan can offer a designated Roth account option. If this provision applies, the participant may find an in-plan conversion more attractive than converting to a Roth IRA in that a Designated Roth Account will provide more creditor protection than a Roth IRA. Furthermore, under the qualified plan rules, the tax treatment of distributions from a contributory 401(k) plan is generally treated separately from the distributions from a separate pension or profit sharing plan maintained by the same employer. This may be attractive for a participant who has made after-tax contributions to the 401(k) plan and has only pre-tax amounts in the pension or profit sharing plan. Upon conversion, the tax will only be paid on the pre-tax contributions and tax deferred earnings and not on the after-tax basis in the contributory 401(k) plan. In general, the taxation of the 401(k) plan distributions will ignore the funds in the separate pension or profit sharing plan and treat the contributory 401(k) plan as a separate plan. This will generally result in less tax recognition as the pro rata aggregation rule (applicable to IRA distributions) does not apply for separate qualified plans (other than IRA based plans).

This ability to convert certain non-Roth amounts inside a 401(k), 403(b) or governmental 457(b) plan to a Designated Roth Account may, however, have limited applicability. First, only plan sponsors that permit annual contributions to Designated Roth Accounts can offer this opportunity. Second, plan sponsors have the discretion of setting up this option and not all sponsors which permit Designated Roth contributions will elect to do so. Third, the distribution must be otherwise permitted under the plan. In effect, an in-plan conversion can only occur after the participant has experienced a distributable event. In most plans, these events are rather limited (e.g., severance from employment, attainment of age 59 1/2) and may depend on the source of the funds (e.g., elective deferrals, employer contributions, after-tax employee contributions, or rollover contributions from other plans). A plan sponsor, however, may expand in-service distribution options so that participants may take advantage of this opportunity. If a plan sponsor does so, it appears that the sponsor will be able to limit such options only to those participants who elect to have the distribution rolled over directly to the Designated Roth Account within the plan. Fourth, the distribution must be an eligible rollover distribution.

Conversions to Designated Roth accounts are subject to the same general rules that apply to Roth IRAs (including the tax treatment of the converted amounts and the special rule for 2010 conversions). Note, however, there are differences between a Designated Roth account and a Roth IRA that should be considered by the client and his or her independent tax advisor before converting, including (but not limited to) the fact that a Designated Roth account is subject to the lifetime required minimum distribution rules, the special Roth IRA ordering distribution rules do not apply, and the qualified distribution requirements for a Designated Roth account are slightly different.

Upon conversion, the participant must include the taxable amount resulting from the conversion into gross income in the year distributed or treated as distributed (a special two-year spreading of income is available for 2010 conversions only). A conversion within a qualified plan differs from a conversion of an IRA in at least one important way. After a conversion, the participant will not be able to re-characterize or “undo” the conversion. There is no escape if the participant losses his job and does not have the money to pay the tax or if the market decreases substantially. Consequently, the risk of making a conversion within a qualified plan is much greater than a conversion to a Roth IRA. This risk will need to be managed.

III. Should Clients Convert their Traditional IRA to a Roth IRA?

IRA holders need to consider the advantages and disadvantages of converting their Traditional IRA balances to a Roth IRA. This requires careful analysis, ideally involving the client's independent tax advisors, before any money is converted from a Traditional IRA to a Roth IRA, since each situation is unique. A rollover from a Traditional IRA to a Roth IRA may or may not be an attractive strategy for many clients currently in high tax brackets.

To assist their clients, producers should consider using a two-prong approach. First, it is suggested that producers use a financial calculator to ***quantitatively*** determine whether the loss of the use of the money which is spent on taxes today is less than the present value of the future tax savings from distributions from the Roth IRA. Second, producers will need to employ a ***qualitative*** approach by considering the many factors which cannot be easily incorporated into numbers. There may be special circumstances or factors (discussed below) which may override the quantitative result.

A. Quantitative Factors to Be Considered Before Converting To a Roth IRA

The three most important factors to consider under the quantitative approach are: (i) the portion of the account which consists of after-tax contributions; (ii) the client's adjusted marginal income tax bracket at conversion and the projected marginal tax bracket when distributions are ultimately taken; and (iii) whether the tax is paid from the IRA itself or from outside sources. Calculators should be selected which permit the user to change the input for each of these three critical factors.

(1) Non-deductible Contributions. What portion of the IRA value reflects non-deductible contributions? The higher the non-deductible portion, the lower the tax paid on the conversion and consequently, the more attractive the rollover will be. For example, if 40% of the converted amount reflects after-tax contributions and the client is in a 28% tax bracket, then only 60% of the amount being converted is taxed. In other words, the client is paying only a 16.8% (60% of 28%) effective tax rate on the amount being converted. However, as indicated above, all the non-Roth IRAs of which a taxpayer is the owner are treated as one IRA for purposes of determining the pro-rata taxable and nontaxable treatment of the converted amount.

