Roth Immersion

Everything the professional advisor needs to know to help clients with their Roth retirement plans

by

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This Special Report is the entire Chapter 5 of the 7th edition (2011) of the author's book *Life and Death Planning for Retirement Benefits* (Ataxplan Publications; www.ataxplan.com). This seminar handout includes material that was cut from 7th edition for reasons of space and also includes selected sections of other Chapters.

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Abbreviations, Symbols, and Defined Terms Used in this Report

§ Section references refer to sections of the Code unless otherwise indicated.

¶ Paragraph references refer to sections of the author's book *Life and Death Planning for Retirement Benefits*. If the referenced section begins with "¶ 5", or is followed by the statement [Appendix A] the section can be found elsewhere in this Report. Otherwise the cross referenced section is NOT reproduced in this Report. The book can be purchased for $89.95 plus shipping through www.ataxplan.com, through Amazon.com, or by calling 800-247-6553.

AMT Alternative minimum tax. § 55.
Applicable Dollar Limit. The maximum permitted annual (regular) contribution to an IRA. ¶ 5.3.03.
Code Internal Revenue Code of 1986, as amended through September 2014.
DRAC Designated Roth account. See ¶ 5.7.01.
Five-Year Period. See ¶ 5.2.05.
HEART Act The "Heroes Earning Assistance and Relief Tax Act" of 2008 (Pub. L. 110-245).
IRA Individual retirement account or individual retirement trust under § 408.
IRD Income in respect of a decedent. § 691.
IRS Internal Revenue Service.
MAGI Modified adjusted gross income. See ¶ 5.3.04(C).
Nonexclusion period. Same as "Five-Year Period"; see ¶ 5.2.05.
NUA Net unrealized appreciation. See ¶ 5.4.04(A).
PPA '06 The Pension Protection Act of 2006 (Pub. L. 109-280).
QRP Qualified retirement plan under § 401(a).
Reg. Treasury Regulation.
RBD Required beginning date. See ¶ 5.2.02(A).
Regular contribution. See ¶ 5.3.02.
RMD Required minimum distribution under § 401(a)(9).
TAPRA The Taxpayer Relief Act of 1997 (Pub. L. 105-34).
Traditional IRA or plan. An IRA or retirement plan that is not a Roth IRA or Roth plan.
WRERA The Worker, Retiree, and Employer Recovery Act of 2008 (Pub. L. 110-458).

Roth Retirement Plans

Roth retirement plans offer the possibility of tax-free distributions to those who are eligible (and can afford) to adopt them.

This Chapter covers everything the advisor needs to know about "Roth" retirement plans except the following matters that are covered in other Chapters: Roth conversions by the participant's surviving spouse (see ¶ 3.2.04 [Appendix A]) or nonspouse beneficiary (¶ 4.2.05) [Appendix A]; the executor's responsibilities with respect to a deceased participant's Roth plan or Roth conversion (¶ 4.1.02); and tax treatment of investment losses (¶ 2.2.11) and management fees (¶ 8.1.04) [Appendix A] with respect to a Roth IRA.

5.1 Roth Plans: Introduction & Miscellaneous

"Tax-free compounding is the best thing in the world." –Jonathan G. Blattmachr, Esq.

5.1.01 ***Introduction to Roth retirement plans***

Prior to the debut of the Roth IRA in 1998, all retirement plans had the same basic tax structure: Contributions to the plan might or might not be tax deductible; and all distributions from the plan in excess of the participant's after-tax contributions would be includible in the recipient's gross income.

§ 408A established a new kind of IRA, called a Roth IRA, effective in 1998. Roth IRA contributions are never deductible, but distributions are normally tax-free. Thus, income tax on the plan's investment returns is not merely deferred, it is eliminated—at the cost of payment of income tax up front on the plan contributions. In addition to tax-free distributions, the Roth IRA offers two other advantages over traditional IRAs: no required minimum distributions during the participant's life (¶ 5.2.02(A)); and no maximum age for making contributions (¶ 5.3.04(A)). Congress later added another type of Roth plan (the "designated Roth account" or "DRAC"; ¶ 5.7) and expanded the number of ways to acquire a Roth plan (¶ 5.3.01).

Roth retirement plans offer the possibility of tax-free investment growth to those who are eligible (and can afford) to adopt them. Through 2009, to be "eligible" to convert an existing traditional plan to a Roth IRA meant having "modified adjusted gross income" of $100,000 or less, and not using married-filing-separately filing status. Starting in 2010, everyone who owns a traditional retirement plan or IRA is eligible to convert to a Roth IRA, regardless of income or filing status. ¶ 5.4.02.

5.1.02 ***What practitioners must know***

Advisors need to know:

✓ The differences between Roth IRAs and traditional IRAs. ¶ 5.2.01.

✓ How the minimum distribution rules apply to Roth IRAs. ¶ 5.2.02.

✓ The income tax treatment of qualified and nonqualified Roth IRA distributions. ¶ 5.2.03–¶ 5.2.07.

✓ The eight ways to fund a Roth IRA. ¶ 5.3.01.

✓ How to fund a Roth IRA with "regular" (annual-type) contributions from compensation income. ¶ 5.3.02–¶ 5.3.04.

✓ The rules for "conversion" of a traditional plan or IRA to a Roth IRA. ¶ 5.4.

✓ How the 10 percent penalty on pre-age 59½ distributions applies to Roth conversions and distributions. ¶ 5.5.

✓ How to undo (recharacterize) a Roth conversion or other contribution to a Roth or traditional IRA. ¶ 5.6.

✓ What a "designated Roth account" (DRAC) is, the tax rules for DRAC contributions and distributions, and how DRACs differ from Roth IRAs. ¶ 5.7.

✓ Which clients should consider or avoid Roth IRAs and DRACs. ¶ 5.8.01–¶ 5.8.05.

✓ How to prepare for and execute a Roth conversion. ¶ 5.8.06.

✓ Which Roth planning ideas do not work. ¶ 5.8.07.

✓ How to handle Roth benefits in a client's estate plan. ¶ 5.8.08.

✓ Which Roth IRA transactions are abusive. ¶ 5.1.03.

✓ How to handle investment losses (¶ 2.2.11) and investment management fees (¶ 8.1.04) [Appendix A] with respect to a Roth IRA.

5.1.03 ***Roth retirement plan abuses***

In a blatant abuse of the Roth IRA retirement savings vehicle, some individuals have attempted to shift income into their Roth IRAs by such means as having the Roth IRA form a

wholly-owned entity (such as an LLC), then shifting value into that entity by (for example) selling property to it at bargain prices. The goal of these schemes is to shelter income in the tax-free Roth.

In Notice 2004-8, 2004-4 IRB 333, the IRS declared war on these devices, attacking them: as disguised IRA contributions in violation of the limits on annual IRA contributions and the requirement that only cash may be contributed to an IRA (¶ 5.3.02); as listed transactions for purposes of the anti-tax-shelter regulations (see Reg. § 54.6011-4); and possibly as prohibited transactions under § 4975 (which would disqualify the IRA; § 408(e)(2)). The IRS will dismantle the transactions through denial of deductions (for, *e.g.*, excessive payments from a business to the IRA-owned entity) or re-allocation of income, deductions, etc., among the persons and entities involved pursuant to § 482; see CCA 2009-17030 in which this principle was applied. This development was predicted in Choate, N., "Retirement Benefits: Unexpected Drama," 143 *Trusts & Estates* 1 (Jan. 2004), p. 40.

Mazzei: Example of Abusive Roth IRA Transaction

In *Celia Mazzei, et al., v. Comm'r,* TC Memo 2014-55 (4/1/14), three members of the Mazzei family collectively owned 100 percent of the stock of two S corporations. The two corporations owned a combined 100 percent of a Partnership. In 1998, each of the Mazzeis established a Roth IRA and caused his or her Roth IRA to purchase stock in a Western Growers, a corporation that qualified as a "foreign sales corporation" (FSC) under § 927. During the years 1998 through 2001, the Mazzei partnership paid the FSC commissions of $200,000 to $300,000 per year on certain international sales made by partnership. The FSC in turn paid dividends to its stockholders, the Roth IRAs. The effect was to transfer substantial sums on a tax-deductible basis, through the FSC, to the tax-exempt Roth IRAs.

This type of transaction was exactly the type of abusive Roth IRA transaction (through use of a related business entity) that the IRA targeted in Notice 2004-8. However, by the time the IRS discovered the transactions (during an audit on a different matter in 2005), the applicable years were "closed," for income tax purposes, due to the statute of limitations. So the IRS instead attacked on grounds that the income-shifting constituted *excess contributions* to the Roth IRAs, subject to the six percent cumulative annual excise tax under § 4973. The IRS asserted, and the Tax Court agreed, that the applicable years were *not* closed by the statute of limitations with respect to this excise tax, because the taxpayers had not filed "Forms 5329" for those years. Form 5329 is the return that must be filed with respect to an IRA-related penalty or excise tax in order to start the statute of limitations running. See *Paschall, Robert, et ux.*, 137 TC 8 (2011).

For more on the excess IRA contribution penalty, see the author's *IRAs with Hair*, downloadable at www.ataxplan.com.

For other planning ideas that Congress or the IRS has considered potentially abusive or just plain too good to be allowed, and therefore has addressed with a change in the law or other loophole-closing action, see ¶ 5.4.04(A) (Roth conversion of NUA stock), ¶ 5.4.03(A) (Roth conversion of certain annuity contracts), ¶ 5.5.02 (Roth conversion followed by immediate distribution while under age 59½), ¶ 5.6.07 (immediate reconversion following a recharacterization), ¶ 5.7.10 (shifting value to a DRAC within a plan), and ¶ 5.8.08(C) (lifetime gift of a Roth IRA).

The IRS's next target for anti-abuse rule changes? I would nominate intentional excess Roth IRA contributions; see Ludwig Example at ¶ 2.1.08(H). Perhaps the IRS will classify any

distribution of the earnings on an excess Roth IRA as a nonqualified distribution, even if made after the corrective distributions deadline (¶ 2.1.08(A); ¶ 5.6.06), or disqualify altogether a Roth IRA that is intentionally (as opposed to accidentally) funded with an improper contribution, to nullify benefits from this type of abusive transaction.

5.1.04 ***Unanswered questions regarding Roth plans***

¶ 5.2.04: Does the rule that the deemed income resulting from a prohibited transaction cannot be a qualified distribution apply to prohibited transactions with Roth IRAs? Or just to prohibited transactions involving a DRAC?

¶ 5.2.05: How is calculation of the Five-Year Period for a participant's future Roth IRAs affected if at all by the participant's closing out all his Roth IRAs?

¶ 5.4.03(A): A special rule applies to valuation of an IRA-owned annuity contract for purposes of converting that contract to a Roth IRA. Does the same rule apply if an annuity contract owned by a *nonIRA plan* is converted to a Roth?

¶ 5.6.07: If a traditional IRA is converted to a Roth IRA, and then the converter "recharacterizes" some or all of the conversion prior to the applicable deadline (so the money is moved back to the traditional IRA, as if the conversion never happened), the individual who so recharacterized cannot convert "that amount" back to a Roth IRA again until at least 30 days have elapsed, or until the next taxable year after the year of the original conversion, whichever is later. Does this mean the individual can convert *some other amount* from the same traditional IRA without waiting for the 30 day/next year period to pass?

¶ 5.8.08(B): How does an executor recharacterize an IRA contribution if the beneficiary of the IRA won't cooperate? Who is the beneficiary of the account following the recharacterization?

¶ 5.7.08(D): In case of a rollover from a DRAC to a Roth IRA, where the individual's basis exceeds the value of the account at the time of the rollover, does the excess basis carry over to the new plan if there is a total and/or direct rollover? Or does this rule apply only to partial 60-day rollovers?

5.2 Roth IRAs: Minimum Distribution and Income Tax Aspects

Roth IRAs are just like traditional IRAs except where the Tax Code says they are different. The differences arise in the treatment of distributions (normally tax-free from Roth IRAs), deductibility of contributions, and application of the minimum distribution rules.

5.2.01 ***Roth (and deemed Roth) IRAs vs. traditional IRAs***

The Tax Code provides that, for federal income tax purposes, Roth IRAs are treated just like traditional IRAs except where the Code specifies different treatment. § 408A(a); Reg. § 1.408A-1,

A-1(b). Thus, if any question about Roth IRAs is not specifically answered in § 408A or the Roth IRA regulations, the answer should be the same as for a traditional IRA.

Here are the ways in which a Roth IRA is NOT the same as a traditional IRA:

- ✓ The minimum distribution rules apply differently to the two types of IRAs. See ¶ 5.2.02(A).

- ✓ "Qualified" distributions from a Roth IRA are income tax-free, whereas traditional IRA distributions are generally taxable. See ¶ 5.2.03–¶ 5.2.05.

- ✓ As with a traditional IRA, the participant's own (already-taxed) contributions to a Roth IRA are not taxed again when they are withdrawn from the account; but there is a big difference between Roth and traditional IRAs in how you determine what portion of a particular distribution consists of the participant's own contributions. See ¶ 5.2.06–¶ 5.2.07.

- ✓ There are different eligibility requirements for making contributions to a Roth versus a traditional IRA. See ¶ 5.3.04, ¶ 5.4.02.

Deemed IRAs: An employer who maintains a qualified retirement plan may permit employees to make voluntary contributions to "a separate account or annuity established under the plan." § 408(q)(1)(A); Reg. § 1.408(q)-1. The separate account must meet the requirements of § 408 (traditional IRA) or § 408A (Roth IRA). The separate account (called a **deemed traditional IRA** or **deemed Roth IRA**) is then treated in all respects the same as a "regular" traditional or Roth IRA and is generally not subject to the qualified plan requirements.

Since a deemed Roth IRA is treated in all respects the same as a "real" Roth IRA, all discussion in this book about Roth IRAs applies equally to deemed Roth IRAs. Deemed IRAs seem to be rare (nonexistent?); at least, this author has never encountered one. Marcia Chadwick Holt, Esq., author of *Estate Planning for Retirement* (Bradford Publishing Co., Denver, CO, 2007), points out that one deterrent to plans' allowing deemed IRAs is that qualified plans often have one or more individual trustees, which are not allowed for IRA assets.

5.2.02 ***Roth IRAs and the minimum distribution rules***

For explanation of the minimum distribution rules, see Chapter 1 of *Life and Death Planning for Retirement Benefits*.

The minimum distribution rules do not apply to a Roth IRA until after the participant dies. Thus, withdrawals beginning at age 70½ that are mandated for traditional IRAs simply do not apply to Roth IRAs. After the participant's death, the minimum distribution rules *do* apply to the Roth IRA beneficiary, with distributions being computed as if the participant died "before his required beginning date."

A. **No lifetime required distributions.** The lifetime required minimum distribution (RMD) rules generally require that a participant must take annual distributions from an IRA beginning at approximately age 70½, using a distribution schedule designed to assure that the projected death benefits to the participant's beneficiary will be no more than "incidental benefits" compared with the value of the projected distributions to the participant. See ¶ 1.3.

These "lifetime RMD rules" do not apply to Roth IRAs. § 408A(c)(5) provides that § 401(a)(9)(A) (which contains the lifetime minimum distribution rules) and the "incidental death benefits" rule do not apply to Roth IRAs. Accordingly, there is no "required beginning date" (RBD; ¶ 1.4) for a Roth IRA. A person who reaches age 70½ does not have to start taking distributions from his Roth IRA as he does from his traditional IRA.

URGENT NOTICE! ROTH CONVERSIONS IN AN RMD-YEAR

For how to do a Roth conversion in a year in which the participant is required to take an RMD from the plan or IRA being converted, see ¶ 5.2.02(E).

B. Post-death RMD rules DO apply. Once death occurs, the minimum distribution rules *do* apply to Roth IRAs. The Roth IRA is not exempted from any minimum distribution rules other than § 401(a)(9)(A) and the incidental death benefits rule, both of which apply only during the participant's life, so distributions must begin coming out of the Roth IRA after his death. Since there is no RBD for a Roth IRA, the post-death minimum distribution rules will *always* be applied "as though the Roth IRA owner died before his" RBD, regardless of when he dies. Reg. § 1.408A-6, A-14(b).

For how to compute RMDs from a Roth IRA after the participant's death, see ¶ 1.5.02–¶ 1.5.03. If the participant's surviving spouse inherits the Roth IRA, see ¶ 1.5.03(B) for how to compute RMDs to her so long as she holds the account as beneficiary. If she rolls the account over to her own Roth IRA (¶ 3.2.03(B) [Appendix A]), it then becomes "her" Roth IRA, and there are no further distributions required until after her death (see "A" above).

C. Roth distributions do not fulfill RMD for traditional IRA. *Distributions from* a Roth IRA cannot be used to fulfill a distribution requirement with respect to any other kind of IRA. Traditional and Roth IRAs are NOT aggregated for RMD purposes. Reg. § 1.408A-6, A-15.

D. RMDs and recharacterizations. See ¶ 1.2.07 regarding effect of a recharacterization occurring after the end of the conversion year on calculation of the RMD for the year of the recharacterization.

E. RMDs and Roth conversions. Beginning in the first year that a minimum distribution is required (the year the participant reaches age 70½ in the case of lifetime RMDs from a traditional IRA; ¶ 1.4.08), the traditional plan or IRA may not be converted to a Roth IRA until *after* the RMD for the year of the conversion has been distributed out of the traditional plan or IRA. Reg. § 1.408A-4, A-6(a), (b). This regulation derives from two rules:

- ♦ An RMD may not be rolled over; it is not an "eligible rollover distribution." § 402(c)(4)(B), § 403(b)(8)(A)(i), § 408(d)(3)(E).
- ♦ The first distribution(s) coming out of a plan or IRA in any year is/are deemed to be the RMD for that year until the entire RMD has been distributed. Reg. § 1.402(c)-2, A-7(a), § 1.408-8, A-4.

See ¶ 2.6.03 for more discussion of these rules, including the "traps" that surround them.

If funds are rolled or transferred from a traditional plan or IRA to a Roth IRA *before* the RMD for the year of the conversion has been distributed out of the traditional plan or IRA, the conversion cannot be a valid Roth conversion to the extent of the RMD. The IRS created a special rule to deal with this situation: The IRS treats the RMD that was improperly "rolled" to the Roth IRA "as if" (1) the RMD had been distributed out of the traditional plan and (2) the recipient then contributed the same amount to the Roth IRA as a "regular contribution" (¶ 5.3.02). Reg. § 1.408A-4, A-6(c).

