

2009

ROTH IRA CONVERSIONS IN 2010 AND BEYOND

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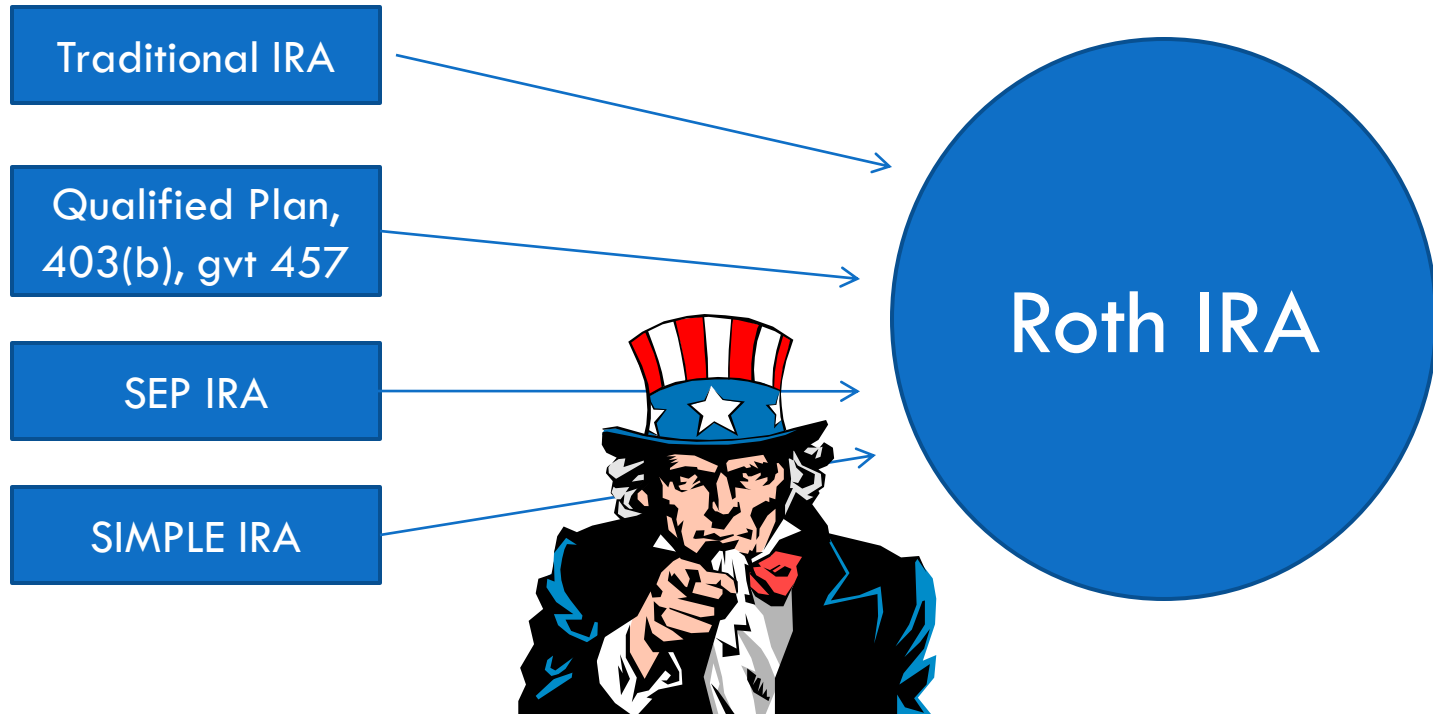
- Taxpayer Relief Act of 1997 – IRC Section 408A
- Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)
- General Rules Governing Roth IRAs
- Economic Analysis

Annual Contributions

- Maximum annual contribution is lesser of **\$5,000** or **100% of earned income**, reduced by traditional IRA contributions
- Catch-up Contributions
- Problem #1 – Phase-outs
 - MFJ if MAGI > \$166,000 - \$176,000
 - Single if MAGI > \$105,000 - \$120,000

- Pre-2010 (Problem #2)
 - AGI < \$100,000
 - Not MFS
- Post 2009 – Tax Increase Prevention and Reconciliation Act of 2005
 - **NO AGI LIMITATION**