(2) Relative Tax Brackets. Whether or not conversion makes financial sense will also depend on your client's marginal income tax bracket (calculated not at the time of conversion but on October 15^{th} of the year following conversion) and what the taxpayer's projected marginal income tax bracket will be when distributions are ultimately received (a future rate which we cannot accurately predict today). If it is considered likely that your client will be in the same or a higher marginal income tax bracket, then converting to a Roth IRA will generally be beneficial. But if the taxpayer will likely be in a lower marginal income tax bracket, then paying the tax at today's rate could be a mistake. If the IRA balance is large, adding the converted amount to the client's current income could push a client into a higher tax bracket. It will be important to calculate the total tax due (state and federal) under each scenario to obtain a better handle. One way to hedge one's bet is to convert only a portion of one's IRA balance to a Roth IRA - just enough so that the client is not pushed into a higher marginal income tax bracket. The possibility that tax rates will be reduced (or increased) by future legislation must also be considered.

Choosing the Appropriate Income Tax Rate for the Year of Conversion

In comparing the tax rates today one cannot simply use the client's marginal income tax bracket. This will often result in a higher tax liability on the conversion than would otherwise actually incur. Most conversions will have the taxpayer moving through various tax brackets before arriving at the highest marginal tax bracket. In addition, there may be various tax deductions which are phased out as income is increased. To find the actual marginal tax bracket, one must look at the additional tax liability incurred by the conversion and divide this amount by the value of the IRA being converted.

Adjust Marginal Income Tax Bracket for Post-Conversion Returns

The incremental effective income tax rate on the conversion amount should be calculated in the year following the year of conversion. As we indicated, a taxpayer may re-characterize (i.e., undo) a Roth IRA conversion as late as October 15^{th} of the year following the year of conversion. The taxpayer has the benefit of hindsight to determine if the original conversion was worthwhile. If the value of the Roth IRA has increased since the conversion, then it generally makes sense to keep the Roth IRA. On the other hand, if the Roth IRA has decreased in value since the time of conversion, the effective tax rate has increased and it generally makes sense to re-characterize the conversion in that the taxpayer would otherwise be paying tax on a portion of the asset that no longer exists.

In determining whether the conversion was worthwhile, the taxpayer needs to re-calculate the incremental income tax liability using the current value of the Roth IRA (as close to the October 15^{th} deadline as possible). For example, let's assume that the taxpayer has calculated that she will pay an additional $30,000 of income tax on the conversion. If the value of the IRA at the time of conversion is $100,000, then effective tax rate is 30%. But, if the value of the IRA increases to $150,000, then the taxpayer's adjusted tax rate decreases to a more reasonable 20%. Conversely, if the value of the IRA decreases to $50,000, then the taxpayer's adjusted tax bracket becomes a confiscatory 60% ($30,000/$50,000).

Consider the Impact of the Alternative Minimum Tax (AMT)

The impact of the AMT on the decision to convert also needs to be considered. Taxpayers may be led to believe that the Roth IRA conversion makes sense when it may not make sense when the additional tax due under the AMT is factored into the calculations. While the AMT generally has a negative impact on the decision to convert to a Roth IRA, there are situations where the AMT has a positive impact. For example, if the taxpayer has an AMT credit carryover, this credit carryover will lower the incremental tax rate on the conversion.

Consider the Impact of the New 3.8% Medicare "Surtax""

Included in the new health care legislation passed in March 2010 is a new so-called Medicare surtax imposed on high income earners. Beginning with the 2013 tax year taxpayers will be assessed a 3.8% Medicare surtax to the extent of the lesser of the taxpayer's "net investment income" or the amount of the taxpayer's "modified adjusted gross income" over the "threshold amount". The net investment income is defined as investment income (e.g., interest, dividends, rents, royalties, capital gains, passive income) less related expenses. Modified gross income (MAGI) is adjusted gross income increased by the net foreign income exclusion while the threshold amount is $250,000 for married couples filing jointly and $125,000 for married couples filing separately, and $200,000 for single and head of household taxpayers. If a taxpayer's MAGI is less the threshold (and the MAGI is projected to be less than the threshold even with RMDs factored in) then this taxpayer will not be subject to the surtax and this surtax can be ignored for purposes of deciding whether or not to convert to a Roth.

Although IRA and plan distributions are not considered "investment income", they are part of "modified adjusted gross income". Therefore, Traditional IRA distributions have the effect of increasing MAGI while Roth IRA qualified distributions have no such effect. If your client is expected to be subject to the surtax because of RMDs, then one way of minimizing this new surtax is to convert enough of the Traditional IRA to a Roth IRA during the 2011 and 2012 time period so that neither the conversion nor future distributions increase MAGI. ***For example:***

> *John who is 68 years old has investment income of $100,000 and other non-investment income of $75,000. In this case, John is not subject to the 3.8% tax because his MAGI is $175,000 and he is below the threshold amount. If in two years, John needs to take a $150,000 RMD from his Traditional IRA and assuming his investment income and other non-investment income remained constant, John would be subject to a Medicare surtax of $3,800 (i.e., the lesser of net investment income of $100,000 or John's MAGI of $325,000 less his threshold amount of $200,000 or $125,000) times 3.8% The RMD from the Traditional IRA caused John to be subject to the Medicare surtax. If John converts his*

Traditional IRA to a Roth IRA before 2013, John could have avoided this surtax.