The good news with this special IRS rule is that there will be no fifty percent penalty for failure to take the RMD (¶ 1.9.02), because the RMD is deemed to have been distributed. The bad news is that the "deemed" regular contribution to the Roth IRA will usually result in an "excess contribution" to the Roth IRA, either because the deemed contribution is larger than the permitted maximum regular contribution (¶ 5.3.03) or because the person is not eligible to make a regular contribution to a Roth IRA. A person who is eligible to *convert* to a Roth (¶ 5.4.02) may be ineligible to make a *regular* contribution to a Roth IRA. ¶ 5.3.04. An excess contribution to the Roth IRA will generate an excess-contribution penalty unless the excess contribution (and net income attributable to it) is withdrawn from the Roth IRA prior to the applicable deadline for corrective distributions; see ¶ 5.3.05.

Angie Example: Angie, age 75, has two traditional IRAs, one worth $100,000 and one worth $200,000. Her 2010 RMD is (assume) $4,367 for the smaller IRA and $8,734 for the larger one. Before taking any distributions in 2010 from either account, she transfers the entire smaller ($100,000) IRA to a Roth IRA. This is a mistake—she should have taken the 2010 RMD attributable to that account *before* doing a Roth conversion. She *could* have taken the RMD for both of her traditional IRAs (total amount $13,101) entirely from either one of them (see ¶ 1.3.04), but it does not appear that she can now correct her rollover/conversion mistake by taking $13,101 from the $200,000 traditional IRA. Instead, the conversion is treated as a taxable distribution of the $4,367 RMD from the smaller IRA; a regular contribution of $4,367 to the Roth IRA; and a conversion contribution of $95,633 to the Roth IRA (i.e., the balance of the smaller IRA after taking out the RMD of $4,367). If Angie is not eligible, or does not want, to make a regular contribution of $4,367 to the Roth IRA, she should withdraw that amount (plus net income attributable to it) from the Roth IRA as soon as possible; see ¶ 2.1.08 for rules on corrective IRA distributions, ¶ 5.6.02 for how to compute the net income attributable. If she is not eligible to make that regular contribution (¶ 5.3.04) and does NOT withdraw it by the applicable deadline then she will owe the six percent penalty for an excess IRA contribution (¶ 5.3.05). However, she will not owe the 50 percent penalty for failure to take an RMD because she is deemed to have *taken* the RMD. She still needs to take the 2010 RMD ($8,734) attributable to her larger IRA from the larger IRA; and after doing that she can convert all or any part of the rest of the larger IRA to a Roth IRA in 2010. For example, she could convert $4,367 of the larger IRA to a Roth IRA if she wants to stick to her original goal of converting exactly $100,000.

5.2.03 ***Tax treatment of Roth IRA distributions: Overview***

"Qualified distributions" from a Roth IRA are income tax-free. It is relatively easy to qualify for "qualified" distributions; see ¶ 5.2.04–¶ 5.2.05. The requirements for a qualified distribution

from a DRAC are slightly different; see ¶ 5.7.04. *Non*qualified distributions from Roth IRAs may or may not be tax-free; see ¶ 5.2.06 (see ¶ 5.7.05 for rules for nonqualified DRAC distributions).

See ¶ 8.2 regarding Roth IRAs and the tax on "unrelated business taxable income" (UBTI).

A. Qualified vs. nonqualified distributions. Qualified distributions from a Roth IRA are not included in the recipient's gross income for federal income tax purposes, regardless of whether the recipient is the participant or a beneficiary. § 408A(d)(1); Reg. § 1.408A-6, A-1(b)(2).

Shane Example: Shane has a Roth IRA. He receives qualified distributions from it. These are excluded from his gross income. Shane dies, leaving his Roth IRA half to his son and half to the Shane Family Trust. The son and the trust both take RMDs and other distributions from the Roth IRA, all of which are qualified distributions. These qualified distributions are income tax-free (regardless, in the case of the trust, of whether they are treated as "income" or "principal" for trust accounting purposes).

B. Aggregation of Roth IRAs for income tax purposes. See ¶ 2.2.08 [Appendix A] for the rule (in § 408(d)(2)) that all of an individual's IRAs are generally aggregated (treated as one account) for purposes of determining how much of any particular distribution constitutes a return of the participant's after-tax contributions. § 408A(d)(4)(A) provides that "§ 408(d)(2) shall be applied separately with respect to Roth IRAs and other individual retirement plans." This means that the taxation of distributions from *traditional* IRAs is computed without regard to the existence of, or distributions from, *Roth* IRAs in the same year; and that all of the participant's Roth IRAs are treated as one single account for purposes of applying the Ordering Rules (¶ 5.2.07). Note, however, that:

✓ *Beneficiaries:* A Roth IRA that an individual holds *as beneficiary of a deceased person* is NOT aggregated with the individual's own Roth IRA(s); it is aggregated only with other inherited Roth IRAs the individual holds as beneficiary of the same decedent. Reg. § 1.408A-6, A-11.

✓ *Spouses:* The Roth IRAs of a husband and wife are not aggregated with each other; each spouse's Roth IRAs are aggregated only with other Roth IRAs of that spouse. Aggregation applies to Roth IRAs of the "individual." Reg. § 1.408A-6, A-9.

✓ *Returned, recharacterized, contributions:* The aggregation rule does *not* apply for purposes of computing net income attributable to a returned or recharacterized IRA contribution. See ¶ 5.6.02. That computation is done with respect only to the IRA (traditional or Roth) that received the contribution that is being returned or recharacterized. Reg. § 1.408-11(c)(3), § 1.408A-5, A-2(c)(4).

C. Actual vs. deemed distributions. Generally, funds in a Roth IRA are treated as distributions only when actually distributed from the account. See ¶ 2.1.01. However, assigning a Roth IRA by lifetime gift "to another individual" causes the Roth IRA to be "deemed" distributed to the owner-donor, and accordingly it ceases to be a Roth IRA. Reg. § 1.408A-6, A-19. For

other events that may cause a "deemed" distribution from an IRA (including a Roth IRA) without an actual distribution, see ¶ 2.1.04.

D. **Basis issues.** A Roth IRA may distribute cash and/or property. If property is distributed from a Roth IRA to the participant or beneficiary, the recipient's basis in such property (for purposes of computing gain or loss when the recipient later sells the property) is its fair market value on the date of the distribution. Reg. § 1.408A-6, A-16. If a Roth IRA is worth less than the participant's basis in the account, see ¶ 2.2.11.

5.2.04 ***Qualified distributions: Definition***

"Qualified distributions" are distributions that occur after a five-year waiting period has elapsed *and* a "triggering event" has occurred. For how to compute the five-year waiting period, see ¶ 5.2.05. The most common "triggering events" are attaining age 59½ and death. For most people, therefore, getting tax-free qualified distributions from their Roth IRA will be a matter of waiting five years and being over age 59½.

More precisely, a qualified distribution is one that is made after the Five-Year Period (¶ 5.2.05) has elapsed; and which *in addition* (§ 408A(d)(2)(A)):

1. Is made on or after the date the participant attains age 59½; or

2. Is made after the participant's death; or

3. Is "attributable to" the participant's being totally disabled (as defined in § 72(m)(7); see ¶ 9.4.02 for discussion of this standard); or

4. Is a "qualified special purpose distribution," i.e., a distribution of up to $10,000 for certain purchases of a "first home." § 408A(d)(2)(A)(iv), (d)(5); § 72(t)(2)(F), (t)(8); see ¶ 9.4.09 for more on the definition of a "first home" for this purpose. Presumably, this "trigger" #4 will rarely be pulled. Remember, an individual can withdraw all of his own contributions to a Roth IRA income tax-free at any time; see ¶ 5.2.06. Therefore this trigger will be needed to shelter a distribution from income tax only if the nondisabled under-age-59½ first-time homebuyer who has owned a Roth IRA for more than five years has to withdraw *all of his contributions to the account plus up to $10,000 of earnings* to afford the "first home."

These conditions for a qualified distribution from a Roth IRA resemble the requirements for avoiding the 10 percent "early distributions" penalty of § 72(t) (¶ 5.5), but are not identical. For example, withdrawals from a Roth IRA to pay higher education expenses are not qualified distributions, even though such withdrawals from an IRA are exempt from the 10 percent penalty (¶ 9.4.08).

Note that certain distributions probably or definitely can NOT be qualified distributions, *even if* the Five-Year Period and triggering event requirements are met:

- ♦ **Corrective distributions.** If various requirements are met, an IRA (or Roth IRA) contribution that is returned (together with any earnings thereon) to the contributor by a

certain deadline is deemed never to have been contributed; see ¶ 2.1.08 for full details on such "corrective distributions." The "earnings" distributed along with a returned IRA contribution apparently cannot be considered a qualified distribution, and therefore will be taxable (and will be subject to the 10% penalty under § 72(t) if the individual is under age 59½ and no exception applies). Reg. § 1.408A-6, A-1(d). (One can speculate that the IRS might apply this principle to the earnings on *any* excess Roth IRA contribution, regardless of whether the excess contribution was returned to the contributor as part of a corrective distribution, although the IRS has made no pronouncement on this subject to date; see ¶ 5.1.03).

♦ **Prohibited transactions.** The IRA owner's engaging in a prohibited transaction with his Roth IRA causes the account to lose its exempt status, and to be deemed to be entirely distributed to the owner, as of the first day of the year in which the prohibited transaction occurs. § 408(e); § 408A(a); Reg. § 1.408A-1, A-1(b). If the Roth IRA is no longer qualified as a Roth IRA as of the date of the distribution, it's hard to see how the deemed distribution resulting from a prohibited transaction can be a tax-exempt qualified distribution. However, there has been no pronouncement from the IRS one way or the other on that point in the more than 15 years since Roth IRAs came on the scene.

5.2.05 ***Computing Five-Year Period for qualified distributions***

Satisfying a five-year waiting period (called in this book "the **Five-Year Period**") is one of two tests a Roth IRA owner must pass in order to have tax-free "qualified distributions" (¶ 5.2.04) from his Roth IRA.

A. **Five-Year Period for participant.** The Five-Year Period (called in the statute the "**nonexclusion period**") for *all* of a participant's Roth IRAs begins on January 1 of the first year for which a contribution was made to *any* Roth IRA maintained for that participant. § 408A(d)(2)(B); Reg. § 1.408A-6, A-2.

Fred Example: On May 3, 1999, Fred put $1,000 into his Roth IRA. Fred's Five-Year Period starts January 1, 1999, and is completed on December 31, 2003. The first year in which he can possibly have a qualified distribution is 2004. If he makes further contributions (either regular or rollover) to the same (or any other) Roth IRA, those contributions do NOT start a new Five-Year Period running. In 2006, Fred converts his $100,000 traditional IRA to a Roth IRA. This new Roth IRA instantly meets the Five-Year Period requirement, because Fred has already completed the Five-Year Period for every Roth IRA he will ever own. If Fred is already over age 59½, he can immediately take qualified distributions from his newly-created Roth IRA in 2006.

If a Roth IRA contribution is entirely recharacterized (¶ 5.6.03), it is treated as if it had never been made. Thus, in the Fred Example above, if Fred had recharacterized his 1999 Roth IRA contribution, that contribution would not start the Five-Year Period running. If he closes all his Roth IRAs, see "C" below.

The Five-Year Period is computed differently for a DRAC. ¶ 5.7.04(B). Furthermore, the method of computing the Five-Year Period for a Roth IRA does not change just because the Roth

IRA receives a rollover from a DRAC, *regardless of how long the DRAC had been in existence*. See ¶ 5.7.09 for details.

B. Five-Year Period for beneficiaries. The five-year holding period requirement is not eliminated by the participant's death; the inheriting beneficiaries still must fulfill this requirement to have qualified distributions. The deceased participant's holding period for the inherited Roth IRA carries over to the beneficiary. Reg. § 1.408A-6, A-7(a). The Five-Year Period is determined separately with respect to the beneficiary's OWN Roth IRAs and for the Roth IRAs he has inherited from each decedent. Reg. § 1.408A-6, A-7(b). See ¶ 4.2.05 [Appendix A] regarding an "inherited" Roth IRA that is created by means of a Roth conversion by a Designated Beneficiary.

As usual, there are special rules for the surviving spouse: If the beneficiary of the Roth IRA is the surviving spouse, she gets to carry over the deceased participant's holding period *even if* she elects to treat the Roth IRA as her own Roth IRA, so in effect she gets to use her own holding period or the deceased spouse's holding period, whichever is longer. Reg. § 1.408A-6, A-7(b).

Scott Example: Scott contributes to his first Roth IRA in 2008. His Five-Year Period will therefore be completed December 31, 2012. He dies in 2010, leaving the Roth IRA in equal shares to his wife (age 45) and daughter (age 22). The wife and daughter divide the account into two separate equal inherited Roth IRAs, one payable to each of them (¶ 4.2.02(B)). The wife elects to treat the separate Roth IRA payable to her as her own Roth IRA.

For Scott's daughter, the Five-Year Period for her inherited Roth IRA will be completed December 31, 2012, because she "carries over" Scott's holding period. Accordingly, for the daughter, all distributions from the inherited Roth IRA after 2012 will be "qualified distributions," because she will have met both the Five-Year Period requirement and the triggering event requirement. Scott's death was the triggering event for her inherited Roth IRA. She started her own first Roth IRA in 2010. She will complete the Five-Year Period with respect to any (noninherited) Roth IRA she may ever own at the end of 2014, but will not meet the triggering event test with respect to *her own* Roth IRAs until she reaches age 59½, or is disabled, etc.

For the Roth IRA payable to Scott's wife that she has elected to treat as her own, her election erases Scott's death as a triggering event, because the Roth IRA is now considered her own Roth IRA (not an inherited Roth IRA), and she owns it as participant (not beneficiary). Reg. § 1.408A-6, A-3. For distributions after 2012 she will have met her Five-Year Period requirement, based on *Scott's* holding period, which she gets to carry over. If she had started a Roth IRA of her own prior to 2008 (the year Scott started his), her Five-Year Period would be based on her *own* Roth IRA. But regardless of which holding period start date applies, she will still not have qualified distributions from this or any of her other (noninherited) Roth IRAs until she attains age 59½ or becomes disabled, etc.

C. Effect of closing out all Roth IRAs. What happens if a participant who has had a Roth IRA in existence beyond the end of all applicable periods for withdrawing a "corrective distribution" (¶ 2.1.08(A)) or recharacterizing (¶ 5.6.06) the contribution then closes out all his Roth IRAs, so he no longer has any Roth IRA? With respect to any future Roth IRA he may own, does the calculation of his Five-Year Period still begin with his first Roth IRA,

or does he lose the benefit of that because he closed them all out? The regulations dealing with *DRACs* (see ¶ 5.7.04(B)) provide that the beginning of the Five-Year Period for a participant's DRACs under a particular retirement plan is *not* redetermined simply because he closes out all his DRACs at any point. However, the Roth *IRA* regulations do not address this point.

5.2.06 ***Tax treatment of nonqualified distributions***

A **nonqualified distribution** is one made before the Five-Year Period (¶ 5.2.05) is up; or which is made after expiration of the Five-Year Period but before any of the triggering events (age 59½, disability, death, etc.; ¶ 5.2.04) has occurred. A nonqualified distribution is not *per se* excludible from gross income. However, even if a distribution is not "qualified" it receives favorable tax treatment compared with distributions from a traditional IRA.

A Roth IRA contains two types of money. First, it contains the participant's contributions; since these amounts were *already* included in the participant's gross income, these originally-contributed funds will not be included in his income *again* when they are later distributed. Thus, the amount of the participant's original contribution(s) to the Roth IRA constitutes the participant's basis (or "investment in the contract") in the Roth IRA. § 72(b)(2); see ¶ 2.2. If the account has grown to be worth more than this basis, the rest of the account value (which represents the earnings and growth that have occurred since the original contribution; the IRS calls this portion the "**earnings**") has not yet been taxed (and may *never* be taxed if it is distributed in the form of a qualified distribution).

The general rule is that all distributions (for exceptions see ¶ 5.2.07) from a Roth IRA are deemed to come *first* out of the participant's contributions. ¶ 5.2.07, #1. Thus, if the participant or beneficiary wants to get money out of the Roth IRA, but does not meet the requirements for a qualified distribution, he can still withdraw money income tax-free, up to the amount the participant contributed:

Jules and Jim Example: In 2007, Jules converted his $400,000 traditional IRA to a Roth IRA. He died in 2009, leaving the account (now worth $500,000) to his son Jim. Jim wants to use the "stretch" life-expectancy payout method for this inherited Roth IRA (see ¶ 1.5.05). Accordingly, he must start taking RMDs in 2010. Jules's death is a "triggering event," but the Five-Year Period will not be up until December 31, 2011, so the distributions Jim is forced to take in 2010 and 2011 are not qualified distributions. Nevertheless, these distributions are tax-free to Jim, because they are deemed to come out of the $400,000 of contributions Jules already paid tax on.

In contrast to this favorable treatment afforded to Roth IRAs, all distributions from a *traditional* IRA are deemed to come *proportionately* from the "basis" (nontaxable) portion and the post-contribution earnings (taxable) of all of the participant's aggregated IRAs. See ¶ 2.2.08 [Appendix A].

Can You Ever Stop Tracking "Basis" Vs. "Earnings?"

It might appear that once the client has met the requirements for a qualified distribution (*e.g.*, he is over age 59½ and has satisfied the Five-Year Rule), he could breathe a sigh of relief and stop keeping track of how many dollars in the account constituted "basis" versus "earnings." Is there any possibility a nonqualified distribution could occur after that point? Yes there is, according to the IRS which give the example of a disabled individual who receives a qualified distribution from a DRAC, then later ceases to be disabled and takes another distribution from the DRAC before reaching age 59½. Reg. § 1.402A-1, A-7. Another example would be, if a participant who has met the requirements for a qualified distribution dies and leaves the Roth IRA to his spouse as beneficiary, and she rolls it over to her own Roth IRA at a time when she is under age 59½ and not disabled. Also, if there is a prohibited transaction with the account, it is possible that the resulting deemed distribution might not be considered qualified (see ¶ 5.2.04). See the last sentence of ¶ 5.7.06 for how to eliminate the need for such tracking with respect to a DRAC.

5.2.07 ***The Ordering Rules***

Any distribution from a Roth IRA is deemed to come from the following sources, in the order indicated. § 408A(d)(4)(B); Reg. § 1.408A-6, A-9. These rules are referred to in this book as the **Ordering Rules**. These rules apply to all Roth IRA distributions *except*: Corrective distributions (¶ 2.1.08), Reg. § 1.408A-6, A-9(e); and (presumably) recharacterizations (¶ 5.6), and (perhaps) prohibited transactions (¶ 8.1.06).

