

ROTH CONVERSIONS

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OUTLINE OF PRESENTATION

- Basic Rules – Why am I interested?
 - What is a Roth IRA?
 - Contribution limits
 - Tax characteristics
 - No tax while in Roth
 - No RMD
 - Rules as to conversions of Traditional IRAs to Roth IRAs.
- Rules of thumb as to conversion and other planning.
 - Everyone should want one – but what is the cost?

ROTH IRA

- What is a Roth IRA?
 - A Roth IRA is a traditional IRA (IRC § 408), except as provided in § 408A (IRC § 408A (a)).

ROTH IRA CONTRIBUTIONS

- Like a traditional IRA, the applicable dollar annual contribution limit (the “dollar limit”) for 2010 is \$5,000, increased to \$6,000 if the participant is over 50.
- Unlike a traditional IRA, contributions to the Roth IRA are made with after tax dollars, i.e. contributions are not deductible. IRC § 408A(c).
- Unlike a traditional IRA, there is no restriction on a person contributing to a Roth if that person is a participant in an employer sponsored qualified plan.

ROTH IRA CONTRIBUTIONS (CON'T)

- Unlike a traditional IRA, a participant may contribute to a Roth IRA after age 70 ½.
- To contribute the full dollar limit to a Roth IRA in 2010, modified adjusted gross income (MAGI) may not exceed \$105,000 for a single taxpayer and \$166,000 for a married taxpayer filing a joint return. The dollar limit is reduced if MAGI exceeds these levels. The dollar limit goes to zero if MAGI exceeds \$120,000 for a single individual and \$176,000 for a married individual filing jointly.

TAXATION OF ROTH

- After creation, like a traditional IRA, a Roth IRA recognizes no income for income tax purposes on annual IRA earnings. IRC § 408(c)(1).
- After creation, neither participant nor beneficiaries pays further income tax on “qualified distributions.”
 - Reg. 1.408A-6, Q&A 1.

WHAT IS A QUALIFIED DISTRIBUTION?

- A distribution is a “qualified distribution” if the following rules are met:
 - Rule 1: The distribution is made after a 5 year taxable period. The five year period begins with the first day of the first taxable year for which a contribution is made to any Roth IRA of the participant and ending 12/31 of the fifth taxable year thereafter. Thus, for purposes of a “qualified distribution” for any of the owners of Roth IRAs, the owner has only one 5 year period, Reg. 1.406-6 Q&A 2. *Caution:* A 5 year period also applies to application of a 10% penalty for early distribution. This 5 year period is not measured in the same way. See Reg. 1.406-6, Q&A 5.

WHAT IS A QUALIFIED DISTRIBUTION?

- Rule 2
 - At least one of the following is true:
 - + Payments are made after death of participant.
 - + Participant is disabled.
 - + Participant is 59 ½ or older.
 - + Distribution is a qualified special purpose distribution.

If the distribution is not qualified, it will be taxable in whole or in part and it may be subject to penalty.

DISTRIBUTION REQUIREMENTS FROM ROTH IRA

- Participant is not subject to Required Minimum Distribution (“RMD”) rules. IRC § 408A(c)(5).
- Roth IRA beneficiaries, other than spouse if spouse rolls to own account, are subject to RMD rules.

BASIC RULES OF CONVERSION

- After January 1, 2010, any traditional IRA or other qualified plan may be converted, in whole or in part, to a Roth IRA. Regular annual contributions are still subject to compensation limits.
- The conversion of a Traditional IRA to a Roth IRA is treated as a taxable distribution of the Traditional IRA.

BASIC RULES OF CONVERSION (CON'T)

- A traditional IRA converted to a Roth IRA may be “recharacterized” in whole or in part without tax consequence any time before the due date (including extensions) for filing the individual income tax return for the year for which the conversion contribution was made. Reg. 1.408A-5, Q&A 1. If recharacterized, the recharacterized conversion amount is treated as if it had never been converted.
- For conversions in 2010, income will be reported one-half of the income in 2011 (tax payable by 4/15/12) and one-half of the income in 2012 (tax payable by 4/15/13). You may opt out of deferral and pay income in 2010 (tax payable by 4/15/11).

SHOULD MY CLIENT CONVERT A TRADITIONAL IRA TO A ROTH IRA – RULES OF THUMB

- Because of the tax benefits, a Roth IRA is something everyone should want to have. The question: What is the cost of conversion?

ECONOMICS OF THE ROTH IRA CONVERSIONS - INTRODUCTION

- If tax rate on distribution is identical and internal rate of return is identical, the overall return from a traditional IRA and Roth IRA are identical to participant assuming tax is paid from IRA funds.

	<u>Traditional</u>	<u>Roth</u>
Starting IRA	100	60
After 30 years	800	480
Less tax (@40%)	<u>320</u>	<u>0</u>
Net after tax	480	480

Assumptions:

7.2% return

40%

Tax paid from traditional IRA on conversion

- If income tax rates in the future go down as to the taxpayer and all else remains the same, recognition of accelerated income caused by conversion of the Roth IRA is not advantageous. If tax rate goes up in the future, the converse is true.
- The more you know you need your IRA to supplement retirement income, don't convert. However, the more you view your retirement benefit as a savings account not needed for retirement, the more beneficial conversion becomes.

PAY TAX OUT OF NON-CONVERSION ASSETS

- Roth IRA conversions make the most sense if you can pay the tax outside the IRA.
- If taxpayer can afford to pay tax on conversion to the Roth from non-IRA funds, Roth IRA conversion will likely produce a better economic result.

WHEN CONVERTING, PAY TAXES OUTSIDE THE IRA

Median Wealth After Taxes and Inflation
 \$1 Million IRA, \$450K taxable Account
 (60%/40%)*

	Traditional IRA	Roth; Tax from IRA	Roth; Tax from Outside IRA**
Initial IRA Assets	\$1.0 Mil.	\$550 K	\$1.0 Mil.
Initial Taxable Assets	450K	\$450 K	\$0
Liquidate After 20 Years	\$2.9 Mil.	\$3.0 Mil.	\$3.5 Mil.

OTHER CONSIDERATIONS

- Taxpayers with large losses or charitable contributions usable in conversion year will significantly mitigate cost of conversion.
- Hedge future income or estate tax issues. For example, if estate taxes are an issue, it may be best to convert and recognize the income. The reduction in estate taxes will likely be more beneficial than the deduction granted beneficiaries for estate tax attributable to the IRA account. You get no income tax deduction for state estate taxes paid.
- Make gifts through a Roth IRA to low income beneficiaries with sufficient compensation income to qualify for a Roth IRA.

RECHARACTERIZATION

- There are benefits to converting or otherwise creating a Roth IRA as soon as possible in 2010, if only to trigger the 5 year rule.
- If a conversion is being made, there will likely be a benefit in converting multiple Roth IRAs.
Reason: At end of conversion period, return loss IRAs and retain as Roths those accounts that have gone up in value. You pay tax on date of conversion value, not on appreciation.
- Try to convert by partial conversion in a manner that does not move you to a higher tax bracket.

CONCLUSIONS

- Roth IRAs are powerful planning tools.
- Roth IRAs are not for everyone – know your client's goals.
- A conversion will generally make sense if you can pay the tax from assets other than the converted IRA assets.
- Run the numbers.