Manipulate Taxable Income

Some higher income individuals may be able to manipulate their income for the year in which the conversion is made. For example, executives may be able to defer salary, or owners of closely-held "C" corporations may be able to draw a lower salary for the year and make up for this lower income by paying themselves a bonus in December of the prior year and again in the following January. A retired person with a substantial amount of investment income might sell assets in the prior year and buy one-year Treasury bills payable on January 1 of the following year, or alternatively, hold tax-free municipal bonds for a year.

Many taxpayers will have little idea on whether their marginal tax rates will be higher or lower in retirement. If that is the case, the taxpayer may wish to place a portion of his retirement assets into a Roth IRA just to give him or her the flexibility to take withdrawals in the most tax-efficient manner possible. The taxpayer could take distributions from the Roth account when his or her marginal tax rate is high and take distributions from the taxable account when his or her marginal tax rate is lower.

(3) Pay Tax From An Outside Source. Does the taxpayer have the financial wherewithal to pay the tax on the amount being converted from sources other than the IRA itself? Assuming tax rates remain constant, paying taxes at the front end of an IRA, instead of the back end, does not create additional values. The real benefit comes if one pays the front end tax with assets from outside the IRA. In effect, those assets are put into the IRA where they will grow faster with no tax drag than they would grow on the outside. Paying the tax with outside funds effectively permits one to save more for retirement in a tax-advantaged way. If your client can pay the tax bill without tapping the retirement funds, switching to a Roth IRA may prove advantageous, assuming your client's tax bracket does not drop significantly at retirement.

Taxpayers who expect to convert should begin to contemplate how they will pay the tax. Ideally, the cash would be on hand to pay the tax due at conversion. If the taxpayer needs to sell appreciated assets to pay the tax due upon conversion, the additional capital gains tax would work against the case for conversion.

Using the funds from the IRA itself to pay the tax will not only generate ordinary income tax on the distribution but will create a 10% penalty tax on the amount of the distribution used to pay the tax if the taxpayer is under age 59½. The taxpayer will also lose the opportunity for tax-free compounding on any amount not converted.

B. Qualitative Factors to Be Considered Before Converting To a Roth IRA

Determining whether or not to convert is not a decision to be made based solely on numbers. There are many qualitative factors that cannot be programmed into the financial calculators. These qualitative factors may ultimately prove to be more important than the quantitative result. Considering the many circumstances which will impact this decision, it becomes clear that clients will need the guiding hand of a knowledgeable and professional producer in addition to advice from their independent tax advisor.

(1) <u>Fees Incurred</u>. Before converting, it is critical to determine what fees or other charges will be incurred in surrendering the current IRA and in rolling the funds into the Roth IRA. Any additional fees paid because of the conversion would reduce the attractiveness of the conversion. Fees and surrender charges may be avoided if the Traditional IRA is simply redesignated (and not rolled over) as a Roth IRA, retaining the existing funds in the account.

(2) <u>Age and Rate of Return</u>. The higher the expected rate of return on the IRAs and the younger the client, the greater the after-tax difference will be between the two alternatives. The argument in favor of converting is strengthened the longer your money can potentially compound tax-free after conversion and before withdrawals are made. While the client’s age or the rate of return will not generally be determinative as to whether or not to convert, it will impact the extent to which the client will benefit from the conversion.

(3) <u>Tax on Social Security Benefits</u>. By converting a Traditional IRA, some senior citizens could push their taxable income above the level that triggers a tax on their Social Security benefits. If most of the client’s Social Security income suddenly becomes subject to income tax, the cost of conversion may appear to be too high. This consideration may not apply to retired taxpayers who have modified AGI of over $100,000 as their Social Security benefits would have already been fully taxed.

Clients who have not yet begun receiving Social Security benefits can “bunch” their income in a single year by converting to a Roth IRA and thereby limit taxes on future Social Security payments. A Roth IRA may make it easier for them to stay below the tax threshold because distributions are not required or if withdrawals are made to meet expenses, these withdrawals will, in all likelihood, not be considered income for purposes of Social Security taxation.

(4) <u>Change in the Income Tax Rate.</u> What are the chances that the marginal income tax rates will increase over time? To the extent that the marginal income tax rates for high income taxpayers will likely increase, the payment of an income tax at today’s lower rate will be attractive and will favor conversion.

(5) **<u>State Income Taxes</u>.** What, if any, state income taxes will be due upon (i) conversion and (ii) at the time of the subsequent withdrawal from the converted Roth IRA? If substantial state income taxes are due as a result of the conversion, this will make the conversion less attractive. Similarly, if the individual state does not provide for income tax-free distributions from a Roth IRA, this will also make the case for conversion less appealing. If the taxpayer plans to relocate to another state upon retirement, the taxpayer will need to take into account whether the new state has lower or higher tax rates than state tax rates the client would be subjected to if he or she converted this year. There is also the complicating factor that state income tax rates could change over time.