Conversions

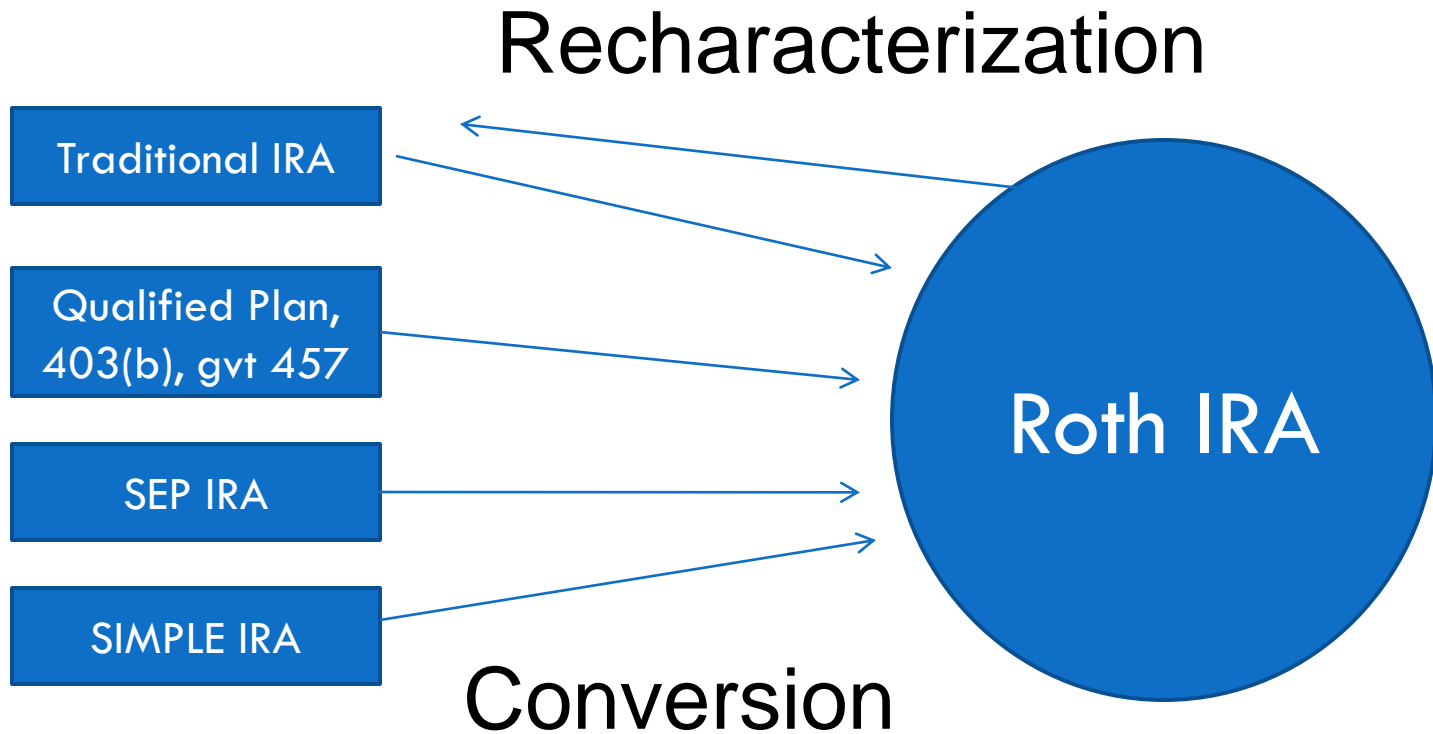


- Income Taxation
 - Amount converted included in gross income
 - Basis in IRAs
 - Must consider all basis (cannot source)
 - If basis exceeds amount distributed can take ordinary loss as miscellaneous itemized deduction subject to 2% floor
 - Basis in Qualified Plan Accounts
 - After-tax contributions
 - Can source