1. Any distribution is deemed to come, first, from the participant's contributions to his Roth IRA(s), to the extent that all previous distributions from his Roth IRA(s) have not yet exceeded the contributions; and

2. If the participant has made both "regular" (¶ 5.3.02) and "rollover" (conversion) (¶ 5.4) contributions, the distributions are deemed to come, first, from the regular contributions, then from rollover contributions on a first-in, first-out, basis; and

3. Once it is determined that the distribution is deemed to come from a particular rollover contribution, the dollars that were includible in gross income by virtue of that rollover (¶ 5.4.03) are deemed distributed first. All of the rollover would be includible in income except the participant's own after-tax money that was included in the rollover; see ¶ 2.2. This particular ordering rule matters *only* to someone who is under age 59½ at the time of the distribution, see ¶ 5.5.02; and

4. Finally, once all contributions have been distributed, the balance of the distribution comes out of earnings. Whew!

Fortunately, practitioners will rarely if ever need to consult the Ordering Rules:

- ♦ For most people, the Ordering Rules matter only for purposes of determining whether a nonqualified distribution is subject to income tax; the Ordering Rules

essentially mean that the participant's already-taxed contributions to the Roth IRA come out *first* and accordingly distributions from the Roth IRA are NOT taxable until the total distributed exceeds those contributions.

♦ The Ordering Rules matter also for someone who converts a traditional plan to a Roth IRA before reaching age 59½, and then takes a distribution within five years of the conversion and while still under age 59½. The Ordering Rules will apply in determining whether the 10 percent penalty applies to the distribution. See ¶ 5.5.02.

5.3 How to Fund a Roth IRA; Regular and Excess Contributions

This section lists every known way to fund a Roth IRA; explains the rules for "regular" Roth IRA contributions; and tells how you can incur an "excess" Roth IRA contribution and what to do about it.

5.3.01 ***The eight ways to fund a Roth IRA***

The law provides at least eight ways to fund a Roth IRA. Each method has its own rules and eligibility requirements.

- An individual who has compensation income (and whose adjusted gross income is under certain levels) can make a "**regular contribution**" to a Roth IRA. See ¶ 5.3.02–¶ 5.3.04.

- A participant who owns a traditional retirement plan or IRA can transfer funds (or "roll over" distributions) from the traditional plan or IRA to a Roth IRA. This is called a "Roth **conversion**." See ¶ 5.4.

- A participant can roll money from a **DRAC** into a Roth IRA. See ¶ 5.7.08.

- See ¶ 3.2.04 [in Appendix A] for the ability of a **surviving spouse** (or ¶ 4.2.05 for other **Designated Beneficiary)** to transfer funds from an inherited traditional plan to a Roth IRA,

- Certain **U.S. military death gratuities** related to post-10/06/2001 deaths can be contributed to a Roth IRA. For details, see § 408A(e)(2) and IRS Publication 590 ("IRAs"; 2013 ed., p. 69). This type of contribution (added by the HEART Act) is not covered in this book.

- A **qualified reservist distribution** may be contributed, at any time within two years after the end of the reservist's active duty period, to any individual retirement plan (IRA or Roth IRA), without regard to the normal limits on IRA contributions. § 72(t)(2)(G)(ii). There is no tax deduction for this type of contribution, so it should always be contributed to a Roth IRA (where it may generate future tax-free income) rather than being made as a nondeductible contribution to a traditional IRA. For more on qualified reservist distributions see ¶ 2.6.06(C), ¶ 9.4.12.

- Certain individuals who received compensation in connection with the **Exxon Valdez** oil spill can contribute up to $100,000 of their settlement to a Roth IRA or other eligible retirement plan. Eligible individuals include both plaintiffs in the Exxon Valdez lawsuit and any individual who is (1) the spouse or immediate relative of a plaintiff and (2) a beneficiary of such plaintiff's estate. (Note that this is the only instance in which a nonspouse beneficiary can transfer inherited funds to the *beneficiary's own* retirement plan; compare ¶ 4.2.04.) This contribution must be made in the same year as the payment is received (or may be made "for" that year at any time up until the *unextended* due date of the tax return for that year). If made to a Roth IRA, the contribution is includible in the individual's income, just like other Roth plan contributions. If contributed to a traditional plan, the contribution is excluded from the individual's income. Either way, the contribution is treated as a rollover contribution. For details, see § 504 of the Emergency Economic Stabilization Act of 2008 and IRS Publication 590 ("IRAs"; 2013 ed., pp. 29, 70). This type of contribution is not covered in the Code or in this book.

- Certain **qualified airline employees** can contribute to a Roth IRA, within 180 days of receipt, or within 180 days of the date of enactment or WRERA if later, certain payments they receive in connection with the bankruptcy of a "commercial passenger airline carrier." Note that, unlike the Exxon Valdez settlement contributions, the airline employee payments may be contributed *only* to a Roth IRA. For details, see § 125 of the Worker, Retiree, and Employer Recovery Act of 2008 and IRS Publication 590 ("IRAs"; 2013 ed., p. 70). This type of contribution is treated as a qualified rollover contribution to the Roth IRA (see ¶ 5.4), and is not covered in the Code or in this book.

*5.3.02 **"Regular" contributions from compensation income***

One way to fund a Roth IRA is by making what the IRS calls "regular" (as opposed to "rollover"; ¶ 5.4) contributions to it. This section discusses the requirements for making a regular contribution to a Roth IRA, as contrasted with the rules governing regular contributions to a traditional IRA. See ¶ 5.6.01 for how to change your mind about your IRA or Roth IRA contribution after you've already contributed.

As with traditional IRAs, **only cash** may be contributed. § 408A(a), § 408(a)(1). See ¶ 5.6.05(A) regarding the **deadline** for making a regular Roth IRA contribution.

"Regular" Roth IRA Contributions: An Elastic Term

The meaning of "regular" Roth IRA contribution fluctuates a bit. It is normally used to mean a permissible annual-type IRA contribution from compensation income. However, the regulations say that *any* contribution to a Roth IRA that is not a qualified rollover contribution is a "regular contribution." Reg. § 1.408A-3, A-1. So certain contributions that are intended to be rollovers or Roth conversions, but don't meet the rollover requirements, such as a "failed conversion," ¶ 5.4.06, or the rollover of an RMD, ¶ 5.2.02(E), would be categorized as "regular" Roth IRA contributions. Adding to the confusion, a "proper" rollover from a DRAC to a Roth IRA is treated as a "regular contribution" to the Roth IRA for purposes of applying the Ordering Rules (¶ 5.7.08(C)).

The first requirement an individual must meet in order to make a regular contribution to either a traditional or a Roth IRA is that the individual must have compensation income. Reg. § 1.408A-3, A-3. The individual's contributions to either type of IRA for a particular year may not exceed the amount of such individual's compensation income for such year (or, if less, the dollar limit described in ¶ 5.3.03). An individual who does not have compensation income, or whose compensation income is not high enough to support the full maximum contribution to an IRA, but whose spouse does have sufficient compensation income, can make a regular contribution to an IRA (or Roth IRA, if eligible) based on the "working" spouse's income. § 219(c)(1)(B)(ii).

"**Compensation**" is partly defined in § 219(f)(1). It includes self-employment income (§ 401(c)(2)), and does *not* include pension, annuity, or deferred compensation payments. It includes taxable alimony and separate maintenance payments (§ 71). It includes (since 2004) nontaxable combat pay; see IRS Publication 590 ("IRAs"; 2013 ed., pp. 12, 64). It includes "wages, commissions, professional fees, tips, and other amounts received for personal services…." Reg. § 1.408A-3, A-4. See Rev. Proc. 91-18, 1991-1 C.B. 522, for further detail.

*5.3.03 **Applicable Dollar Limit for regular contributions***

This brief summary of the amount that may be contributed as a "regular" contribution to an IRA or Roth IRA is included for convenience. For more detail on the maximum IRA contribution see IRS Publication 590, § 219 and related regulations, or Denise Appleby Quick Reference charts (http://iraeducationcenter.com/page-1836484).

The maximum annual regular *Roth* IRA contribution amount derives from the maximum annual regular *traditional* IRA contribution amount.

The maximum amount that may be contributed to all of a person's *traditional* IRAs for a particular year is the lesser of a particular dollar amount (called in this book the "Applicable Dollar Limit") or the individual's compensation income (¶ 5.3.02) for the year. The maximum regular contribution for a particular year to all of a person's *Roth* IRAs is the exact same amount—minus the amount of regular contributions made to any traditional IRA(s) for that person for that year. § 408A(c)(2).

The Applicable Dollar Limit is the sum of the *general dollar limit* and the permitted "*catch-up contribution*" if the individual is age 50 or older as of the end of the year.

The general dollar limit was $5,000 for the years 2008–2012. For 2013–2014 it is $5,500, to be increased by cost-of-living adjustments (COLA) if there is sufficient inflation in future years. § 219(b)(5)(A), (D); see www.irs.gov. The catch-up contribution for the 50-and-older set is $1,000 for 2006 and later years (with no COLA). § 219(b)(5)(B).

An individual who has compensation income (¶ 5.3.02), and who meets the other eligibility requirements (see ¶ 5.3.04 for Roth IRAs, § 219 for traditional IRAs) may contribute to either a traditional IRA or a Roth IRA (whichever he is eligible to contribute to), or both if he is eligible to contribute to both, provided that the total contributed to both types of accounts for the year may not exceed the lesser of (1) the Applicable Dollar Limit or (2) the individual's compensation income for the year. Note that:

✓ Contributions made on the individual's behalf to a SEP-IRA or a SIMPLE (¶ 8.3.13) are ignored for this purpose; these are considered *employer* contributions, and as such have no

effect on the maximum the *individual* may contribute to his own traditional or Roth IRA. § 408A(f).

✓ As with virtually every rule in the retirement benefits area, there are exceptions in how to determine the maximum contribution, not discussed here. For example, higher limits apply in case of certain individuals whose employer went bankrupt, but lower contribution limits apply to an individual who also contributes to a "§ 501(c)(18) plan" (not covered in this book); see IRS Publication 590.

5.3.04 ***Who may make a "regular" Roth IRA contribution***

Any individual who has compensation income (¶ 5.3.02), regardless of his age or whether he participates in a workplace retirement plan, may make a "regular" contribution to a Roth IRA—*provided* that his income is below certain levels.

A. **No age limit.** There is no maximum age for contributing to a Roth IRA, as there is for contributions to a traditional IRA; a taxpayer can contribute to a Roth IRA even after age 70½. § 408A(c)(4); compare § 219(d)(1); § 408(o)(2)(B)(i).

B. **Participation in an employer plan is irrelevant.** A person who meets the income test (see "C") and has compensation income (¶ 5.3.02) may contribute to a Roth IRA regardless of whether he also participates in a "workplace" retirement plan in the same year. Active participation in an employer plan is relevant only for determining whether a contribution to a *traditional* IRA is deductible. See § 219(g)(3).

C. **Income must be below certain levels.** Only individuals with "modified adjusted gross income" (MAGI) below certain limits can contribute to a Roth IRA. The income test for making a regular contribution to a Roth IRA is not the same as the income test that applied (through 2009) to determine eligibility to convert a traditional plan to a Roth IRA (¶ 5.4.02(E)). Also unlike the income limit formerly applicable to Roth conversions, the income limit applicable to making "regular" Roth IRA contributions did *not* disappear at the end of 2009.

The definition of MAGI for purposes of the Roth IRA income limits starts with the modified definition of AGI used under § 219(g)(3) (income limits for making a deductible contribution to a traditional IRA when the individual is also a participant in an employer plan). However, MAGI for purposes of Roth contribution eligibility does NOT include the deemed distribution amount (¶ 5.4.03–¶ 5.4.04) that results from converting a traditional retirement plan or IRA to a Roth IRA. § 408A(c)(3)(B)(i). The gross income resulting from a Roth conversion is disregarded *solely for purpose of determining whether the taxpayer's MAGI is low enough to make him eligible to contribute to a Roth IRA.*

For example, the gross income resulting from a 2010 Roth conversion is excluded from MAGI for purposes of determining whether the individual is eligible to make a regular contribution to a Roth IRA in the years 2010–2012, regardless of whether that conversion income is included in his gross income in 2010 or in 2011–2012 (¶ 5.4.05). The conversion income is includible in the

individual's "real" gross income, and he has to pay tax on it—it is just excluded from the "MAGI" figure for purposes of determining eligibility.

In order for an individual to be eligible to contribute the full Applicable Dollar Limit (ADL) (¶ 5.3.03) to a Roth IRA, his MAGI may not exceed a certain "applicable dollar amount." The applicable dollar amount depends on filing status, and is adjusted upwards, after 2006, for post-2005 inflation. The applicable dollar amount was originally $95,000 for a single taxpayer, $150,000 for a married taxpayer filing a joint return, or $zero for a married taxpayer filing a separate return. § 408A(c)(3)(A). The 2014 applicable dollar amounts are: modified adjusted gross income (MAGI) of $114,000 (single), $181,000 (married filing jointly), and $zero (married filing separately). IRS Notice 2013-73, 2013-49 IRB (12/3/13)..

If the individual's MAGI exceeds this applicable dollar amount, the Applicable Dollar Limit amount that he can contribute to a Roth IRA is phased downward. It is reduced to zero once his income exceeds the applicable dollar amount by $15,000 (or by $10,000 in the case of a married taxpayer filing separately or jointly). § 408A(c)(3)(A), (B)(ii). Note that the phase-out applies to the *entire* ADL (including the over-50 catch-up amount), not just to the general dollar limit.

So, for 2014, a single taxpayer can contribute a reduced amount of the ADL if his income is between $114,000 and $129,000 (zero if income exceeds $129,000). A married taxpayer filing jointly can contribute a reduced amount of the ADL if the couple's income is between $181,000 and $191,000 (zero if income exceeds $191,000). A married taxpayer filing separately can contribute a reduced amount of the ADL if his income is between zero and $10,000 (zero if income exceeded $10,000).

For this purpose, "a married individual who has lived apart from his or her spouse for the entire taxable year and who files separately is treated as not married." Reg. § 1.408A-3, A-3(b).

An individual who is prevented from contributing the full ADL to a Roth IRA because of the income limit can contribute his reduced ADL to the Roth and the balance of the ADL to a traditional IRA (if he is under age 70½). Reg. § 1.408A-3, A-3(d), Example 4.

D. Regular traditional IRA contribution followed by conversion. An individual who is under age 70½ and who is prevented from making a regular contribution to a Roth IRA due to the income limit can make a regular contribution to a traditional IRA, then convert that to a Roth IRA. This anomalous situation arises because there is an income ceiling applicable to *regular* Roth IRA contributions but no income ceiling applicable to either traditional IRA contributions or to Roth *conversions*.

There is no waiting period or minimum holding period following the making of a contribution to a traditional IRA before the individual is eligible to convert it to a Roth IRA, just as (before direct plan-to-Roth IRA conversions were permitted; see ¶ 5.4.01(B)) there was no waiting period that prevented an eligible individual who rolled money from a traditional nonIRA retirement plan to a traditional IRA from immediately converting the traditional IRA to a Roth IRA.

Sandy Example: In 2014, Sandy, age 28, has compensation income of $300,000 and participates in a 401(k) plan at her job. Because of her high income, she is not eligible to make a regular contribution to a Roth IRA. So instead she makes a nondeductible contribution of $5,500 to a traditional IRA on June 1, 2014. Soon thereafter she converts the account to a Roth IRA. Though there is no legally-mandated waiting period before she can do that conversion, she might want to

wait long enough to be sure she has a clear paper trail showing that the money went into a traditional IRA first—for example, she might wait until she gets her June account statement clearly showing the existence of the traditional IRA. She does not elect to treat the transfer to the Roth IRA as a recharacterization of her traditional IRA contribution (¶ 5.6.03). If she has no other IRAs at any time during 2014, her conversion will be "tax-free," because the converted account contains nothing other than her own after-tax contribution. If she does have other IRAs in 2010, the conversion will be taxed under the "cream-in-the-coffee" rule; see ¶ 5.4.03(B).

5.3.05 ***Penalty for excess Roth IRA contributions***

There is an excise tax of six percent imposed on "regular" contributions to Roth IRAs in excess of the applicable limits (¶ 5.3.03), just as there is for excess contributions to traditional IRAs. § 4973; Reg. § 1.408A-3, A-7. The penalty for excess IRA contributions is applied separately to the individual's traditional and Roth IRAs. Reg. § 1.408A-3, A-7. See ¶ 2.1.08 for details on the excess IRA contribution penalty. Remedies for excess contributions include corrective distribution (¶ 2.1.08(A)–(E)), recharacterization (¶ 5.6.03), and "absorption" (¶ 2.1.08(H)).

5.4 Conversion of Traditional Plan or IRA to a Roth IRA

The other main way to create a Roth IRA, besides making annual-type "regular" contributions, is to transfer funds to a Roth IRA from a traditional IRA or nonIRA plan. The amount so transferred is generally included in the participant's gross income as if it had been distributed to him. § 408A(d)(3)(A)–(C). This type of contribution is called a "Roth conversion."

This Chapter describes the FEDERAL income tax treatment of Roth conversions. State income tax treatment may vary, and is not covered in this book. See ¶ 5.8.06(F).

Since there is no limit on the amount that can be converted from a traditional plan or IRA to a Roth IRA, a conversion contribution can be a much more substantial amount than the few thousand dollars per year maximum regular Roth IRA contribution (¶ 5.3.03).

See ¶ 5.5 for how a Roth conversion interacts with the 10 percent penalty on early distributions. See ¶ 5.6.05 regarding the deadline for completing a Roth conversion.

This ¶ 5.4 deals with Roth IRA conversions by the participant. Regarding the ability or inability of a beneficiary to convert an *inherited* plan or IRA to a Roth IRA, see ¶ 3.2.04 [Appendix A] (for the surviving spouse) or ¶ 4.2.05 (for other beneficiaries) [Appendix A].

Funds from a traditional plan or IRA can NOT be rolled or converted to a designated Roth account (DRAC; ¶ 5.7); a Roth IRA is the only possible destination for "conversions." Reg. § 1.401(k)-1(f)(3), third sentence.

5.4.01 ***What type of plan may be converted to a Roth IRA***

Here are the types of traditional retirement plans a participant may "convert" to a Roth IRA.

A. **Individual retirement accounts.** An "individual retirement plan" may be converted to a Roth IRA. § 408A(d)(3)(B), (C); Reg. § 1.408A-4, A-5. "Individual retirement plans" include individual retirement accounts (IRAs) and individual retirement trusts (IRTs) under § 408(a), (h). Traditional IRA-to-Roth IRA conversions have been permitted since 1998. See ¶ 5.4.03 for the *tax treatment* of converting an IRA. See ¶ 5.4.07 for *how to convert* an IRA.