(6) **<u>Retirement Needs</u>**. Will the IRA account holder need the IRA funds during retirement? Since the Roth IRA does not require that any lifetime distributions be made at age 70½ (as is required from a Traditional IRA), the Roth IRA would be more attractive to those clients who do not need retirement income and would like to pass an income tax-free inheritance to their children and grandchildren (note, however, the after-death required minimum distribution rules still apply to Roth IRAs). For those clients who have substantial assets, converting to a Roth IRA may make sense simply from an estate planning perspective.

This elimination of lifetime required minimum distributions allows for more income tax-free growth potential during life. If the client leaves his Roth IRA to his spouse, the Roth IRA balance can be left intact until the surviving spouse dies, allowing for even greater tax-free growth potential. It also permits clients to pass on more to their heirs, which can be a tremendous benefit. If the Roth IRA holder leaves the account balance to a young heir, it will generally be possible to “stretch out” the potentially income tax-free withdrawals over the heir’s life expectancy. Such a “stretch” may allow for substantial tax-free growth. This can make the Roth IRA extremely valuable.

(7) **<u>Radical Reform of Tax Structure</u>.** What are the chances that the federal income tax structure will be repealed or radically changed in the form of a value added tax, a flat tax or more likely, lower income tax rates combined with a value added tax To the extent that major tax reform is later enacted, the early payment of an income tax may prove disadvantageous.

(8) **<u>Impact on Financial Aid Eligibility.</u>** Clients who have children in college or about to enter college should consider the impact of the conversion (i.e., increasing the family’s adjusted gross income) on their family’s eligibility to receive financial aid.

(9) E<u>xtraordinary Home Assistance and Medical Expenses</u> Clients who are considering converting to a Roth IRA will also need to consider the possbilibiliy that they may have extraordinary home assistance and medical expenses that they may be able to pay by making withdrawals from their IRAs and qualified retirement plans on an essentially tax-free basis. Under current law qualified medical and health care expenses are deductible to the extent that they exceed 7.5% of the taxpayer's adjusted gross income (AGI) or to the extent they exceed 10% of the taxpayer's AGI if the taxpayer is subject to the alternative minimum tax.[4] If there is a strong possibility that your client may be able to spend down relatively large IRAs during their last years on a tax-free basis, then converting to Roth IRA and paying up to a 35% tax on the value of the IRA may not be a wise decision.

(10) <u>Impact on Creditor Protection.</u> It will be important to check the protection provided to IRAs by the taxpayer's state of residence. While IRAs enjoy protection in bankruptcy for up to $1,000,000 plus any rollover amounts, the protection afforded IRAs outside of bankruptcy depends upon the individual state laws. In some states, Roth IRAs may enjoy less creditor protection than Traditional IRAs. This factor may be especially important to those individuals who may be subject to liability because of their business or professional risks.

(11) <u>Estate Taxes.</u> If your client's IRA will be passed on to his or her heirs, the value of your client's estate will be lower if he or she has converted to a Roth IRA. By paying the income tax up front, the size of the estate is reduced. Assuming a 35% estate tax rate and a 35% income tax rate, the effective tax on the conversion is only 22.75% (1 - estate tax rate of .35 or .65) x (marginal income tax rate of .35). On the other hand, if the taxpayer was considering using this Traditional IRA to fund a charitable bequest, then this transfer tax benefit would be nullified.

Section 691 (c) Deduction

This advantage is partly offset by the fact that the beneficiary of the regular IRA receives an income tax deduction under Section 691(c) of the Code for the amount of the estate taxes paid.. But this advantage is not completely offset because the deduction is only for federal estate taxes, not state death taxes. State estate taxes paid on the IRA value are not deductible for federal income tax purposes. Thus, there is double taxation on the value of the estate that is equal to the state estate taxes paid.

[4] For tax years beginning after December 31, 2012, qualified medical expenses will be deductible to the extent they exceed 10% (rather than 7.5%) of AGI. The AGI threshold will remain at 7.5% if the taxpayer or spouse has reached age 65 before the close of the tax year (for AMT purposes, the exception for taxpayers age 65 or over and their spouses won't apply); however, for tax years ending after December 31, 2016, the AGI floor on deductible medical expenses will be 10% of AGI for all taxpayers.

Although the deduction under 691(c) does provide some income tax relief, it does exhaust after a period of time. The 691(c) deduction offsets only the amount of income equal to the value of the IRA at death. It does not offset the additional income due to growth of the IRA after death. 100% of this income is subject to income tax whereas all post mortem growth with the Roth IRA is potentially tax free.