Conversions in 2010

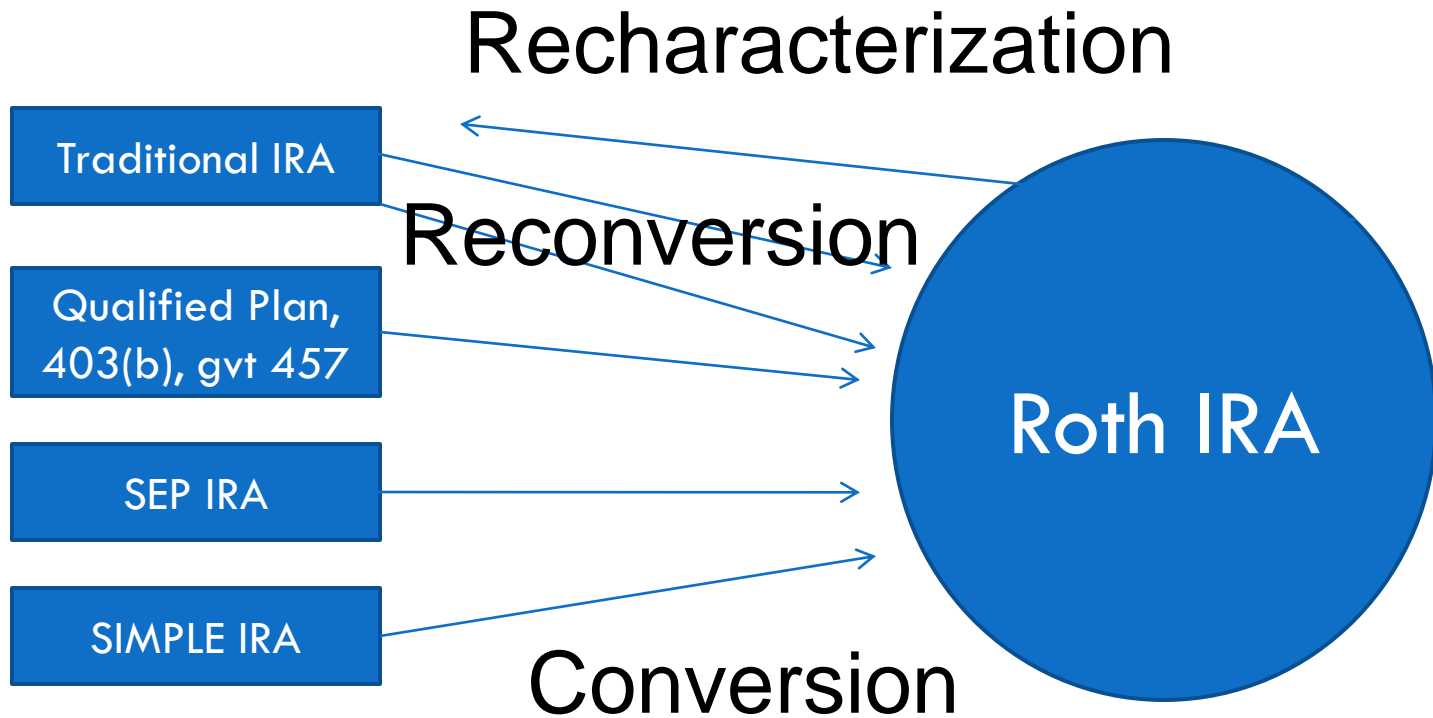
- Default Rule:
 - 50% of 2010 distribution taxed in 2011
 - 50% of 2010 distribution taxed in 2012
 - Must make election to tax 100% in 2010
- Why make election?
 - \$100,000 conversion in 2010
 - 2011 & 2012 rates increase 5%
 - Need 9% after-tax return on money
 - 2011 & 2012 rates increase 10%
 - Need 17% after-tax return on money

Recharacterizations



Recharacterization

- Reason – don't need one
- Manner – transfer back to IRA
- Election – notify and transfer
- Timing – 10/15 of year following year of transfer
- Amount – include earnings/losses



- Reason – don't need one
- Manner – convert back to Roth IRA
- Timing – not before later of:
 - Beginning of tax year following year of conversion
 - 30 days from date of recharacterization
 - Example:
 - Convert IRA to Roth on 1-1-2010
 - Recharacterize conversion on 9-1-2010
 - Earliest reconversion date is 1-1-2011

- Qualified Distributions = tax-free
 - 5 year period AND
 - Distribution made
 - On or after age 59 ½
 - After death of owner to estate or beneficiary
 - Owner is disabled
 - Qualified first time home buyer

- Non-Qualified Distributions
 - Subject to income tax to extent cumulative distributions exceed basis
 - Ordering Rules:
 - Regular Contributions
 - Conversion Contributions (FIFO)
 - Earnings
 - 10% early distribution penalty applies to earnings (unless distribution of conversion assets within 5 years)

- Required Minimum Distributions
 - Owner's Lifetime – do not apply
 - Owner's Death (same as traditional IRA)
 - No “designated beneficiary” – 5 years
 - “Designated beneficiary” – beneficiary's life expectancy
 - Spousal rollovers