The Code provides that a SEP-IRA (§ 408(k)) or SIMPLE IRA (§ 408(p)) cannot be "redesignated" as a Roth IRA. § 408A(f). That prohibition is almost meaningless because, in the real world, a traditional IRAs is not normally converted to a Roth IRA by being "redesignated" as a Roth IRA; it is converted by having assets or money transferred from the traditional IRA to an entirely different account (with a different account number and form of agreement) that is a Roth IRA. The IRS clarifies (in Reg. § 1.408A-4, A-4) that "An amount in an individual's SEP IRA can be converted to a Roth IRA on the same terms as an amount in any other traditional IRA," subject to two limitations:

- ✓ A SIMPLE IRA distribution "is not eligible to be rolled over into" a Roth IRA "during the 2-year period...which begins on the date that the individual first participated in any SIMPLE IRA Plan maintained by the individual's employer....". Reg. § 1.408A-4, A-4(b); and,

- ✓ Contributions under the SEP or SIMPLE plan may not be made to a Roth IRA. Reg. § 1.408A-4, A-4(c).

So, subject to the two-year restriction applicable to SIMPLE plans, an individual who has money in a SEP or SIMPLE IRA can transfer funds out of the SEP or SIMPLE IRA and into a Roth IRA at any time and from time to time, just as he could do with funds in any other traditional IRA. The SEP or SIMPLE (traditional) IRA can continue to receive future contributions under the SEP or SIMPLE plan. But the employer cannot contribute *directly* to any Roth IRA on the employee's behalf. Accordingly, an employee whose only retirement plan is a SEP-IRA, and who wants a Roth and nothing but a Roth, must go through this two-step dance every year: Employer contribution goes into the (traditional) SEP-IRA, and the employee pulls it out and transfers it to a Roth IRA. If the employee's plan is a SIMPLE, he must satisfy the two-year waiting period before performing the second step of the "dance."

B. **NonIRA plans.** Prior to 2008, the Code permitted rollovers into Roth IRAs only from IRAs and DRACs (¶ 5.7). Thus, someone who desired to "convert" money in a traditional nonIRA retirement plan had to first roll the money to an IRA, then convert the IRA. The expanded rollover provision effective in 2008 and later years now permits rollovers into Roth IRAs directly from several *additional* types of eligible retirement plans, eliminating the necessity of the two-step process in the conversion of nonIRA plans (though the two-step process continues to exist hypothetically in the tax treatment of these conversions; see ¶ 5.4.04(A)). See ¶ 5.4.04 for the tax treatment of nonIRA plan-to-Roth conversions. See ¶ 5.4.08 for how to convert a nonIRA plan. Here are the types of nonIRA plans that may be converted directly to Roth IRAs:

1. Qualified retirement plans under § 401(a) ("QRPs"). § 408A(e) (first sentence), § 402(c)(8)(B)(iii).

2. 403(a) and (b) contracts and plans. § 408A(e) (first sentence), § 402(c)(8)(B)(iv), (vi).

3. 457(b) plans maintained by a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State. § 408A(e) (first sentence), § 402(c)(8)(B)(v), § 457(e)(1)(A). This type of plan is called in this book a "**governmental 457(b) plan**." Rollovers from a nongovernmental 457 plan (§ 457(e)(1)(B)) to a Roth IRA are not permitted.

See § 408A(e), as amended by PPA '06, § 824. This change rendered Reg. § 1.408A-4, A-5, obsolete. Notice 2008-30, 2008-12 IRB 638 (3/24/08) Section II, questions 1–7, and Notice 2009-75, 2009-39 IRB 436 (9/28/09), both deal with plan-to-Roth-IRA conversions.

5.4.02 ***Who may convert: age, plan participation, income, etc.***

This ¶ 5.4.02 explains who is eligible to convert a plan or IRA to a Roth IRA, including the effects (or noneffects) of age (A), participation in other plans (B), prior conversions (C), filing status (D), and income (E).

If a person converts a traditional IRA or plan to a Roth IRA but is not eligible to do so, the result is a "failed conversion." See ¶ 5.4.06. After 2009 the only ways a person can be "ineligible" to convert a traditional plan or IRA are: If he reconverts a traditional IRA to a Roth too soon after recharacterizing (see "C"); or if he is a beneficiary and tries to convert an inherited IRA to a Roth IRA, or to convert an inherited plan to a Roth IRA without meeting the requirements described in ¶ 4.2.05 [Appendix A]. Prior to 2010, a person could also be ineligible to convert to a Roth based on his filing status ("D") or income ("E").

A. **Age: Under 59½, over 70½, or in between.** Any IRA owner or plan participant can convert his traditional plan or IRA to a Roth IRA regardless of his age; you are never too young or too old to convert to a Roth IRA. However, if the participant is under age 59½, see ¶ 5.5 regarding how the 10 percent penalty on early distributions applies to certain post-conversion distributions. Also, an individual who is turning (or is past) age 70½ in the conversion year must take the RMD for that year *before* he can convert any money from the account to a Roth IRA; see ¶ 5.2.02(E).

B. **Participation in other plan(s).** Participation in another retirement plan is relevant for purposes of determining whether a high-income individual can take an income tax deduction for a regular contribution to a traditional IRA. § 219(g)(3). However, participation in any other retirement plan *has no effect* on the ability to convert to a Roth IRA. An individual can convert his traditional plan or IRA to a Roth regardless of what other plan(s) he may be participating in that year.

C. **Prior conversion.** There is generally no limit on the number of times a participant can convert all or part of any traditional plan or IRA to a Roth IRA; see ¶ 5.4.07. The only exception applies in the case of someone who has *un*converted (recharacterized) and then wants to *re*convert the same amount; see ¶ 5.6.07.

D. **Filing status.** For conversion of plan distributions made in 2010 and later years, there is no filing status test; anyone can convert regardless of his income tax filing status. For years prior to 2010, a person who used the filing status "married filing separately" could not do a Roth conversion. For details on the now-obsolete filing status test, see the author's *Special Report: Ancient History* (free download at http://www.ataxplan.com/order/downloads.cfm).

E. **Income limit.** For conversion of plan distributions made in 2010 and later years, there is no income test; anyone can convert regardless of his income level. For distributions occurring in years prior to 2010, an individual was not eligible to convert if his modified adjusted gross income exceeded $100,000. For details, including how MAGI was computed for purposes of this now-obsolete test, see the author's *Special Report: Ancient History* (free download at http://www.ataxplan.com/order/downloads.cfm).

5.4.03 ***Tax treatment of converting traditional IRA to Roth IRA***

A rollover from a traditional IRA to a Roth IRA is generally treated, for income tax purposes, as a *distribution* from the traditional IRA. The term "conversion" is often used (including in § 408A) for the rollover of funds from a traditional IRA to a Roth IRA, which is a taxable event, just as a handy way to distinguish that type of rollover from a "normal" rollover, which is nontaxable.

A. **A Roth conversion is a "taxable rollover.**" Under § 408(d)(3), rollovers generally are nontaxable. However, § 408A(d)(3)(A) provides that "Notwithstanding" § 408(d)(3), "there shall be included in gross income any amount which would be includible were it not part of a qualified rollover contribution." Thus, Roth conversions *are* taxable despite § 408(d)(3). Whatever amount of a traditional IRA is converted or rolled over to a Roth IRA is taxed exactly as if it had been distributed from the traditional IRA and not rolled over, with the following exceptions:

- For conversions in 1998 or 2010, special "income spreading" treatment was allowed; see ¶ 5.4.05.

- If the converted property includes an annuity contract, the contract must be valued at fair market value for purposes of determining the amount of income includible by reason of the conversion, even if some different valuation method might have applied for determining the contract's value for minimum distribution purposes (¶ 1.2.08(A)) or for purposes of computing the distributee's income if the contract had been distributed and not converted to a Roth IRA. Reg. § 1.408A-4, A-14; see Appendix B for more on this.

So how are IRA distributions (and accordingly Roth conversions) taxed? Generally, all IRA distributions are taxable, but there are exceptions:

- ✓ Several exceptions to the general rule that IRA distributions are taxable have no application to a Roth conversion, such as the exceptions for distributions rolled over to an eligible retirement plan, contributions returned to the participant by a certain date, divorce-related divisions of the account, qualified charitable distributions, etc. For a catalogue of these no-tax or low-tax distributions that are *not* relevant to Roth conversions, see ¶ 2.1.06.

- ✓ The one significant exception that DOES apply to Roth conversions is the rule that the participant's own after-tax IRA contributions are not taxable when distributed to him (or converted to a Roth IRA); see "B."

B. Treatment of after-tax money in participant's IRA(s). The amount converted is includible in the participant's gross income except to the extent it is excluded from income as a return of the participant's basis (investment in the contract); to that extent it is nontaxable. Reg. § 1.408A-4, A-7(a). For how to determine how much basis the participant has in his IRAs, see ¶ 2.2.06. To determine much of any particular IRA-to-Roth IRA conversion is treated as a tax-free conversion of the participant's basis, see ¶ 2.2.08 [Appendix A]. Someone with after-tax money in an IRA who also participates in a QRP that accepts rollovers, and who is therefore able to roll money from his IRA to his QRP account, can apparently follow the sequence described at ¶ 2.2.09(A) [Appendix A] to achieve a tax-free Roth IRA conversion of the after-tax money in the IRA. Except for that sequence, there is no known way to convert only the after-tax money in an IRA.

C. Realizing a loss on a Roth conversion. Suppose the individual's traditional IRA consists entirely of after-tax money, and the value of the IRA (at the time of conversion to a Roth) is less than his basis:

Tucker Example: Tucker made nondeductible contributions totaling $20,000 to a traditional IRA in the years leading up to 2010. This was and is his only IRA, and he made no contributions to it in 2010. As of the date in 2010 when he does his conversion to a Roth the account is worth only to $17,000. What becomes of his "missing" $3,000 of basis?

A transfer from a traditional to a Roth IRA is to be taxed as if it were a distribution that was not rolled over. § 408A(d)(3)(A)(i). If Tucker's IRA had been totally distributed to him, rather than being rolled to an IRA, he would have been entitled to deduct the $3,000 loss as a miscellaneous itemized deduction. See ¶ 2.2.11. Accordingly, it would appear that Tucker would report a miscellaneous itemized deduction of $3,000 on his Form 1040 for 2010 as a result of the Roth conversion.

5.4.04 ***Tax treatment of converting nonIRA plan to Roth IRA***

In adding plan-to-Roth-IRA rollovers, Congress applied the same rule it had used to make IRA conversions taxable (see ¶ 5.4.03(A)), just throwing a few more Code sections into the "notwithstanding" clause: "Notwithstanding sections *402(c), 403(b)(8)*, 408(d)(3), and *457(e)(16)*, there shall be included in gross income any amount which would be includible were it not part of a qualified rollover contribution." § 408A(d)(3)(A)(i), (B), and (C), as in effect after 2007. Emphasis added.

Notice 2008-30, 2008-12 IRB 638, Section II, questions 1–7; Notice 2009-75, 2009-39 IRB 436; and IRS Notice 2014-54, 2014-41 IRB (9/18/14) provide guidance on plan-to-Roth-IRA conversions.

For conversions in 2010, special "income spreading" treatment was allowed; see ¶ 5.4.05. If the assets converted include an annuity contract, see Appendix B.

A. The fictional two-step process. The income tax treatment of a Roth conversion directly from a nonIRA plan employs a fiction: "For this purpose, the amount included in gross income is equal to the amount rolled over, reduced by the amount of any after-tax contributions that are included in the amount rolled over, in the same manner as if the distribution had been rolled over to a non-Roth IRA that was the participant's only non-Roth IRA and that non-Roth IRA had then been immediately converted to a Roth IRA." Notice 2009-75, A-1(a).

Thus, the one-step process of transferring funds directly from the nonIRA plan to a Roth IRA is treated as if it were a two-step process, with the distribution passing through a hypothetical traditional IRA (deemed, under this fiction, to be the individual's only traditional IRA) on its way to the Roth IRA. The two-step fiction means that special tax treatments that might otherwise be available for (*e.g.*) a lump sum distribution (LSD) from the nonIRA plan are NOT available for a Roth conversion, even if the amount converted otherwise qualifies as a "lump sum distribution."

For example, if an employee takes an LSD of appreciated employer stock from the employer's QRP, the "net unrealized appreciation" (NUA) inherent in the stock receives special income tax treatment if it is not rolled over to an IRA; see ¶ 2.5. If the employee rolls (converts) the NUA stock to a Roth IRA, the conversion will be fully taxable as ordinary income (except to the extent of any after-tax money included in the distribution; see "B"), just as if the stock had been rolled to a traditional IRA that was then converted to a Roth IRA. The special tax deal that applies to an LSD of NUA stock can NOT be combined with a Roth conversion of the stock.

B. If the plan contains after-tax money. The conversion of funds from a QRP to a Roth IRA presents a planning opportunity if the participant's account contains after-tax money (basis or "investment in the contract"; see ¶ 2.2.01).

Myron Example: Myron is retiring. His profit-sharing plan account at Acme Widget consists of $50,000 of after-tax money (all post-1986) and $100,000 of pretax money. He can direct the plan to transfer the entire account to a Roth IRA. § 401(a)(31). Myron's Roth conversion of his $150,000 account is "cheap" because only the $100,000 of pretax money in the account is included in his gross income. He gets a $150,000 Roth IRA but has to pay income tax on only$100,000.

Alternatively, Marvin may decide to convert only the after-tax money to a Roth IRA (effecting a tax-free Roth conversion), while rolling the pretax money to a traditional IRA in a traditional nontaxable rollover. He can accomplish this split rollover by requesting, as part of a single transaction (such as distribution of his account upon his retirement), that the after-tax money be transmitted via direct rollover to a Roth IRA he has established and that the pretax money be transmitted via direct rollover to a traditional IRA he has established. See IRS Notice 2014-54, 2014-41 IRB (9/18/14), Example 4.

C. **Income tax withholding.** A direct rollover from a QRP to a Roth IRA (or any IRA) is not subject to the mandatory 20 percent income tax withholding that normally applies to the distribution of an eligible rollover distribution from a qualified plan (¶ 2.3.02(C)). However, any distributee and plan administrator can arrange for voluntary withholding even for a direct rollover. Notice 2008-30, A-6. It would presumably not be advisable to arrange for such withholding on a Roth conversion, since it would reduce the amount going into the Roth IRA. It is generally considered more favorable to pay the income tax resulting from a Roth conversion from funds held outside any retirement plan.

5.4.05 ***Income spreading for conversions in 1998 or 2010***

For rollovers in **1998** ONLY, the gross income resulting from a Roth conversion could be spread equally over the four taxable years 1998–2001. For details on this election, and on the acceleration of taxation in case of distributions from the converted account prior to 2001, see the author's *Special Report: Ancient History* (free download at http://www.ataxplan.com/order/downloads.cfm).

The income resulting from a Roth conversion in **2010** could similarly be reported in two equal instalments in 2011 and 2012 instead of being reported in 2010. For details see the author's *Special Report: Ancient History* (free download at http://www.ataxplan.com/order/downloads.cfm).

5.4.06 ***Failed conversions***

"The term **failed conversion** means a transaction in which an individual contributes to a Roth IRA an amount transferred or distributed from a traditional IRA or Simple IRA (including a transfer by redesignation) in a transaction that does not constitute a conversion under Sec. 1.408A-4 A-1." Reg. § 1.408A-8, A-1(b)(4). Although this definition has not been explicitly extended to include defective conversions from nonIRA plans, it may be that defective conversions from nonIRA plans are deemed included in this definition by virtue of the fact that a Roth conversion from a nonIRA plan is treated for tax purposes "as if" it passed through a traditional IRA on its way to the Roth; see ¶ 5.4.04(A).

A failed conversion is generally treated for tax purposes as if the amount transferred to the Roth IRA had been (1) distributed from the original plan or IRA and then (2) contributed to the Roth IRA as a "regular contribution" (¶ 5.3.02). See Regs. § 1.408A-4, A-3(b) and § 1.408A-4, A-6(c) (discussed at ¶ 5.2.02(E)).

The deemed distribution will normally result in the distribution's being included in the recipient's gross income, with no option to spread the income over future years (¶ 5.4.05). The

deemed distribution will be subject to the 10 percent early-distribution penalty if the individual is under age 59½ and no exception applies. ¶ 5.5.02(A).

Typically the deemed regular contribution to the Roth IRA resulting from a failed conversion will be an "excess contribution." See, *e.g.*, CCA 2001-48051. See ¶ 5.3.03 for the definition of excess contribution. See ¶ 5.3.05 for the penalty on excess IRA contributions, and how to fix an excess contribution to avoid the penalty.

A failed conversion can be corrected by recharacterization (¶ 5.6). Reg. § 1.408A-4, A-3.

5.4.07 ***Mechanics of traditional IRA-to-Roth IRA conversions***

There are three methods a participant can use to convert assets from a traditional IRA to a Roth IRA:

1. A distribution from a traditional IRA may be contributed (rolled over) to a Roth IRA within 60 days after the distribution is made. See ¶ 2.6.06 and ¶ 5.6.05(B) regarding this deadline.

2. An amount may be transferred directly from the traditional IRA to the Roth IRA, with the same or a different trustee (or custodian). See ¶ 2.6.01(E).

3. The traditional IRA can simply be "redesignated" as a Roth IRA maintained by the same trustee or custodian; this is treated as a transfer of the entire account balance. Reg. § 1.408A-4, A-1(b)(3).

All three of these transactions are considered rollovers ("a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA"). Although a Roth conversion generally must meet the requirements applicable to other types of rollovers (see, *e.g.*, ¶ 5.2.02(E)), a Roth conversion is *not* considered a rollover for purposes of the one-rollover-per-year limitation in § 408(d)(3)(B) (see ¶ 2.6.05), so a Roth conversion may occur even if it is within 12 months of a tax-free traditional IRA-to-IRA rollover. Reg. § 1.408A-4, A-1(a), (c).

Prior to the arrival of Roth IRAs, "rollovers" were always tax-free, and many presumably still associate that word with tax-free transfers from one retirement plan to another. In contrast, the rollover of funds from a traditional IRA to a Roth IRA is taxable. ¶ 5.4.03(A).

Both partial and total conversions are allowed. An eligible individual (¶ 5.4.02) may choose to convert all, part, or none of his traditional IRA to a Roth IRA. There is no minimum or maximum dollar or percentage amount that must or may be converted.