Funding a Credit Shelter Trust

A taxpayer who has only a Traditional IRA to fund a credit shelter trust at death could also benefit from a Roth IRA conversion. The credit shelter trust could be funded with the Roth IRA after death. Distributions from the Roth IRA would not be income in respect of a decedent as long as they were qualified distributions and thus, would be more valuable to the beneficiaries than taxable distributions. If conversion occurs on one's death bed, the federal and state income taxes incurred prior to death and payable because of the conversion may be deductible for estate tax purposes.

Funding the credit shelter trust with a Roth IRA (as compared to a Traditional IRA) can have significant benefits in term of wealth transfer. For example, if we assume a 40% income tax rate and a federal estate tax exemption amount of $5,000,000 at death, then if the credit shelter trust is funded with a Traditional IRA, only $3,000,000 ($5,000,000 less the amount of income tax to be paid of $2,000,000 ($5,000,000 times 40%) passes to the trust's beneficiaries. On the other hand, if a Roth IRA is used to fund the trust, then the entire $5,000,000 would pass to the trust's beneficiaries. Furthermore, with the Roth IRA even more wealth would be transferred in that the Roth IRA would be growing potentially income tax-free.

Viewed in another way, high net worth individuals converting to a Roth IRA are effectively prepaying the future income tax for their heirs. This prepayment is tantamount to a gift; however, it does not count toward the gift tax annual exclusion or the gift or estate tax exemption. The Roth IRA conversion should be considered one of the more attractive wealth transfer strategies for the high net worth individual. For high net worth individuals, the decision of whether to convert or not must consider the estate tax impact of the conversion.

(12) **Tax Diversification.** The client may benefit from having various tax buckets which are treated differently (e.g., tax free, tax-deferred and tax advantaged) in which the assets are held. When withdrawing monies during retirement, to the extent that the client can access funds which are tax-free or tax-advantaged, he or she may be able to prevent moving into a higher marginal tax bracket and thus, minimize his or her overall taxes.

IV. What Actions Can Be Taken Today?

All taxpayers should begin to collect the necessary information to help analyze their particular situation and begin to determine what action, if any should be taken. If it is expected that the stock market will increase, it will be important to act early in the calendar year so tax will not have to be paid on any future appreciation. The following questions will be important to ask:

What is the current balance of each of the taxpayer's IRAs, SEPs, SARSEPs and SIMPLE IRAs?

How much of each IRA account consists of the taxpayer's after-tax contributions? (Obtaining a copy of the taxpayer's most recent Form 8606 - Non-deductible IRAs - will be helpful in uncovering this amount. Alternatively, information on prior year's after-tax contributions may be obtained from the IRA custodian or copies of prior year's tax returns can be purchased from the IRS).

Does the taxpayer have an existing 401(k), 403(b) or eligible governmental 457 plan from a previous employer? If so, what is the current balance and how much of that amount consists of after-tax contributions? Does the taxpayer's current employer plan accept rollovers from a previous employer plan?

Does the taxpayer's current 401(k), 403(b) or 457(b) plan permit rollovers to a Designated Roth Account under the same plan? If so, is the taxpayer eligible for a rollover to a Designated Roth Account?

V. CONCLUSION

The advantage of potentially income tax-free growth and no required minimum distributions during the Roth IRA owner's life make the Roth IRA a valuable investment vehicle which should appeal to many retirement savers. All taxpayers regardless of income can now take advantage of the exciting opportunity to convert their Traditional IRA into a Roth IRA. In deciding whether to pay taxes today in exchange for a tax benefit later we suggest taxpayers follow a two-prong approach. First, taxpayers should consider using a financial calculator to quantify the benefit (or detriment) of converting to a Roth IRA and then in a second step, examine a host of qualitative factors which, while important, cannot easily be incorporated into the financial software. The taxpayer will soon discover that the many factors and considerations involved make this a more complicated decision than it may initially appear.

This *Legal & Tax Trends* attempts to provide some guidance to the taxpayer on the key question of whether it is better to keep one's Traditional IRA or convert a part or all to a Roth IRA. In summary, conversion tends to be advantageous to the taxpayer when (i) the IRA's tax basis is high (i.e., when after-tax contributions were made to the IRA), (ii) the tax due on the conversion is paid from an outside source and not the IRA itself, (iii) the taxpayer is young and has a long investment horizon, (iv) the tax rate expected to be paid on IRA distributions is expected to be the same or higher than the adjusted tax rate paid on the conversion and/or (v) the taxpayer expects to pay estate taxes and would like to pass the IRA on to his or her heirs. Taxpayers will need to become familiar with the new Roth IRA opportunities so that they can maximize their retirement savings. For the financial services community, these changes present a great opportunity to talk with clients and to assist clients in their retirement planning. We hope that this Legal & Tax Trends will assist in that process.