- Legislative Background
 - TIPRA (2005) – CBO Cost Estimate
 - Reduces federal tax revenues by \$69.1 BILLION from 2006 through 2015
 - Elimination of AMT Limitation on Roth Conversions RAISES \$6.4 billion (most in 2011 and 2012)
- Impact on long-term government revenues
 - IRAs - \$3.67 Trillion
 - Defined Benefit Plans - \$2.15 Trillion
 - Defined Contribution Plans - \$2.97 Trillion
 - \$8.79 Trillion of assets subject to future income tax

- Ability to pay conversion income taxes from non-conversion sources
- Current vs. Future Income Tax Rates
- Lifetime Spending of Retirement Plan Assets
- Who are the beneficiaries?
- Estate Taxes

Payment of Conversion Taxes

- Value of income tax-free compounding
- Example:
 - Assumptions:
 - 45 year old individual
 - \$300,000 in traditional pre-tax IRA
 - \$150,000 in after-tax savings account
 - Marginal income tax bracket - 28%, 35% for year of conversion
 - 7% pre-tax rate of return
 - 5.4% after-tax rate of return

Payment of Conversion Taxes

- Example (continued)
 - If no conversion the individual will have the following assets at age 70

Traditional IRA (7%)	\$1,628,230
Savings Account (5.4%)	\$512,813
Total	\$2,142,043

Payment of Conversion Taxes

- Example (continued)
 - If IRA is distributed in full at age 70, assuming a 35% marginal income tax, the individual will have the following assets after paying \$569,880 of income taxes:

Net IRA Distribution	\$1,058,350
Savings Account	\$512,813
Total	\$1,571,163

Payment of Conversion Taxes

- Example (continued)
 - If conversion at age 45 the individual will incur \$105,000 of income taxes and will have the following assets post-conversion

Taxes Paid From	Conversion Assets	Outside Assets
Roth IRA	\$195,000	\$300,000
Savings Account	\$150,000	\$45,000
Total	\$345,000	\$345,000

Payment of Conversion Taxes

- Example (continued)
 - If conversion at age 45, at age 70 the individual will have the following assets

Taxes Paid From	Conversion Assets	Outside Assets
Roth IRA (7%)	\$1,058,350	\$1,628,230
Savings Account (5.4%)	\$512,813	\$153,844
Total	\$1,571,163	\$1,782,074

Payment of Conversion Taxes

□ Example (continued)

■ Conclusions

- Value of tax-free compounding is \$210,911 over a 25 year period
- If tax rates are the same and tax paid with outside assets the individual is indifferent to conversion

	No Conversion	Taxes Paid with Outside Assets	Taxes Paid with Conversion Assets
Net IRA/Roth IRA	\$1,058,350	\$1,628,230	\$1,058,350
Savings Account	\$512,813	\$153,844	\$512,813
Total	\$1,571,163	\$1,782,074	\$1,571,163

Current vs. Future Income Tax Rates

- Individual circumstances
 - Conversion Year
 - Phase-outs
 - Bracket jumps
 - Distribution Period
 - RMDs, Pensions
 - Social Security
 - Phase-outs
- Legislative changes in future tax rates/tax system
- State income taxes

Current vs. Future Income Tax Rates

- A decrease in future tax rates can be absorbed if conversion tax paid from outside assets

	No Conversion	Taxes Paid from Outside Assets	Taxes Paid from Conversion Assets
Net IRA/Roth IRA	\$1,058,350	\$1,628,230	\$1,058,350
Savings Account	\$512,813	\$153,844	\$512,813
Total	\$1,571,163	\$1,782,074	\$1,571,163

Net IRA (22.0466%)	\$1,269,261
Savings Account	\$512,813
Total	\$1,782,074

Lifetime Spending

- Does the individual need the retirement plan assets to provide income during retirement?
- Longer periods of tax-free accumulation favor conversion

Who are the beneficiaries?

- Ages
- Financial Needs/Responsibility
- Charities
- **There is no better asset for an individual to inherit than a Roth IRA**

- Consider federal and state estate and inheritance taxes
- Paying the conversion tax removes assets from estate that would otherwise be subject to estate and inheritance taxes
- Deduction for estate taxes attributable to IRD
 - Miscellaneous itemized deduction
 - Does not include state estate or inheritance taxes

- Be prepared to answer the conversion question
- Consider converting early – can always recharacterize and reconvert later
- Consider all of the factors but remember the power of tax-free compounding