Generally, there is no limit on the number of times an individual may convert traditional IRA funds to Roth IRA status. A person who converts part of his traditional IRA to a Roth IRA is free at any later time (in the same or a later year) to convert more of the same or another IRA to a Roth IRA. The one exception applies to someone who did a Roth IRA conversion, then later undid the conversion via a "recharacterization"; see ¶ 5.6.07.

5.4.08 ***Mechanics of conversion from other traditional plans***

A participant can transfer a distribution from a traditional 401(a), 403, or governmental 457(b) plan to a Roth IRA either by direct rollover or by 60-day (indirect) rollover. ¶ 5.4.01(B).

definitions of direct, indirect, and 60-day rollover, see ¶ 2.6.01. The direct rollover is preferable because it avoids the mandatory 20 percent withholding for federal income taxes otherwise applicable to the taxable portion of the distribution. § 3405(c); see ¶ 2.3.02.

Generally, when a plan is about to make a distribution to an employee, the plan MUST offer the employee the option of having the distribution sent, via direct rollover, to any eligible retirement plan (which includes a Roth IRA) and MUST comply with the employee's request for such a direct rollover. § 401(a)(31); Notice 2008-30, 2008-12 IRB 638, A-4. (There are exceptions to this rule for certain small distributions and multiple distributions.)

The plan may allow employees to have direct rollovers of their distributions into multiple "destination" IRAs (*e.g.*, a traditional and a Roth); however, the plan is not required to offer that option. The most options the plan *must* offer the participant with respect to his distribution is to split it into two distributions, one rolled directly to one other eligible retirement plan and one paid directly to the participant. Since the direct payment to the participant will trigger mandatory withholding the plan could be "forced" to write up to three checks (one to an eligible plan as a direct rollover, one to the participant, and one to the IRS). Reg. § 1.401(a)(31)-1, A-10.

Plan-to-Roth IRA rollovers, like traditional IRA-to-Roth IRA rollovers, are called "qualified rollover contributions." Only traditional IRA-to-Roth IRA transfers are also called "conversions," according to the IRS in Notice 2008-30, Section II, Introductory paragraph. This book uses "conversion" for both types of rollover.

A major difference between converting a traditional IRA to a Roth, and converting money from a nonIRA plan, has to do with the participant's ability to obtain a distribution that he can convert. An IRA owner, regardless of age or employment status, is generally free (at least under the Tax Code) at any time to withdraw money from his account. He will be taxable on the distribution, and will owe a penalty on the distribution if he is under age 59½ and doesn't qualify for an exception, but nobody can stop him from taking the distribution if he wants to do so and is willing to pay the taxes.

Not so with a qualified plan. Most qualified plans prohibit *any* distributions prior to attaining retirement age or severance of employment. 401(k) plans are generally forbidden to distribute the employee's elective deferral account prior to age 59½ or termination of service. § 401(k)(2)(B)(i). There is a hardship exception to that rule, but hardship distributions cannot be rolled over. § 402(c)(4)(C). Plans that do permit "in-service distributions" often restrict such distributions to employees over age 62. § 401(a)(36). So, realistically, the advisor is likely to encounter the opportunity for plan-to-Roth conversions mainly when the participant is leaving the service of the employer that sponsors the plan.

5.5 Roth Plans and the 10% Penalty For Pre-Age 59½ Distributions

Generally, there is a 10 percent "additional tax" (penalty) on distributions from a retirement plan that occur while the participant is younger than age 59½. § 72(t). For details on this "early distributions" penalty, and the more than one dozen exceptions to the penalty, see Chapter 9. This ¶ 5.5 discusses the 10 percent penalty as it applies to Roth IRAs and DRACs (¶ 5.7).

5.5.01 ***Penalty applies to certain Roth plan distributions***

The 10 percent penalty under § 72(t) applies to pre-age 59½ distributions from Roth IRAs the same as it applies to such distributions from traditional IRAs, under the rule that Roth IRAs are treated the same as traditional IRAs unless § 408A provides otherwise. Reg. § 1.408A-6, A-5. Similarly, there is nothing in the Code that exempts distributions from DRACs (¶ 5.7) from the 10 percent penalty. If the distribution qualifies for any exception from the penalty, there is no penalty. See ¶ 9.2–¶ 9.4 for the exceptions to the 10 percent penalty. If no exception applies, then:

A. **Qualified distribution.** A qualified distribution (from either a DRAC or Roth IRA) is excluded from gross income. See ¶ 5.2.03(A), ¶ 5.7.04. Since the 10 percent penalty generally applies only to amounts includible in gross income (*for the one exception; see ¶ 5.5.02*), the penalty does not apply to any qualified distribution. See § 72(t)(1); Notice 87-16, 1987-1 C.B. 446, Question D9.

B. **Nonqualified distribution from Roth IRA.** In the case of a nonqualified distribution from a Roth IRA (¶ 5.2.06), the portion of the distribution allocable, under the Ordering Rules (¶ 5.2.07), to the *earnings* of the Roth IRA would be includible in the participant's gross income and would accordingly be subject to the penalty. Reg. § 1.408A-6, A-5(a).

C. **Nonqualified distribution from DRAC.** In the case of a nonqualified distribution from a DRAC (¶ 5.7.05), the portion of the distribution allocable to the earnings of the account would be includible in the participant's gross income and would therefore be subject to the penalty. See Reg. § 1.402A-1, A-3.

D. **Conversion followed by distribution within five years.** See ¶ 5.5.02 for a special rule that may result in a penalty being applied to the return of the participant's own contribution.

5.5.02 ***Roth conversion prior to reaching age 59½***

The 10 percent penalty does not apply to the deemed distribution that results from converting a traditional retirement plan or IRA to a Roth IRA. § 408A(d)(3)(A)(ii); Reg. § 1.408A-4, A-7(b); Notice 2008-30, A-3. Thus a young person may convert his traditional plan or IRA to a Roth IRA without penalty. However, this does not mean he can forget about the 10 percent penalty. The 10 percent penalty can still come into the picture in several ways. For one thing, the penalty would apply to any income taxes withheld from the conversion amount (¶ 2.3); such a tax payment would not qualify for the "conversion exception" since it is sent to the IRS and *not* converted to a Roth IRA. Also:

A. **Penalty applies to failed conversion.** A person who recharacterizes a Roth conversion (¶ 5.6), then attempts to "reconvert" the same amount to a Roth IRA prior to expiration of the waiting period (¶ 5.6.07), has a "failed conversion." His attempted *re*conversion does not qualify for the penalty exception applicable to successful Roth conversions. Reg. § 1.408A-4, A-3(b) (last sentence).

B. Penalty applies to certain distributions within five years after a conversion. Though a person who is under age 59½ can convert to a Roth IRA without penalty, he has to come up with the money to pay the income tax on the conversion from some source *other* than the newly-converted Roth IRA money, because he will owe the penalty to the extent he taps that money, under the following special rule:

If a participant who is under the age of 59½ receives a distribution from a Roth IRA; and "any portion" of that distribution is allocable under the Ordering Rules (¶ 5.2.07) to funds that were rolled over to the Roth from a traditional plan or IRA and were includible in gross income; and "the distribution is made within the 5-taxable-year period beginning with the first day of the individual's taxable year in which the conversion contribution was made"; then the § 72(t) penalty will apply to "such portion" of the distribution (unless an exception applies). § 408A(d)(3)(F); Reg. § 1.408A-6, A-5(b); Notice 2008-30, A-3. See ¶ 9.2–¶ 9.4 for the exceptions to the 10 percent penalty.

This provision was not included in the original Roth IRA legislation (TAPRA '97), but was added by the IRS Restructuring and Reform Act of 1998, effective retroactively to January 1, 1998. This retroactive imposition of the penalty was held to be constitutional in *Kitt v. U.S.*, 277 F. 3d 1330 (Fed. Cir., 2002).

Note that this five-year period is *not the same* as the Five-Year Period for determining "qualified distributions" (¶ 5.2.05). The latter begins in the first year *any* contribution is made to *any* Roth IRA; the former begins, as to any conversion of a traditional plan to a Roth IRA, with the year of that *particular* conversion. Reg. § 1.408A-6, A-5(c). Note also that this penalty applies *even though* the distribution is not included in gross income in the year it occurs.

Rand Example: Rand, age 32, converted his $100,000 traditional IRA to a Roth IRA in 1999. He had no basis in the traditional IRA, so the entire $100,000 was includible in his gross income in 1999. He has no other Roth IRAs, and makes no other contributions to this one. In 2002, at age 35 (i.e., within five years after the conversion, and while he is still under age 59½) he withdraws $20,000 from the Roth IRA in order to buy a rare *Spiderman* comic book. Under the Ordering Rules, this distribution is deemed to come out of the portion of the 1999 conversion-contribution that was includible in his gross income in 1999, and therefore it is subject to the 10 percent penalty *in 2002.*

This special penalty rule that makes a conversion-contribution "off limits" for five years after the conversion does not prevent the participant from withdrawing (tax- and penalty-free) *other* contributions he has made to the same or another Roth IRA that are not subject to the rule:

Leslie Example: In 2004, Leslie (age 40) converted a $100,000 traditional IRA to a Roth IRA. In 2009, when that Roth IRA had grown to $140,000, Leslie made a regular contribution (¶ 5.3.02) of $5,000 to the same account. In 2010, he does another conversion, transferring $50,000 more from his traditional IRA to the same Roth IRA that holds all his prior contributions and earnings. In 2011, the Roth IRA has grown to $210,000, and Leslie, now age 47, withdraws $15,000 from the account to pay the income tax on his 2010 conversion. Assume he does not qualify for any of the exceptions to the 10 percent penalty. Under the Ordering Rules (¶ 5.2.07), this distribution is deemed to come first from his 2009 regular contribution ($5,000), and the balance ($10,000) is deemed to come from his 2004 conversion contribution of $100,000. There is *no income tax* on this distribution, since it is deemed (under the Ordering Rules) to be coming entirely from his own already-taxed

contributions; see ¶ 5.2.07. There is also *no penalty* applicable to withdrawal of his 2009 $5,000 "regular" contribution, because the special penalty rule applies only to *conversion* contributions. Since the rest of his 2010 distribution is deemed to come from his 2004 conversion, which happened more than five years earlier, there also is no 10 percent penalty on the distribution of this "old and cold" conversion money.

C. Penalty applies to earnings distributed prior to age 59½ (regardless of holding period). Roth conversions before age 59½ are very confusing, because there are TWO of everything:

- There are TWO separate parts of the Roth IRA, the contribution(s) and the earnings.
- There are TWO different taxes to worry about, the income tax and the 10 percent penalty.
- There are TWO completely different five-year holding periods!

Regardless of whether his Roth IRA was created by conversion or some other method, and regardless of how many years it has been since he created the Roth IRA, NO ONE can withdraw the earnings inside his Roth IRA penalty-free until he is over age 59½, unless the distribution is income tax-free (see ¶ 5.2.04) or unless one of the penalty exceptions applies. To figure out whether a distribution is coming out of the participant's own contribution or out of "earnings," see ¶ 5.2.07. To figure out whether some other exception to the penalty applies see ¶ 9.2–¶ 9.4.

Arthur Example: Arthur, age 40, converts a $100,000 traditional IRA (all pretax money) to a Roth IRA in 2009. He owes income tax (but no 10% penalty) on $100,000 in 2009. This is the first Roth IRA he has ever owned. The Roth IRA grows in value to $120,000 and Arthur then cashes it out.

❑ If the cashout occurs in 2012, when Arthur is 43, he owes income tax on $20,000 (the earnings), because he is withdrawing the earnings before he has met the two tests for a "qualified distribution" (five-year holding period, triggering event). He hasn't met EITHER of the two tests and he would have to meet BOTH tests to receive a tax-free distribution of earnings. He owes the 10 percent penalty on the *entire* $120,000. He owes the 10 percent penalty on the original $100,000 contribution because he cashed it out less than five years after his penalty-free conversion and while he is still under age 59½. He owes the 10 percent penalty on the earnings because he withdrew them before reaching age 59½.

❑ If the cashout occurs in 2014, when Arthur is 48, he owes income tax on $20,000 (the earnings), because he is withdrawing the earnings before he has met both of the tests for a qualified distribution (five-year holding period plus triggering event). He has met the five-year test but not the triggering event test, because he is still under age 59½ and not disabled, etc. He does not owe the 10 percent penalty on the original $100,000 contribution (even though he is still under age 59½) because he cashed it out more than five years after his conversion. He owes the 10 percent penalty on the $20,000 of earnings because he withdrew them before reaching age 59½.

5.5.03 ***Conversion while receiving "series of equal payments"***

The 10 percent penalty does not apply to IRA distributions that are part of a "series of substantially equal periodic payments" (SOSEPP; see ¶ 9.2). Generally, qualification for the "SOSEPP" exception is lost (and a recapture tax imposed) if the series is "modified" prior to the date the participant attains age 59½, or, if later, the fifth anniversary of the first payment (yet *another* five-year rule!). A modification would include such things as skipping a payment or taking an extra distribution; see ¶ 9.3.

If a participant who is receiving a SOSEPP from a traditional IRA converts the traditional IRA to a Roth IRA, the conversion is "not treated as a distribution for purposes of determining whether a modification" of the series has occurred, so the conversion itself does not trigger the loss of the penalty-exempt status of the series. Reg. § 1.408A-4, A-12.

However, the conversion does not mean that the participant can stop taking his periodic payments. "[I]f the original series...does not continue to be distributed in substantially equal periodic payments *from the Roth IRA* after the conversion, the series of payments will have been modified and, if this modification occurs within 5 years of the first payment or prior to the individual becoming disabled or attaining age 59½, the taxpayer will be subject to the recapture tax of section 72(t)(4)(A)." Reg. § 1.408A-4, A-12; emphasis added.

This statement in Reg. § 1.408A-4 seems to assume that the participant converted the entire traditional IRA to a Roth IRA. If he converted only part of the traditional IRA to a Roth IRA, it is not clear whether the rest of his "series" payments would have to come all from the Roth IRA, or proportionately from the new Roth IRA and the (now-diminished) traditional IRA; or whether the participant could take the payments from whichever of the two accounts he chooses.

There is a SOSEPP exception also for distributions from a QRP, provided the participant has separated from the service of the employer that sponsors the plan. § 72(t)(3)(B). There is no IRS guidance on converting a former employee's qualified plan account to a Roth IRA while the former employee is receiving a SOSEPP from the plan.

5.6 Recharacterizing an IRA or Roth IRA Contribution

A taxpayer who is unhappy with any IRA contribution he made for a particular year, or who discovers that he was not eligible to contribute to the type of IRA he contributed to, or who contributed more than he was entitled to contribute, has some ability to remedy the problem through return, "absorption," and/or recharacterization of the contribution.

5.6.01 ***Ways to fix or change an IRA contribution***

A contribution made to a traditional IRA can be "cancelled" by being returned to the contributor. If the contribution is returned, along with the income it has earned, by a certain deadline, then the distribution gets special treatment under the income tax rules and for purposes of the penalty on excess IRA contributions. See ¶ 2.1.08(A)–(E) for the rules applicable to, and benefits of, these "corrective distributions." The same treatment applies to a returned *Roth* IRA contribution. Reg. § 1.408A-6, A-1(d).

Another remedy a participant has to change or correct an IRA contribution is to have the contribution (together with its earnings) transferred (via trustee-to-trustee transfer) out of the IRA it was contributed to and into the *other type* of IRA (traditional or Roth), and have it be treated "as if" it had been contributed to that other type of IRA to start with. § 408A(d)(6). The IRS calls this remedy "recharacterizing" an IRA contribution. Reg. § 1.408A-5. This ¶ 5.6 explains the recharacterization remedy.

Although the Code makes it appear that *any* transfer of the IRA contribution amount to the other type of IRA before the applicable deadline is automatically treated as a recharacterization, the Regulation is clear that the treatment is elective. Reg. § 1.408A-5, A-1(a), (b), A-6.

Under both the "corrective distribution" and "recharacterizing" remedies, it is necessary to compute the net income attributable to the IRA contribution; see ¶ 5.6.02.

Not all IRA contributions can be recharacterized. The only type of "rollover" contribution that can be recharacterized is a Roth conversion—a rollover from a traditional plan or IRA into a Roth IRA. If money has been rolled over from a *traditional* retirement plan into a *traditional* IRA via a tax-free rollover (whether by direct rollover or 60-day rollover), the taxpayer cannot later change his mind and "recharacterize" that as a Roth conversion by moving the rolled amount to a Roth IRA. "[A]n amount contributed to an IRA in a tax-free transfer cannot be recharacterized." Reg. § 1.408A-5, A-10, Example 4.

Similarly, employer contributions to a SEP or SIMPLE IRA may not be recharacterized as contributions to a Roth IRA, because the employer could not have made direct contributions to a Roth IRA in the first place. Reg. § 1.408A-5, A-5. But the employee may be able to convert the SEP or SIMPLE account to a Roth IRA; see ¶ 5.4.01(A).

Here is a summary of when recharacterization is appropriate:

✓ A regular contribution to an IRA or Roth IRA (¶ 5.3.02) can be reversed by means of a corrective distribution (¶ 2.1.08(A)-(E)), or (if the contributor was eligible to contribute the amount to the other type of IRA) by recharacterization (see the rest of this ¶ 5.6), or (if it is an excess contribution, but the contributor will be eligible to contribute to a Roth IRA in future years) by absorption (¶ 2.1.08(H)).

✓ The contribution (conversion) to a Roth IRA of a distribution from a traditional plan or IRA may be recharacterized as a contribution to a traditional IRA. Both valid Roth conversions and "failed" conversions (¶ 5.4.06) may be recharacterized. Reg. § 1.408-8, A-8(b).

✓ There is no such thing as a rollover in the other direction (from a Roth IRA to a traditional plan or IRA), so there is no type of rollover that can be recharacterized other than a Roth conversion.

5.6.02 ***Income attributable to the contribution***

One requirement that must be met in order for a returned IRA or Roth IRA contribution to qualify for the special income tax and penalty-avoidance treatment applicable to "corrective distributions" is that the "net income attributable" to the contribution must also be distributed (along with the returned contribution) by the applicable deadline. § 408(d)(4)(C); ¶ 2.1.08(B). Similarly, to recharacterize an IRA contribution (¶ 5.6.03), not only the original contribution but also *any net*

income attributable to such contribution must be transferred to the other type of IRA. § 408A(d)(6)(B); Reg. § 1.408A-5, A-2(a).

This ¶ 5.6.02 explains how to compute the net income attributable to an IRA or Roth IRA contribution for purposes of a corrective distribution or recharacterization.