APPENDIX I. *Background on Traditional IRAs*

A Traditional IRA permits a taxpayer to save for retirement on a tax-favored basis. The Traditional IRA grows tax-deferred and contributions are tax deductible if neither the taxpayer, nor (if applicable) the taxpayer's spouse is covered by a retirement plan at work. If either the taxpayer or (if applicable) the taxpayer's spouse is an "active participant" in an employer sponsored retirement plan, the amount contributed may be deductible if the taxpayer's income does not exceed certain thresholds. For a single taxpayer who is an "active participant" in 2010, the ability to make the full $5,000 ($6,000 if age 50 or older) deductible contribution is phased out at MAGI between $56,000 and $66,000. For married taxpayers filing a joint return where one or both of the spouses is an "active participant", the phase-out for the spouse(s) who is an active participant occurs between $89,000 and $109,000 of MAGI and the phase out for the spouse who is a not an active participant is between $167,000 and $177,000 for 2010. The phase-out range for married couples filing separate returns is between $0 and $10,000 of modified adjusted gross income. If the taxpayer's income exceeds those thresholds, taxpayer can still make contributions but those contributions are not deductible.

Taxpayers over age 70 1/2 must begin to take required minimum distributions and cannot contribute to a Traditional IRA. Amounts distributed from a Traditional IRA are generally taxable as ordinary income when received assuming that none of the taxpayer's non-Roth IRAs contain non-deductible contributions. Premature distributions may be subject to an additional 10% penalty tax. If a taxpayer dies with a Traditional IRA, his or her beneficiary must also take required minimum distributions. The beneficiary will pay ordinary income tax on the distributions received, but no 10% penalty will apply (unless the surviving spouse is the sole beneficiary and elects to continue the IRA as his or her own in which case the 10% penalty may apply if the surviving spouse receives a distribution before reaching age 59 ½.)

APPENDIX II. *Background on Roth IRAs*

Congress, in an effort to boost the national savings rate, provided several retirement incentives in the Taxpayer's Relief Act of 1997. The law expanded the opportunity to make deductible contributions to Traditional Individual Retirement Accounts (IRAs), and created a new type of tax-favored accounts (so-called Roth IRAs). Contributions to a Roth IRA are non-deductible and like a Traditional IRA, the Roth IRA accumulates on a tax-deferred basis.

Eligibility

In order to make contributions to a Roth IRA, taxpayers must satisfy certain income limits. For a single taxpayer in 2011, the ability to make the full $5,000

($6,000 if age 50 or older) contribution is phased out at MAGI between $,107,000 and $,122,000. For married taxpayers filing a joint return, the phase-out occurs between $,169,000 and $,179,000 of MAGI. In contrast to deductible contributions to a Traditional IRA, eligibility for a Roth IRA is not affected by the taxpayer's participation in an employer-sponsored retirement plan. The phase-out range for married couples filing separate returns is between $0 and $10,000 of modified adjusted gross income. Non-deductible traditional IRAs are still available for those individuals who are unable to qualify for either a deductible IRA or a Roth IRA.

If eligibility is not phased out based on combined MAGI, each spouse can establish his/her own Roth IRA even if only one of them has earned income, as is the case with Traditional IRAs. Thus, both husband and wife can contribute up to $5,000 ($6,000 for each spouse that is age 50 or older); provided that the combined earned compensation that's includable in the couple's gross income for the year is at least equal to the total contributed amount. Lastly, unlike Traditional IRAs, even an individual who is over age 70½ can fund a Roth IRA as long as he/she has earned income, and MAGI does not exceed the income phase-outs.

The contribution limits on traditional IRAs and Roth IRAs are coordinated. Thus, the maximum annual contribution an individual can make to any type of IRA in 2011 - Roth, deductible or non-deductible IRA - is the lesser of $5,000 ($6,000 if age 50 or older) or the individual's earned compensation that's includible in his or her gross income for the year. This limit applies in the aggregate to the total contributions made to all the individual's IRAs (both Traditional and Roth IRAs) for the year. This amount is adjusted for inflation after 2008. Individuals aged 50 or older can contribute an additional $1,000.

Qualified Distributions

Regular Roth IRA contributions can be withdrawn income tax-free anytime but earnings from a Roth IRA can be withdrawn without tax only, after meeting a two-prong test which includes (i) meeting a 5-tax-year holding period, <u>and</u> (ii) must be one of the following:

(1) Made on or after the date on which individual attains age 59½;
(2) Made to a beneficiary (or the individual's estate) on or after the individual's death;
(3) Attributable to the individual being disabled (as defined by the federal tax law); or
(4) A distribution to pay for qualified first-time homebuyer expenses (as defined by the federal tax law and up to a lifetime maximum of $10,000).

Withdrawals of earnings not meeting the aforementioned conditions are considered non-qualifying and will be taxed at ordinary income tax rates and may be subject to a 10% tax penalty.

For purposes of the qualified distribution 5-tax-year holding period, each Roth IRA owner has only one 5-tax-year holding period for all the Roth IRAs of which he or she is the owner. The Roth IRA owner's five-tax-year holding period begins with the earlier of:

(1) the first taxable year for which a regular contribution is made to any Roth IRA of which the taxpayer is the owner; or
(2) the first taxable year in which a conversion or rollover contribution is made to any Roth IRA of which the taxpayer is the owner.