Note that the "net income" may be a negative amount—a loss, in other words. Reg. § 1.408A-5, A-2(b); A-2(c)(6), Example 1.

"Corrective" IRA distributions are unusual. Similarly, it would be unusual to recharacterize a "regular" IRA or Roth IRA contribution, though it is allowed. Advisors are likely to encounter the requirement of computing net income attributable to an IRA contribution primarily in connection with recharacterizing Roth IRA conversions, which is why this section is included here.

There are two ways to compute the net income attributable to an IRA contribution:

Method 1: If the contribution in question was made to a separate IRA (traditional or Roth) that contained no other funds, *and* there have been no other contributions to or distributions from that separate IRA, then:

✓ For a corrective distribution, distributing the entire account balance to the participant will satisfy the requirement of returning the contribution and net income attributable thereto. § 1.408-11(a)(2).

✓ If the entire contribution is being recharacterized, transferring the entire account balance to the other type of IRA satisfies the requirement. Reg. § 1.408A-5, A-2(b); see Fouad Example below.

Because Method 1 is much simpler to apply than Method 2 (below), there is an advantage to keeping each year's Roth IRA conversion contributions in a separate Roth IRA account (not commingled with any pre-existing Roth IRA), until the period has expired for recharacterizing such contributions (¶ 5.6.06).

Method 2: If Method 1 is not available, then the net income attributable to the contribution must be calculated using the following formula (Reg. § 1.408-11(a)(1)):

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

The "adjusted opening balance" means the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions or transfers (including the contribution that is being recharacterized and any other recharacterizations) made to the IRA during the computation period.

The "adjusted closing balance" means the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including contributions returned pursuant to § 408(d)(4); see ¶ 2.1.08) and recharacterizations of contributions made from the IRA during the computation period.

The "computation period" means the period beginning immediately prior to the time the particular contribution being recharacterized is made to the IRA and ending immediately prior to

the recharacterizing transfer of the contribution. If a series of regular contributions was made to the IRA, and consecutive contributions in that series are being recharacterized, the computation period begins immediately prior to the time the first of the regular contributions being recharacterized was made. Reg. § 1.408A-5, A-2(c). See the regulation for examples.

For purposes of applying this formula, IRAs are *not* aggregated; earnings are computed only with respect to the actual account to which the contribution was made, even if the individual owns multiple IRAs. Reg. § 1.408-11(a)(2), § 1.408A-5, A-2(c)(4). Compare ¶ 5.2.03(B).

Fouad Example: Fouad converted $200,000 from his 401(k) plan to a new separate Roth IRA account in January 2010. By November 2010, the account had declined in value to $160,000, and he decided to recharacterize. He closed the Roth IRA and transferred its entire value ($160,000) to a traditional IRA. He has successfully recharacterized his entire conversion, because he transferred to the traditional IRA the $200,000 contribution plus the "earnings thereon"; the "earnings" were a loss of $40,000. He can then "reconvert" this IRA to a Roth in 2011 (see ¶ 5.6.07).

5.6.03 ***How to recharacterize certain IRA/Roth IRA contributions***

The Code regulations provide broad relief to taxpayers who wish to "adjust" their IRA contributions by switching the contribution from a Roth IRA to a traditional IRA or vice versa. § 408A(d)(6). The IRS calls this relief "recharacterizing" an IRA contribution, and it is available to anyone who changes his mind about which type of IRA he wants his "regular" contribution to go to, as well as for those who need to correct Roth IRA conversions or contributions for which they were ineligible (¶ 5.3.04, ¶ 5.4.02). Reg. § 1.408A-5, A-10, Example 2.

A recharacterization is effected by transferring the contribution (plus earnings attributable thereto) to the other type of IRA by a certain deadline. § 408A(d)(7). A recharacterized contribution will be treated for income tax purposes as having been contributed to the transferee IRA (rather than the transferor IRA) "on the same date and (in the case of a regular contribution) for the same taxable year that the contribution was made to the" transferor IRA. Reg. § 1.408A-5, A-3.

See ¶ 1.2.07 regarding the effect of a recharacterization on calculation of the required minimum distribution

"A" below explains the rules applicable to all recharacterizations. See also "B" for additional recharacterizing a Roth IRA conversion, or "C" for recharacterizing a "regular" contribution made to either a traditional or a Roth IRA.

For which contributions may NOT be recharacterized, see ¶ 5.6.01. For partial recharacterizations, see ¶ 5.6.04.

A. Rules applicable to all recharacterizations. Here are the requirements for effecting a recharacterization:

1. Recharacterization is accomplished by moving the recharacterized traditional or Roth IRA contribution to the other type of IRA (Roth or traditional) by direct trustee-to-trustee transfer following the required notifications (see #3). A "60-day rollover" may *not* be used. Reg. § 1.408A-5, A-1(a). See ¶ 2.6.01 for the difference.

2. Not only the original contribution but "any net income attributable to such contribution" must be transferred. Reg. § 1.408A-5, A-2(a). See ¶ 5.6.02 for how to determine the net income attributable to a contribution that is being recharacterized.

3. Treatment of a transfer as a recharacterization is elective, not automatic. The election to recharacterize is made by providing notice and directions to the IRA sponsors involved, *on or before the date of the transfer*, to carry out the transfer of funds or property directly from the transferring IRA into the transferee IRA. Reg. § 1.408A-5, A-6(a).

4. The election to recharacterize "cannot be revoked" after the transfer to the other type of IRA has occurred. Reg. § 1.408A-5, A-6(b).

5. A recharacterization is "never treated as a rollover for purposes of the one-rollover-per-year limitation…, even if the contribution would have been treated as a rollover contribution by the…[transferee] IRA if it had been made directly to the" transferee IRA in the first place. Reg. § 1.408A-5, A-8. See ¶ 2.6.05 regarding the one IRA-to-IRA rollover per year limitation.

B. **Recharacterizing a Roth conversion.** A timely corrective distribution (¶ 2.1.08) can be useful for undoing a *regular* Roth IRA contribution, but it is not much help for someone who has *converted* a traditional plan or IRA to a Roth IRA and then wishes he hadn't (or who discovers after the fact that he wasn't eligible). This person usually does not want to distribute the money out to himself, as would be required for a "corrective distribution"; he just wants to restore the pre-conversion status quo. His Roth IRA contribution may be recharacterized by transferring the contribution (together with its net income) to a traditional IRA no later than the extended due date of the individual's tax return *for the year in which the distribution from the traditional plan or IRA that was converted occurred*. See ¶ 5.6.06 for meaning of "extended due date." A Roth conversion that comes from a *nonIRA* plan (¶ 5.4.01) is recharacterized by moving the converted amount (and earnings) out of the Roth IRA and *into a traditional IRA*, NOT back into the traditional nonIRA plan it was in prior to the Roth conversion. See Notice 2008-30, 2008-12 IRB 638, A-5, A-7.

C. **Recharacterizing a regular contribution.** A "regular" contribution (¶ 5.3.02) made to *either type of IRA* for a particular year may be recharacterized as a contribution to the other type, by transferring the contribution (together with the "net income attributable" to the contribution) to the other type of IRA, no later than the "extended due date" of the individual's tax return *for the year of the contribution*. § 408A(d)(6), (7). For meaning of "extended due date," see ¶ 5.6.06.

Thus, an individual who made a "regular" contribution to a traditional IRA for Year 1 by the deadline of April 15, Year 2, can "recharacterize" that contribution as a contribution to a Roth IRA by moving the contribution (via IRA-to-IRA transfer; see ¶ 2.6.01) to a Roth IRA no later than (generally) October 15, Year 2. An individual who made a "regular" contribution to a Roth IRA for Year 1 by the deadline of April 15, Year 2, can "recharacterize" that contribution as a contribution

to a traditional IRA by moving the contribution (via IRA-to-IRA transfer) to a traditional IRA no later than (generally) October 15, Year 2.

*5.6.04 **Partial recharacterizations***

Partial recharacterizations are permitted. Reg. § 1.408A-5, A-1(a).

However, you cannot "cherry pick" the assets you recharacterize so as to recharacterize only the "losers." If a participant converted his IRA to a Roth IRA at a time when the account contained 100 shares of Acme and 100 shares of Omega, and then a few months later the Acme had appreciated but the Omega had declined in value, the participant might like to recharacterize just the Omega stock. But the regulation's definition of the "income" on the account (the income that must be transferred to a traditional IRA right along with the contribution being recharacterized; see ¶ 5.6.02) is based on the appreciation and depreciation *of the entire account*, not of the particular assets you might choose to recharacterize. Reg. § 1.408A-5, A-2(c)(5), (c)(6), Example 2. For a planning strategy designed to avoid this rule, see ¶ 5.8.06(Q).

*5.6.05 **Deadline for Roth IRA contributions and conversions***

The various deadlines for contributions, conversions, corrective distributions, and recharacterizations are extremely confusing. Some deadlines are based on the calendar year end, some on the extended due date of the return, and some on the *unextended* due date; and some of the deadlines qualify for an automatic extension—but you do not get the "automatic" extension unless you ask for it!

A. Deadline for "regular" contribution. Starting with the easiest one: The deadline for making a regular contribution to a Roth IRA (¶ 5.3.02) for a particular year is the same as the deadline for contributing to a traditional IRA, i.e., the *unextended* due date of the tax return for that year, in other words, for most people, April 15 following the year in question. Reg. § 1.408A-3, A-2(b), § 219(f)(3).

For example, a contribution "for" the year 2009 may be made at any time after December 31, 2008, and before April 16, 2010. When a participant makes a regular IRA contribution between January 1 and April 15, the IRA provider must ask which year it is for, since between those dates it could be for either the year in which the contribution occurs or the prior year.

Meaning of "April 15"

The deadline for filing an individual's income tax return is the 15th day of the fourth month following the end of the individual's taxable year. § 6072(a). That means April 15th for most people. However, the actual deadline will be a bit later if April 15th falls on a weekend or holiday. § 7503. Also, the deadline may be extended for individuals in an area affected by a disaster; and of course the deadline is different for an individual whose taxable year is not the calendar year. In this book, "April 15" is used as shorthand for "the unextended due date of the individual's income tax return for the year in question, whatever that may be."

B. **Deadline for "conversion" contribution.** Conversions are slightly more complicated. Because the conversion is technically a "rollover" (see ¶ 5.4.03(A)), a conversion contribution is tied to the traditional plan distribution that is being "rolled over." Therefore a Roth IRA conversion that is supposed to be "for" the year 2010 must be tied to a *distribution that occurs in the calendar year 2010*. The due date of the 2010 return is *irrelevant*. A distribution made from a traditional plan in the calendar year 2010, if it is to be contributed to a Roth IRA, must be so contributed within 60 days after the date of the distribution. Reg. § 1.408A-4, A-1(b)(1). See § 402(c)(3)(A), § 408(d)(3), and ¶ 2.6.06.

Note that the ability to recharacterize a "Year 1" IRA contribution until October 15 of "Year 2" (see ¶ 5.6.06) does *not* create a new extended right to do Roth conversions between January 1 and October 15 of Year 2 that will count as Year 1 conversions. If, in Year 1, there was no traditional plan or IRA distribution that was contributed to a Roth IRA, there is nothing to "recharacterize."

January 1, 2010, would be the first date in 2010 on which an amount could be distributed out of a traditional IRA; therefore the earliest possible date for a "2010 Roth conversion" would be January 1, 2010 (same-day conversion of a January 1 distribution). The last possible date in calendar 2010 on which an amount could be distributed out of a traditional plan would be December 31, 2010. Therefore the last possible date for a "2010 conversion" would be 60 days after December 31, 2010 (the deadline for rolling over a distribution made on December 31, 2010). § 408(d)(3)(A)(i). Note that:

- ♦ Roth conversions are usually accomplished by transferring sums directly from a traditional plan or IRA into a Roth IRA. If both accounts are with the same administrator or IRA provider, the traditional plan distribution and the Roth IRA contribution would normally occur simultaneously. Thus in this typical situation there would be no need to calculate the 60-day period.

- ♦ The IRS can extend the 60-day rollover deadline in cases of hardship. See ¶ 2.6.06. To date there is no published ruling in which this provision has been used to allow a longer period to complete a Roth IRA conversion.

- ♦ If a 2009 distribution is contributed to a Roth IRA in 2010 (within the applicable deadline for completing an indirect rollover) that is still considered a *2009* conversion for purposes of the eligibility tests (¶ 5.4.02). Reg. § 1.408A-4, A-2(a).

5.6.06 ***Recharacterization deadline: Meaning of due date "including extensions"***

Generally, the deadline for recharacterizing an IRA contribution is the due date of the tax return for the applicable year *including extensions of time.* § 408A(d)(6), (7). So:

1. A regular contribution (¶ 5.3.02) to either a Roth IRA or a traditional IRA for a particular year, that was made by the *unextended* due date of the return for that year, can be recharacterized by the *extended* due date of the return for that year.

2. A <u>conversion contribution</u> to a Roth IRA may be recharacterized by the extended due date of the return for the taxable year in which the *distribution* that was converted to a Roth was distributed (which may not be the year the distribution was contributed to a Roth IRA; see ¶ 5.6.05(B)), and not the year the *recharacterization* occurred.

"Due date including extensions" or "extended due date" has a special meaning under IRS regulations. The taxpayer does not actually have to get an extension of his income tax return in order to go beyond April 15 for his recharacterization decision. Reg. § 301.9100-2(b) provides an automatic six-months extension (from the *unextended* due date of the return) for all "regulatory or statutory elections whose due dates are the...due date of the return including extensions *provided* the taxpayer timely filed its return for the year the election should have been made and the taxpayer takes" necessary corrective actions (such as filing an amended return if necessary). Emphasis added.

What's confusing is that there are two different "automatic" six months extensions, neither of which is totally automatic. Any taxpayer can obtain a "automatic" six months extension of time to file his income tax return (i.e., to October 15 instead of April 15)—but it's not truly automatic because to get this extension the taxpayer has to request it by April 15th, usually by filing Form 4868. Reg. § 1.6081-4.

Then there's the "automatic" six months extension of time to recharacterize an IRA contribution. This extension *is* automatic in the sense that the taxpayer doesn't have to request it; but to qualify for this automatic extension he has to "timely" file his income tax return. "Timely" filing the income tax return means filing the return by April 15 (*or* getting an extension of time to file from the IRS, and then filing the return by the extended due date).

Putting all these rules together, we find that if a taxpayer wants to recharacterize a regular Roth IRA contribution made for Year 1, or the Roth conversion of a distribution made in Year 1, he must complete the necessary actions (¶ 5.6.03) by whichever one of the following deadlines applies:

A. **October 15 if return is timely filed.** If he files his income tax return for Year 1 on or before its due date, he has until October 15 of Year 2 to complete the recharacterization. The "due date" of the Year 1 income tax return is April 15, Year 2, *unless* he obtains an extension of time to file the return, in which case the due date is whatever date the return was extended to. For example, if, on or before April 15, Year 2, he filed Form 4868 with the IRS requesting the "automatic" six months extension, the due date of his Year 1 return is October 15, Year 2. However, *regardless* of whether he got an extension of time to file his income tax return, as long as he filed the income tax return by whatever date it was due, the deadline for recharacterizing his IRA contribution is October 15, Year 2, under the automatic extension rule of Reg. § 301.9100-2(b).

B. **April 15 if return is filed late.** If the individual does not file his income tax return for Year 1 on or before the date it is due (whether that due date is April 15 or some later date he qualified for under an extension), he must complete the recharacterization by April 15 of Year 2.

C. **Disaster relief; "9100" relief.** For the taxpayer who misses the deadline for recharacterizing, there is still hope:

First, Congress and the IRS sometimes grant blanket extensions of time and other relief to the victims of particular disasters. If the taxpayer is affected by such a disaster he may be entitled to complete a Roth recharacterization later than other taxpayers.

Second, there are procedures for applying to the IRS for relief in cases of good faith errors. See Reg. § 301.9100-1 *et seq*. Applying for relief on a Roth recharacterization gets it own special reduced "user fee" of $4,000. Rev. Proc. 2010-8, 2010-1 IRB 234, § 6.01(9). In dozens of private letter rulings, the IRS has been generous in using these relief provisions to grant extensions for recharacterizations of erroneous Roth conversions, where the taxpayers requested relief before the IRS caught the mistake. See, *e.g.*, PLRs 2001-16053 (taxpayer erroneously believed that due date of her return was October 15 and that capital gain did not count toward the then-applicable $100,000 Roth conversion income limit); 2001-16057 (recharacterization of improper Roth conversion was late due to financial institution error); 2001-16058, 2001-19059, 2001-20040, 2001-22050, 2001-28058, and 2001-30058 (taxpayers unaware they didn't qualify for Roth conversion and unaware of recharacterization deadline); 2001-26040 (taxpayers had been erroneously advised that the Roth IRA conversion income limit then applicable was $150,000, that the deadline for a 1998 conversion was 4/15/99, etc.); and 2001-29040 (taxpayer ineligible to convert, and thought she had timely recharacterized all her Roth IRAs, but missed the deadline on one of them because she forgot about that account). For additional examples, see PLRs 2008-50052, 2008-26040, 2009-09073, 2009-21036, 2009-28044, 2009-48065, 2010-04037, and 2010-16095.

Most, though not all, of these numerous rulings involved people who: were not actually eligible to convert to a Roth IRA; had a good excuse (such as advisor error) for not knowing they were ineligible; and discovered the mistake after the recharacterization deadline. After 2009, the "I wasn't eligible to convert!" excuse will rarely apply, since the eligibility restrictions have been largely abolished (see ¶ 5.4.02). PLR 2010-24071 may signal a new hard IRS line on these extensions, perhaps due to this change in the law. In this PLR, the IRS refused to grant an extension of time to recharacterize to a person wanted to recharacterize because his Roth IRA had declined in value dramatically after the conversion, and who claimed that he did not know about the recharacterization deadline.

5.6.07 ***Same-year and immediate reconversions banned***

Once a recharacterization of an amount converted from a traditional IRA to a Roth IRA occurs, the individual "may not reconvert that amount" to a Roth IRA until the taxable year following the taxable year of the original conversion, or until at least 30 days have elapsed since the recharacterization, *whichever is later*. Thus, recharacterization cannot be used to flip back and forth quickly between traditional and Roth IRA status.

This rule applies (under Reg. § 1.408A-5, A-9) effective in 2000 and later years. For the limits applicable to reconversions in 1998 and 1999, see the author's *Special Report: Ancient History* (free download at http://www.ataxplan.com/order/downloads.cfm).

If the individual defies this rule and attempts to reconvert before the prescribed time period ends, the result is a *failed conversion*. See ¶ 5.4.06.