For example, Jim opens a Roth IRA in December, 2007 and makes his first regular contribution for the 2007 tax year. He makes annual contributions from 2008 through 2011. Jim's five-tax-year holding period begins on January 1st 2007 and will end on December 31, 2011. Withdrawal of all Roth IRA earnings after December 31, 2011 would be income tax free provided the second requirement was also met (e.g., he has attained age 59 ½).

A second 5-Year holding period

In addition to the qualified distribution 5-tax-year holding period, there is also a 5-tax-year holding period for purposes of determining whether a withdrawal of certain converted amounts will be subject to the 10% federal income tax penalty. This 10% penalty 5-tax-year holding period begins with the year in which the amount converted is contributed to a Roth IRA. Each conversion contribution has its own five-tax-year holding period for purposes of the 10% federal income tax penalty. The 10% federal income tax penalty only applies to the portion of the converted amount that was includable in income as a result of the conversion and only applies if the owner takes the withdrawal before reaching age 59 ½ (unless one of the other exceptions to the penalty applies). Note, however, the second requirement necessary for a withdrawal to be a qualified distribution are also exceptions to the 10% federal income tax penalty and, therefore, a withdrawal that satisfies the qualified distribution requirements will not be subject to the 10% federal income tax penalty even if made before the end of the 10% penalty 5-tax-year holding period.

***In the above example**, if in addition to the annual contributions Jim converted a Traditional IRA to a Roth IRA in 2011, the 10% penalty five-tax-year holding period for the converted amounts would begin on January 1, 2011 and would not end until December 31, 2015.*

Excess contributions to a Roth IRA are subject to the six percent excise tax. As is the case with Traditional IRAs, a regular contribution to a Roth IRA for a tax year can be made by the due date for filing the individual's tax return for the year (without regard to extensions). In such a case, the five-tax-year holding period (discussed above) begins to run with the tax year for which the contribution relates, not the year in which the contribution is actually made. However, if the Roth IRA owner's qualified distribution 5-tax-year holding period begins with a conversion or rollover contribution, the clock starts to run with the year in which the conversion or rollover contribution is actually deposited into the owner's Roth IRA (not the year the conversion or rollover contribution is, for instance, distributed or transferred from the qualified retirement plan or IRA).

> ***Example 1****: Jane makes a regular contribution to her Roth IRA in March 2009, designating the contribution as made for 2008, and not for 2009 when the contribution was actually made. Jane's holding period begins January 1, 2008.*
>
> ***Example 2:*** *Jane takes a lump sum distribution from her IRA in December 2010 and rolls it over to a Roth IRA in February 2011. Jane's holding period for this converted Roth IRA begins January 1, 2011.*

Favorable Ordering Rule for Non-Qualified Distributions

Nonqualified distributions are includible in income to the extent attributable to earnings, and are subject to the 10 percent early withdrawal tax unless an exception applies. Some of the exceptions for which nonqualified withdrawals can be made without penalty are the owner's death or disability, or to pay certain excess medical expenses, health insurance premiums for an unemployed individual or qualified education expenses.

The '97 Act provides a favorable FIFO (first in, first out) ordering rule for purposes of determining what portion of a nonqualified distribution is includible in income. Nonqualified distributions are treated as made from nontaxable amounts (e.g., after-tax contributions) first and thus, no portion of a distribution is treated as includible in gross income until the total of all distributions from the Roth IRA exceeds the nontaxable amounts. In other words, even if an individual does not meet the five-tax-year holding period and age 59½ requirements for income tax-free qualified distributions, the holder can generally withdraw his or her after-tax contributions income tax-free and penalty-free at any time, paying taxes and early withdrawal penalties only on distributions in excess of the amount of those original after-tax contributions. However, as indicated above, certain conversion contributions may be subject to the early withdrawal penalty tax if taken too soon (unless an exception applies).

In 2008, Joe establishes a Roth IRA and contributes $5,000 to it. Joe contributes $5,000 in each of 2009 and 2010 and dies in 2011, with his son, Junior, as beneficiary. On December 31, 2011 the IRA is worth 18,000. If Junior withdraws the $18,000 in January 2012, the $3,000 gain will be taxable to him. However, if Junior withdraws $15,000 (Joe's basis) in January 2012 and the balance in January, 2013 (after the end of the five-tax-year holding period), both distributions will be income tax-free.

Non-qualified Roth IRA distributions are made according to the following ordering sequence:

(1) aggregate annual contributions and rollovers of after-tax amounts from other Roth plans
(2) conversion amounts from non-Roth qualified retirement plans and IRAs
(3) earnings on annual contributions and conversion amounts, and earnings rolled over from other Roth plans (unless treated as after-tax amounts because the earnings satisfied the designated Roth account qualified distribution rules when distributed or transferred from the designated Roth account).