Essentially, this rule bars immediate "reconversions" only for an individual who converted *all* of his traditional IRAs to a Roth IRA. Someone who converted only part of his traditional IRAs can avoid the effect of the rule by simply converting *some other amount* immediately before or after he recharacterizes the first Roth conversion.

Brittany Example: Brittany's IRA (traditional IRA #1) in 2010 holds 30,000 shares of Acme stock worth $10 a share ($300,000). In January 2010 she moves 10,000 shares from her traditional IRA #1 to Roth IRA #1, thus effecting a $100,000 Roth conversion. A month later the Acme stock has declined to $7 per share, so her Roth IRA is worth only $70,000 and her traditional IRA only $140,000. Brittany wants to undo her Roth conversion that occurred at a higher price, but she wants to stick with her goal of converting about $100,000 worth of Acme stock in 2010. She recharacterizes the first conversion by moving the Acme stock out of Roth IRA #1 back to a new traditional IRA (IRA #2). She then immediately transfers another $100,002 worth of Acme stock (14,286 shares at $7) from traditional IRA #1 to Roth IRA #2. This new conversion is not banned because it is not a conversion of the same "amount."

A Roth conversion made by transfer from a nonIRA plan can be recharacterized under § 408A(d)(6). Notice 2008-30, 2008-12 IRB 638, A-5. The rule banning same-year reconversions, by its explicit terms, applies only with respect to recharacterized conversions from *an IRA* to a Roth IRA, not to conversions from a nonIRA plan. However, the IRS may take the position that this ban automatically also applies to plan-to-Roth-IRA conversions, under the rule that plan-to-Roth-IRA conversions are taxed "as if" the money went through a traditional IRA first on its way to the Roth IRA; see ¶ 5.4.04(A).

5.7 Designated Roth Accounts

In 2006, a new type of "Roth" plan joined the roster, the "designated Roth account" inside a 401(k) or 403(b) plan.

5.7.01 ***Meet the DRAC: Roth 401(k)s, 403(b)s***

Employees have long been permitted to make "elective deferral" (also called "salary reduction") contributions to workplace retirement plans. Under such a "cash-or-deferred arrangement" (CODA), the participant can choose either to receive a certain amount of his compensation in cash or to have such amount contributed to a vested account for his benefit in a retirement plan.

Needless to say, elective deferrals are subject to many complicated tax rules. Through 2005, the reward for successfully complying with these rules was that the amount of the elective deferral would be excluded from the participant's income (except for FICA tax purposes; see ¶ 5.7.02(E)). The deferred salary (and earnings thereon) would not be taxed until they were later distributed to the participant or his beneficiaries (typically after retirement or death).

Since 2006, the participant may have an additional option for his elective deferrals under a 401(k) or 403(b) plan: Instead of deferring income tax on the deferred compensation, he can pay tax on it currently and have it contributed to a **designated Roth account** (**DRAC**) within the plan; later qualified distributions from the DRAC will be tax-free. § 402A(d)(1). The portion of the elective deferral that the participant elects to have contributed to a DRAC is called a "designated Roth contribution." § 402A(a)(1). See ¶ 5.8.05(B) regarding factors to consider when choosing between the two types.

Only "applicable retirement plans" are permitted to have DRACs. § 402A(a). Applicable retirement plans include qualified (§ 401(a)) plans that have elective deferral (401(k)) provisions, and 403(b) plans, so DRACs are sometimes called "Roth 401(k)" or "Roth 403(b)" accounts. § 402A(e)(1). This book will refer only to 401(k) plans; unless specifically otherwise indicated the same rules apply to 403(b) plans. Reg. § 1.403(b)-3(c)(1). Note that 457 plans of any type are not included in the definition of "applicable retirement plan" and so are not permitted to have DRACs. § 402A(e)(1).

5.7.02A ***DRAC contributions via elective deferral***

A. **Who may contribute.** After 2005, any participant in a 401(k) or 403(b) plan can elect to have all or part of his elective deferral ("salary reduction") go into a DRAC, *if* his employer's plan permits designated Roth contributions (plans are not required to offer this option). A self-employed individual who has a self-employed (Keogh) 401(k) plan can have all or part of his elective deferral contributed to a DRAC.

In contrast to Roth IRAs (¶ 5.3.04(C)), there is no income ceiling above which the participant is not allowed to make designated Roth contributions. § 402A. The DRAC was the first Roth retirement plan not to limit contributions to individuals with income below certain levels.

There is no age limit above which the participant cannot contribute to a Roth 401(k). Traditional IRAs are the only plans that do not allow contributions after the participant has reached age 70½.

An individual can contribute to a Roth 401(k) even if he is also a participant in other retirement plans offered by the same or another employer. Though the deductibility of traditional IRA contributions for a high-income individual depends on whether he participates in another retirement plan offered by the employer, no such limitation applies to Roth (or regular) 401(k)s; however, participation in another plan may limit the *amount* that may be contributed; see "B."

B. **How much may be contributed.** The maximum amount that may be contributed to a DRAC is whatever maximum amount of elective deferral contribution the participant may make to his 401(k) plan for the year in question. § 402(g)(1)(B).

The dollar limit for elective deferrals in 2014 is $17,500, plus an additional $5,500 "catch-up" contribution if the participant is 50 or older by the end of the year. § 402(g)(1)(B), (C); IRS Notice 2013-73, 2013-49 IRB (12/2/13). Cost-of-living adjustments (COLAs) increase both the base amount (§ 402(g)(4)) and the catch-up contribution (§ 414(v)(2)(C)) after 2006. Note the contrast with IRAs, where the "catchup contribution" for individuals over age 49 is *not* subject to a COLA. ¶ 5.3.03.

A highly useful resource to find each year's maximum permitted contribution amount is Denise Appleby's Quick Reference charts, http://iraeducationcenter.com/page-1836480.

The DRAC option does not increase the amount the participant may contribute to a plan through elective deferrals. Rather, the participant may choose to put his total permitted elective deferral contribution amount into a DRAC, or into a traditional 401(k) account, or partly into each, as long as the combined total so contributed does not exceed his permitted maximum.

As a reminder, as is true for a traditional 401(k) plan, the elective deferral limits apply to an individual based on *all* elective deferral plans he participates in (with this or any other employer; § 402(g)); and § 415 also limits the amount that may be contributed. These limits are beyond the scope of this book; see instead Chapter 27 of *The Pension Answer Book* by Stephen Krass.

C. **Election is irrevocable.** The election to have part of one's compensation contributed to a DRAC is irrevocable once the money has been contributed to the plan. Thus, a participant cannot retroactively designate a DRAC contribution as a regular contribution or vice versa. Reg. § 1.401(k)-1(f)(1)(i). This is *unlike* a Roth IRA, contributions to which can be withdrawn or recharacterized for a certain period of time, if the contributor changes his mind; see ¶ 5.6.01. The irrevocability of the DRAC decision will make planning more difficult; a participant might prefer to wait until the end of the year (when he has a better idea of his income and tax situation) to decide whether he wants a tax deduction now or tax-free income later.

D. **FICA taxes.** Elective deferral contributions are treated as "wages" for purposes of the Federal Insurance Contributions Act (FICA). § 3121(a)(5)(C), (D), (H), (v)(1)(A). Since these contributions are subject to FICA taxes in any event, the employee's decision to have his elective deferral paid into a DRAC, into a traditional 401(k) account, or to himself in cash will have *no effect* on either the employee's or the employer's FICA tax obligations.

5.7.02B ***DRAC contributions via transfer or rollover***

From 2006 until September 27, 2010, The ONLY contributions that could go into a DRAC were: (1) certain rollovers from other DRACs (see ¶ 5.7.07); and (2) a participant's post-2005 elective deferral contributions. Reg. § 1.401(k)-1(f)(3), third sentence.

That changed with the Small Business Jobs Act of 2010, which permitted (after September 27, 2010) existing traditional plan balances in 401(k) and 403(b) (and, after 2010, 457) plans to be converted, inside the plan, into DRACs. See § 402A(c)(4). But such conversions were permitted *only* for funds that the employee would have been permitted to take out of the plan. Since "elective deferral" accounts cannot be distributed prior to separation from service (or attaining age 59½), younger employees who were still employed were effectively frozen out of Roth conversions for their *existing* 401(k)/403(b)/457 balances.

So in-plan Roth conversions, pre-ATRA, had a very small potential "market." The only person who could convert existing plan balances to Roth status was someone who also had the right to take the money out of the plan, such as a person who had separated from service (or retired), or who (though still employed) was over age 59½ (in a plan that permitted in-service distributions or Roth conversions).

The market was even smaller than that because, among those who could get their money out of the 401(k) plan and wanted to do a Roth conversion, most would be better off converting to a Roth IRA rather than doing a Roth conversion totally "inside" the 401(k) plan. A conversion to a Roth IRA can be reversed up until October 15 of the year after the year of the conversion (see ¶ 5.6), whereas an in-plan Roth conversion is irrevocable.

Next came the American Taxpayer Relief Act (ATRA): Effective for 2012 and later years, a plan that has a DRAC program can allow the employee to transfer *any* amount from his traditional

plan account(s) to a DRAC in the same plan, even if such amount could not legally be distributed to the employee at the time of such transfer. § 402A(c)(4)(E)(i). ATRA's change vastly expands the number of people and plan dollars eligible for Roth conversion, by adding all still-employed employees who are under age 59½ to the list of potential Roth converters. This group of people does not have the alternative of converting to a Roth IRA, because (unless they quit their jobs) they can't get their money out of the 401(k) plan prior to age 59½, so it's either do an in-plan Roth conversion or do NO Roth conversion.

Will there be a mad rush of people taking advantage of this new option? It seems unlikely. How many under-age 59½ individuals are champing at the bit to make an irrevocable election to prepay income taxes on their retirement plans? We'll find out!

Note that IRS regulations (such as Reg. § 1.401(k)-1(f)(1)(i)) may not yet reflect these changes.

5.7.02C ***What can NOT be contributed to a DRAC***

The employ*er* cannot make matching (or any other) contributions to a DRAC. The employer's matching contribution (if any), and any other employer contributions to the plan on behalf of the participant, must be made to the participant's "*traditional*" 401(k) account, regardless of whether the participant's contribution that is being "matched" was made to a traditional 401(k) account or to a DRAC

Money cannot be rolled from a Roth IRA into a DRAC, even if that Roth IRA contains nothing but money rolled into it from the same or another DRAC. Reg. § 1.408A-10, A-5.

5.7.03 ***RMDs and other contrasts with Roth IRAs***

A DRAC (unlike a Roth IRA) is part of a 401(k) or 403(b) plan. As such it is subject to all the same rules that apply to traditional 401(k) or 403(b) plan accounts, except to the extent § 402A provides otherwise.

For example, DRACs are subject to the same lifetime and post-death minimum distribution rules as other 401(k) plan benefits. Reg. § 1.401(k)-1(f)(3). A DRAC owner approaching age 70½ should consider rolling over his DRAC to a Roth IRA to avoid "lifetime" required distributions; see ¶ 5.2.02(A).

DRAC distributions are subject to the income tax withholding rules applicable to other distributions from qualified plans; see ¶ 2.3. DRACs are also subject to federally granted spousal rights (see ¶ 3.4), and the rules restricting distributions from elective deferral accounts (not covered in this book; see, instead, Chapter 27 of *The Pension Answer Book*). Roth IRAs are subject to none of these. Other differences include the irrevocability of contributions (¶ 5.7.02(C)), the definition of qualified distributions (¶ 5.7.04), the treatment of nonqualified distributions (¶ 5.7.05), and the rollover rules (¶ 5.7.06–¶ 5.7.09).

5.7.04 ***DRACs: Definition of "qualified distribution"***

As with a Roth IRA, there are two types of distributions from a DRAC, qualified distributions and other (nonqualified) distributions. Qualified distributions from a DRAC, like qualified distributions from a Roth IRA, are income tax-free. § 402A(d)(1); § 408A(d)(1); Reg.

§ 1.402A-1, A-2(a). However, the definition of qualified distribution is different for the two types of Roth plan. Each involves a five-year waiting period and a triggering event, but the computation of the Five-Year Period, and the triggering events, are not the same.

A. Qualified distribution triggering events. A DRAC distribution is a qualified distribution only if it is either (1) made on or after the date the participant reaches age 59½, (2) made after his death, or (3) attributable to the participant's being disabled "within the meaning of section 72(m)(7)." An additional category of qualified distribution from a Roth IRA, the first-time homebuyer distribution, does NOT apply to DRACs; compare ¶ 5.2.04, #4. § 402A(d)(2)(A); § 408A(d)(2)(A).

B. How the Five-Year Period is computed for a DRAC. As with Roth IRAs, DRACs have a five-year waiting period (called the "nonexclusion period" in the statute, the "Five-Year Period" in this book) before a qualified distribution can occur. § 402A(d)(2)(B). However, there is a difference in the way the Five-Year Period is calculated. With a Roth IRA, the Five-Year Period begins with the first year there is a contribution to *any* Roth IRA; see ¶ 5.2.05.

For a DRAC, in contrast, the Five-Year Period is five consecutive years beginning with the first year the employee made a contribution to a DRAC *in that particular plan* (i.e., the year the elective deferral was included in his income). § 402A(d)(2)(B)(i). If the employee takes distribution of the entire account during the Five-Year Period then later makes more contributions, the start of the Five-Year Period is not "redetermined"; it still begins with the *first* contribution. Reg. § 1.402A-1, A-4(c).

The Five-Year Period is computed plan-by-plan even for two plans maintained by the same employer. Reg. § 1.402A-1, A-4(a), (b). For the only exception to this rule (applicable to certain rollover amounts), see ¶ 5.7.07(D).

However, certain DRAC contributions do NOT start the Five-Year Period tolling. "A contribution that is returned as an excess deferral or excess contribution does not begin the 5 taxable-year period of participation. Similarly, a contribution returned as a permissible withdrawal under section 414(w) does not begin the 5 taxable-year period of participation." Reg. § 1.402A-1, A-4(a). (§ 414(w) came into effect in 2008, allowing for "eligible automatic contribution arrangements.") This rule avoids game-playing: The participant cannot start the five-year clock running with a contribution that is returned to him.

Once the Five-Year Period has elapsed, and the triggering event requirement is met, subsequent distributions are qualified (for exceptions, see "C"). Qualified status is determined based on *the year in which the distribution actually occurs*, not on some prior year to which it may relate. For example, a required minimum distribution (RMD) that is taken in the year the required beginning date (RBD) occurs (after completion of the Five-Year Period) but which actually is the RMD for the prior year (which was within the Five-Year Period), is a qualified distribution. A distribution received after completion of the Five-Year Period (and after a triggering event) is a qualified distribution, even if it is part of a series of substantially equal periodic payments that started prior to the completion of the Five-Year Period. T.D. 9324, *Preamble*, "Determination of 5-Taxable-Year Period for Qualified Distributions."

For how to compute the Five-Year Period with respect to a reemployed **veteran**, see Reg. § 1.402A-1, A-4(e).

C. List of never-qualified distributions. Certain DRAC distributions can NEVER be qualified distributions, *even if* the Five-Year Period and triggering event requirements are met. Reg. § 1.402A-1, A-2(c), A-11. These "never-qualified distributions" are listed by cross-reference to Reg. § 1.402(c)-2, A-4:

- Corrective distributions of excess plan contributions (including income thereon) made by the plan in order to comply with the § 415 limits. A-4(a).

- Corrective distributions of excess deferral amounts (including income thereon) made to comply with the elective deferral limits of Reg. § 1.402(g)-1(e)(3) and the cash-or-deferred plan rules. A-4(b), (c).

- Plan loans that are treated as deemed distributions under § 72(p). A-4(d). See ¶ 2.1.07(A).

- Dividends paid on employer securities as described in § 404(k). A-4(e). § 404(k) allows a corporation to take a tax deduction on certain dividends it pays on its stock held in a retirement plan for its employees. If the dividend is paid out to the employee-participant it cannot be a tax-free qualified distribution from the Roth 401(k) account. However, if the dividend is held in the plan and reinvested in more employer stock it loses its never-qualified status, and therefore can be included in a qualified distribution at a later time. Reg. § 1.402A-1, A-11.

- The deemed income resulting from plan-owned life insurance. A-4(f). See ¶ 8.2.01.

- "Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin." A-4(h).

The never-qualified category is needed to prevent game-playing. For example, if excess contributions (and earnings thereon) could be distributed tax-free as long as the participant met the five-year and triggering event tests, then everyone over 59½ with five years of DRAC participation would have an incentive to transfer all his wealth into his DRAC. That would be an excess contribution, but any penalties could be avoided by distributing the excess contribution (and earnings thereon) back to himself by a certain deadline (see ¶ 2.1.08); and if there were no income tax on the distributed earnings the participant would have done an end run around the Code's contribution limits.

Though the above list of never-qualified distributions generally tracks the list of distributions that are not "eligible rollover distributions," the regulations clarify that some distributions that are not *eligible rollover distributions* nevertheless CAN be *qualified distributions*, if the Five-Year and triggering-event requirements are met. Reg. § 1.402A-1, A-11. Hardship distributions, required minimum distributions, and distributions that are part of a series of substantially equal periodic payments fall into this category.

D. QDROs and payments to beneficiaries. In the case of a distribution to an alternate payee under a QDRO, or to a beneficiary, it is the death, age, or disability of the participant that determines whether the distribution is qualified. See Reg. § 1.402A-1, A-4(d), regarding QDRO payments from designated Roth accounts.

*5.7.05 **Nonqualified DRAC distributions***

Though not automatically entitled to 100 percent tax-free treatment the way a qualified distribution is, a nonqualified distribution may be partly or wholly tax-free. However, the treatment of nonqualified distributions is one of the big differences between Roth IRAs and DRACs.

As is true with a Roth IRA, if the DRAC has appreciated since the original contribution(s), then the DRAC contains two kinds of money: the participant's contributions (which comprise the participant's basis in the account—the money he has already paid tax on—also called the "after-tax money" or "investment in the contract"; see ¶ 2.2.01), plus the appreciation (which is pretax money; the IRS calls this the "earnings"). Hopefully, the "earnings" will NEVER be taxed, because they will come out eventually in the form of a tax-free qualified distribution (¶ 5.7.04).

But if there is a nonqualified distribution, the earnings cannot come out tax-free. Accordingly, we need to determine how much of any nonqualified distribution represents a return of the participant's basis (tax-free) and how much is considered earnings (taxable), and here's where we find the difference between Roth IRAs and DRACs. With a Roth IRA, the participant's own contributions (i.e., the after-tax money) come out first. ¶ 5.2.06, ¶ 5.2.07. Accordingly, even nonqualified Roth IRA distributions are income tax-free until the entire basis has been distributed.