Conversion contributions are treated as coming out in the order in which they were contributed (i.e. first in, first out) and each conversion contribution is treated as coming from the portion that was includable in income as a result of the conversion first. The following example shows how a non-qualifying distribution would be taxed:

Tim, age 45, converts $50,000 into a Roth IRA in 2010 and then begins to make annual contributions of $5,000 for 2010, 2011 and 2012. In 2013 the Roth IRA has a balance of $100,000 and therefore has earnings of $35,000. If Tim takes distributions from his Roth IRA, the first $15,000 withdrawn will be considered a return of his annual contributions, the second $50,000 will be considered a distribution of conversion money and final $35,000 will be considered earnings.

Distributions of annual Roth contributions are always income tax-free and are never subject to the 10% early withdrawal penalty. Earnings, however, can be withdrawn income tax-free only if the distribution is qualified. Thus, Tim could withdraw his contributions, the first $15,000, income tax-free. The distribution of conversion amounts is also income tax-free, but these amounts may be subject to the 10% early withdrawal penalty. The 10% penalty tax will apply to the distribution of the $50,000 converted amount if the distribution was made (i) within the five-tax-year holding period for that conversion contribution while the account owner is under age 59 ½ and (ii) to the extent the converted amounts were includable in income as a result of the conversion. This penalty tax on conversion amounts is designed to prevent taxpayers under age 59 1/2 from converting to a Roth IRA and then liquidating the new Roth IRA in an effort to circumvent the 10% penalty.

Tim will not pay income tax on these converted amounts but will pay the 10% penalty tax of $5,000 (assuming the entire conversion contribution was includable in income as a result of the conversion) unless the distribution is made on account of the owner's death or disability, used to pay certain medical expenses, used to pay health insurance premiums by an unemployed owner, used to pay higher education expenses, used to pay qualified expenses for a first time homebuyer or received as part of a series of substantially equal periodic payments based on life expectancy. Finally, the $35,000 of earnings is subject to ordinary income tax and may also be subject to the 10% penalty tax.

Income Limit for Roth Contributions Indirectly Eliminated

While the income limits for direct investments in a Roth IRA are still in place, using a backdoor approach TIPRA may have effectively eliminated the income limits on contributions. All taxpayers (up to age 70½) with earned income are able to contribute to a non-deductible Traditional IRA, for which there are no income restrictions, and then in a second step convert this non-deductible IRA to a Roth IRA.

> ***For example**, Judy, age 52, who has no other IRAs, makes a $6,000 non-deductible contribution to a Traditional IRA in December 2010 and a second non-deductible $6,000 contribution to the same IRA in January 2011. In February 2011 when the value of the IRA is $13,000, Judy converts her entire Traditional IRA to a Roth IRA. Judy pays tax on only the $1,000 of gain.*

This back door opportunity to contribute to a Roth IRA will not be as attractive if Judy has substantial balances in other IRAs funded by deductible contributions. In this situation, Judy must consolidate all of her IRAs for the purpose of calculating the tax due on conversion and any amount converted will be considered taken pro-rata from the taxable pot and the nontaxable pot.

> ***For example**, let's assume the same facts as above except that Judy has a second IRA consisting of only deductible contributions worth $87,000 at the time of conversion. Judy again converts only the $13,000 non-deductible IRA. In this case, since all of her IRAs are consolidated, Judy would report 88% ($88,000/$100,000) of the $13,000 amount or $11,440 as taxable income and 12% ($12,000/$100,000) of the $13,000 or $1,560 would be considered non-taxable return of basis.*

It is possible that the IRS may decide to attack this backdoor strategy with rulings or regulations. For instance, the IRS could apply the step transaction doctrine and treat this two-step conversion as a single transaction. It may be prudent to wait a reasonable period of time between the contribution to the non-deductible IRA and the Roth conversion. If the IRS's argument prevailed, the attempted conversion would be treated as surrender of the non-deductible IRA and an excess contribution to the Roth IRA. Before recommending this strategy, the potential risks should be discussed with the client's tax or legal advisor. It is also possible that due to the high cost to the Treasury, this ability to circumvent the law with a two-step process may be curtailed by future legislation.

An Attractive Time to Convert

Conversion from a Traditional IRA to a Roth IRA may be especially attractive at this time as the federal government's projected deficits may lead to higher marginal income tax rates in the future. Moreover, even though the market has recently increased, the values of existing IRA balances are still somewhat depressed due to earlier market declines. These lower values will generally make this conversion less painful as the amount of taxable gain will be less than it otherwise would have been. However, for conversions involving annuity contracts, the taxable amount attributable to the annuity contract may be based on the fair market value of that contract, which may be greater than the contract's account value. Finally, it is not clear how long this change in the tax law will last, as the Obama Administration has appointed a tax reform commission. If the Administration can convince Congress to reform the tax code, then this provision may have a limited lifespan.

Legal & Tax Trends is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, Lillie Nkenchor and Barry Rabinovich. All comments or suggestions should be directed to Thomas Barrett at tbarret@metlife.com or John Donlon at jdonlon@metlife.com.

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Please note that the state income tax treatment of your Roth IRA conversion and subsequent distributions from your Roth IRA may vary depending upon your state of residence.

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