With DRACs, in contrast, there is no special rule allowing the participant's basis to come out first. So, the regular rule of § 72(e)(8) will apply—the "cream-in-the-coffee rule," under which any distribution carries out proportionate amounts of the participant's basis (after-tax money) and earnings (pretax money). Reg. § 1.402A-1, A-3; see ¶ 2.2.02. Thus, every nonqualified distribution from a DRAC will be partly taxable unless either (1) there has been no appreciation in the account since the original contributions or (2) the earnings portion is rolled over (¶ 5.7.06).

The good news is that the participant's DRAC is treated as a separate account from the participant's *traditional* accounts in the plan for purposes of applying § 72. § 402A(d)(4). Thus, distributions can be taken from each category (traditional or Roth) separately, without their being aggregated for purposes of the "cream-in-the-coffee rule."

However, if the participant has more than one DRAC inside a single 401(k) plan (for example, an elective deferral account and a rollover account), these are treated as a single account for purposes of § 72. Reg. § 1.402A-1, A-9(a). The only exceptions to this are: If an account is divided between the participant and his spouse pursuant to a QDRO, each spouse's share of the employee's DRAC is treated as a separate account (or "separate contract," in the lingo of § 72; see ¶ 2.2.04(C)); and, the plan can split the DRAC into multiple separate accounts for the participant's multiple beneficiaries after the participant's death, and each such account will be treated as a separate "contract" under § 72. Reg. § 1.402A-1, A-9(b).

5.7.06 ***Rollovers of DRAC distributions: General rules***

A distribution from a DRAC may be rolled over *only* to another DRAC or to a Roth IRA. § 402A(c)(3); Reg. § 1.402A-1, A-5(a). See ¶ 5.7.07 for the rules for DRAC-to-DRAC rollovers, ¶ 5.7.08 for DRAC-to-Roth IRA rollovers.

Though both direct rollovers and indirect (60-day) rollovers are permitted (see ¶ 2.6.01 for the difference), different rules apply to these two types of rollovers:

♦ If a DRAC pays a distribution from the participant's account directly to another DRAC (trustee-to-trustee transfer or direct rollover), that is treated as a separate distribution from "any amount paid directly to the employee," for purposes of determining how much of each of these "separate distributions" is after-tax money and how much is pretax money. Reg. § 1.402A-1, A-5(a), third sentence; A-6(a). Although this regulation addresses only direct rollovers from one DRAC to another, Notice 2009-68, 2009-39 IRB 423, at p. 429, provides the same rule for rollovers from *any* QRP to any other eligible retirement plan; see ¶ 2.2.04(A).

♦ If a distribution is paid to the participant (rather than being rolled directly to another plan or IRA), and the participant rolls over only *part* of the distribution (using a 60-day rollover), the part rolled over is deemed to come first out of the "income" portion of the distribution. § 402(c)(2), last sentence; Reg. § 1.402A-1, A-5(b). See ¶ 2.2.05 [Appendix A] for more on this rule.

These rules for tracking the participant's "income" and "investment in the contract" in the distributing DRAC must be observed, in the case of a partial distribution from a DRAC, even if the distribution is a qualified distribution (so it is tax-free; ¶ 5.2.03(A)), because of the possibility that the participant might later receive a *non*qualified distribution from that DRAC; see ¶ 5.2.06.

However, a DRAC or Roth IRA that *receives* a rollover of a qualified distribution from a DRAC is apparently *not* required to keep track of the basis and income "inside" that qualified distribution, because a qualified DRAC distribution that is rolled into a DRAC or a Roth IRA comes in as "investment in the contract" for purposes of taxation of later distributions from that receiving account. Reg. § 1.402A-1, A-6(a), last sentence; § 1.408A-10, A-3(a), third sentence.

5.7.07 ***DRAC-to-DRAC rollovers***

For general rules applicable to all rollovers of DRAC distributions, see ¶ 5.7.06. DRAC-to-DRAC rollovers are subject to several additional *very complicated* rules:

A. **May roll to any other DRAC.** An eligible rollover distribution from a DRAC can be rolled to any other DRAC (including a DRAC in a different type of plan; for example, a 403(b) plan DRAC can be rolled into a 401(k) plan DRAC), *provided* the recipient plan offers DRACs as part of its own elective deferral program, and *provided* the rest of the rules in this ¶ 5.7.07 are complied with. Reg. § 1.402A-1, A-5(a); T.D. 9324 (Preamble).

B. **Direct rollover.** The participant can do a DRAC-to-DRAC rollover by means of a direct rollover of any DRAC distribution. If the distribution from the first DRAC is a qualified distribution, then the entire amount rolled into the transferee DRAC is allocated to the participant's "investment in the contract" (basis) in the transferee DRAC. Reg. § 1.402A-1, A-6(a). See "C" for the advantage of rolling the *entire* DRAC distribution into the new DRAC by means of a *direct rollover*. See "D" for the advantage of rolling at least *some* of the DRAC distribution into the new DRAC by means of a *direct rollover*.

C. **Total direct rollover preserves basis in excess of value.** If the ENTIRE account in the distributing DRAC is transferred by direct rollover to the recipient DRAC, and the employee's basis in the distributing DRAC exceeds the fair market value of the distribution, the employee's basis in the distributing DRAC becomes part of his basis in the recipient DRAC, despite the fact that his basis exceeds the account's value. This rule helps an employee whose DRAC is "under water" preserve his high basis when he changes jobs, and is a good reason to do a 100 percent DRAC-to-DRAC direct rollover in those circumstances. Reg. § 1.402A-1, A-6(b). A similar (but not identical) rule applies to DRAC-to-Roth-IRA rollovers; see ¶ 5.7.08(D) below.

D. **Direct rollover preserves holding period.** One advantage of doing a direct DRAC-to-DRAC rollover is that the participant's holding period from the transferor plan is tacked on to the holding period in the transferee plan for purposes of computing the Five-Year Period (¶ 5.7.04(B)). With an "indirect" (60-day) rollover, the years in the prior plan *will not count* in computing the Five-Year Period for the transferee plan. § 402A(d)(2)(B); Reg. § 1.402A-1, A-4(b).

E. **60-day ("indirect") rollover.** If the participant actually receives the distribution (i.e., he did not arrange for a direct rollover), then he has 60 days to roll all or part of that distribution into another DRAC; see ¶ 2.6.06. Here are additional rules regarding such indirect DRAC-to-DRAC rollovers:

1. The participant can roll the earnings (pretax) portion of the distribution to another DRAC. This is consistent with the rule that, in case of a partial indirect rollover, the portion rolled is deemed to come first out of the part of the distribution that would be taxable if not rolled over. § 402(c)(2); Reg. § 1.402A-1, A-5(a), second sentence. See ¶ 2.2.05 [Appendix A].

2. The nontaxable portion of a DRAC distribution (the basis) may NOT be rolled to another DRAC by means of a 60-day rollover. § 402(c)(2); Reg. § 1.402A-1, A-5(a), second sentence.

3. With a 60-day rollover, the transferee DRAC does NOT tack on the participant's holding period from the prior DRAC. Compare "D" above. The participant's Five-Year Period for the DRAC that receives the rollover is based on the first year he made a contribution to *that particular DRAC* (whether that first contribution was the rollover contribution or some other contribution). Reg. § 1.402A-1, A-5(c).

4. Finally, since a 60-day rollover involves the distribution of an eligible rollover distribution to the participant, it is subject to mandatory 20 percent withholding of federal income tax from the taxable portion of the distribution. § 3405(c). To roll over the withheld amount, the participant must use substituted funds. ¶ 2.3.02.

5.7.08 ***DRAC-to-Roth-IRA rollovers: In general***

For the *general* rules applicable to all rollovers of DRAC distributions, see ¶ 5.7.06.

A DRAC-to-Roth-IRA rollover may be accomplished by either direct rollover or 60-day (indirect) rollover. Reg. § 1.402A-1, A-5(a). For the effect of such a rollover on computation of the Five-Year Period, see ¶ 5.7.09. For effects of a partial indirect rollover, see ¶ 2.2.05 [Appendix A]. Here are *additional* rules and considerations that apply to DRAC-to-Roth-IRA rollovers:

A. **Who is eligible.** A rollover from a DRAC to a Roth IRA is permitted *even if* the participant is not otherwise eligible to contribute to a Roth IRA. Reg. § 1.408A-10, A-2. He can establish a Roth IRA purely for the purpose of receiving a rollover from his DRAC. Both qualified and nonqualified DRAC distributions can be rolled to a Roth IRA; all that is required is that the participant is entitled to take a distribution from the DRAC. If he can take the distribution out, he can roll it over to a Roth IRA—provided, of course, that it's an eligible rollover distribution; see ¶ 2.6.02.

B. **Minimum distribution effects.** Rolling over from a DRAC to a Roth IRA will end the requirement of lifetime RMDs with respect to the rolled funds. ¶ 5.2.02(A). Also, if the rollover occurs after the participant's Required Beginning Date (RBD), the rollover changes the method of computing the Applicable Distribution Period (ADP) that will apply to the participant's beneficiaries from the "death post-RBD rules" to the "death pre-RBD rules"; see ¶ 1.5.02. For the meaning of RBD and ADP with respect to any particular participant or plan, and the minimum distribution rules applicable in case of death pre- or post-RBD, see Chapter 1.

C. **Favorable effect on basis recovery.** Rolling from a DRAC to a Roth IRA enables the participant (once the rollover is completed) to withdraw his own contributions tax-free from the Roth IRA while leaving any "earnings" inside the account, something he could NOT do with the DRAC, because the Roth IRA has more favorable rules for recovery of basis than a DRAC. Compare ¶ 5.2.06 with ¶ 5.7.05.

D. **Rollover when basis is higher than market value.** There is a special rule for determining basis in the Roth IRA when there is a rollover into the Roth IRA from a DRAC, *if* the employee's basis in the DRAC exceeded the DRAC's value on the date of distribution: If the employee takes a distribution of the *entire balance* of his DRAC, and rolls PART of that distribution to a Roth IRA by means of a 60-day rollover, and at the time of the distribution his basis in the DRAC exceeded the market value of the DRAC, the excess basis is treated as a regular contribution to the Roth IRA (i.e., it is added to the employee's basis in the Roth IRA). Reg. § 1.408A-10, A-3(b).

Does this ability to preserve "excess basis" also apply to *direct* DRAC-to-Roth-IRA rollovers (not just 60-day rollovers), and to a rollover of the *entire* distribution (not just to partial rollovers)? The regulation specifically mentions only partial 60-day rollovers. The IRS *may* have intended that carryover of "excess" basis would also apply for direct rollovers of the entire account balance, by its cross reference, in Reg. § 1.408A-10, A-3(a), to Reg. § 1.402A-1, A-6 (see ¶ 5.7.07(C)); it's not clear.

Preserving the "excess basis" could be important in two situations. One is if the participant or beneficiary later takes a *nonqualified* distribution from the Roth IRA. Such a distribution would be includible in income only to the extent the distribution exceeded the participant's basis. ¶ 5.2.06. For that purpose, having the benefit of a larger basis means that less (or none) of the distribution will be income-taxable. The other advantage of preserving basis would occur if the individual cashed out all of his Roth IRAs, and the total sum received was less than the individual's basis in the account, so the individual would be entitled to a loss deduction. See ¶ 2.2.11.

5.7.09 ***DRAC-to-Roth IRA rollovers: Effect on Five-Year Period***

The Five-Year Period for a Roth IRA begins January 1 of the first year the participant has any Roth IRA (¶ 5.2.05), *regardless* of whether the Roth IRA holds money rolled over from a DRAC; whatever holding period the DRAC owner had established in the plan that originally held the DRAC does NOT carry over to the Roth IRA, regardless of whether the DRAC-to-Roth-IRA rollover is a "direct rollover" or a "60-day rollover." Reg. § 1.408A-10, A-4.

With DRAC-to-DRAC rollovers, Congress specified that the employee's holding period carries over from one DRAC to the other. § 402A(d)(2)(B); see ¶ 5.7.07(D). However, Congress said nothing about a carryover of holding period in the case of a DRAC-to-Roth-IRA rollover, so the Regulations allow no such carryover.

This rule will adversely affect some (see "C"), but is not the disaster it at first appears (see "A" and "B").

A. **Rollover of a qualified distribution.** If the DRAC distribution that is rolled over to the Roth IRA is *itself* a qualified distribution (¶ 5.7.04), then the entire rollover amount is treated as a "regular contribution" to the Roth IRA. Reg. § 1.408A-10, A-3(a). A regular contribution can be withdrawn from a Roth IRA at any time, tax-free. ¶ 5.2.06. Thus, only the post-rollover earnings on the rollover amount may be subject to a "fresh start" Five-Year Period in order to become tax-free qualified distributions. Reg. § 1.408A-10, A-4(b), Example 3.

Denny Example: Denny, age 60, receives a qualified distribution of $40,000 from his DRAC in 2010 and rolls it over to a Roth IRA. This is the first Roth IRA Denny has ever had. He cannot have a qualified distribution from the Roth IRA until 2015. Any distributions he takes from the Roth IRA before 2015 will be nonqualified. However, he can take out up to $40,000 of nonqualified distributions tax-free as recovery of basis, because the $40,000 contribution is deemed to be his tax-paid "regular contribution" to the account, and that comes out first under the Roth IRA ordering rules. ¶ 5.2.07. Only post-rollover appreciation ("earnings") will be taxable if withdrawn prior to 2015.

B. Rollover if participant already has a Roth IRA. If the participant had already established a Roth IRA prior to the rollover, the money rolled from the DRAC gets the benefit of the years the participant's pre-existing Roth IRA has already completed towards the Roth IRA Five-Year Period (regardless of whether the DRAC distribution is rolled into the pre-existing Roth IRA or into a brand new Roth IRA). If the participant has already completed the Five-Year Period with respect to the existing Roth IRA(s) he owned prior to the rollover, then the rollover from the DRAC gets the benefit of that—even if the money was in the *DRAC* for less than five years. See Reg. § 1.408A-10, A-4(b), Example 1.

Amanda Example: Amanda, age 60, started a Roth IRA in 1998 with $1,000. In 2009 she makes a $20,000 DRAC contribution to her proprietorship's "self-employed 401(k) plan." In 2010 she retires and rolls the DRAC over to a Roth IRA (either the existing one or a new one—it doesn't matter). Even though her holding period for the DRAC was less than five years, so the DRAC distribution is a nonqualified distribution, it "instantly" becomes qualified once she rolls it to a Roth IRA, because she has already completed the Five-Year Period for any Roth IRAs she may ever own. Since she is over 59½, she has also met the "triggering event test" (¶ 5.2.04) so she can withdraw as much as she likes tax-free at any time from any Roth IRA she owns.

C. Danger: Rolling to a new Roth IRA. The person who may be hurt by this rule is someone who had no prior Roth IRA, and had completed one or more years in his DRAC at the time he rolls a *non*qualified distribution from the DRAC to a Roth IRA. He loses the years he had completed, and starts the 5-year clock over again. Because his rollover was NOT of a qualified distribution, only his basis in the DRAC (i.e., the amount of his original elective deferral contribution(s)) is treated as a "regular contribution" to the Roth IRA. The rest of the rollover is treated as "earnings," meaning that it cannot be distributed tax-free except in a qualified distribution. Reg. § 1.408A-10, A-4(b), Example 2.

This will make little difference to a person who is rolling from the DRAC to a Roth IRA when he is under age 54½ (because, absent disability, he will have to wait five or more years ANYWAY before he can have a qualified distribution from the Roth IRA). However, it could be tough for a person who has accumulated many years in the DRAC and then rolls to a Roth IRA *shortly before reaching age 59½*. If the first year for which he has ever owned a Roth IRA is the year he establishes a Roth IRA with his DRAC rollover, then he will have to wait five *more* years to have a qualified distribution from that Roth IRA.

Bryon Example: Bryon, age 38, establishes a $15,000 DRAC in 2006 in his employer's 401(k) plan. He makes no further contributions to the DRAC. In 2026, he retires at age 58 and rolls over the DRAC (now worth $45,000) to a Roth IRA. This is his first Roth IRA; accordingly, computation of his Five-Year Period for the Roth IRA starts with the year of the rollover (2026), so he cannot have a qualified distribution from the Roth IRA until 2031. His basis in the DRAC ($15,000) will be treated as his only "investment in the contract" in the Roth IRA. Though he can withdraw that basis tax-free at any time, he cannot withdraw the post-2006 earnings ($30,000 at the time of the rollover) tax-free until 2031. If he had just waited until he had reached age 59½ before rolling the DRAC to a Roth IRA, the rolled distribution would have been a qualified distribution and the fresh-start rule would have applied only to post-rollover earnings (see "A"), not to ALL earnings.

*5.7.10 **Employer obligations and DRAC accounting***

An elective deferral contribution to a DRAC is includible in the employee's income and thus is subject to income tax withholding. Reg. § 1.401(k)-1(f)(1)(ii); Reg. § 1.199-2(e)(1). Presumably the income tax on the contribution would have to be withheld from the nondeferred portion of the employee's salary, to avoid diminishing the plan contribution.

The plan must maintain separate records for the participant's traditional and Roth accounts in the 401(k) plan until the DRAC has been completely distributed. § 402A(b)(2), Reg. § 1.401(k)-1(f)(2). The IRS is concerned that employers will try to arrange the plan accounting so that profits are shifted into the DRAC; the regulation provides that any transaction or methodology that has the effect of transferring value into a DRAC from another account violates the requirements of § 402A. However, swapping assets between accounts at fair market value is permitted. Reg. § 1.402A-1, A-13(a).

A plan that holds a DRAC must keep track of each participant's investment in the contract and also the Five-Year Period for such participant. Reg. § 1.402A-2, A-1.

5.8 Putting it All Together: Roth Planning Ideas and Principles

This ¶ 5.8 looks at planning decisions and ideas connected with Roth retirement plans. It covers the decision of whether to go into a Roth plan in the first place (¶ 5.8.01–¶ 5.8.05); tips and ideas collected from planners nationwide regarding the Roth conversion process (¶ 5.8.06); Roth planning ideas that *do not* work (¶ 5.8.07); and the estate planner's concerns in connection with Roth plans and conversions (¶ 5.8.08).

*5.8.01 **Roth plan or traditional? It's all about the price tag***

A Roth IRA is a nice asset to own. It offers the ability to generate income tax-free investment accumulations that can be spent in retirement or left to heirs, and the additional advantage of no required distributions during the participant's life. And *unlike* with a traditional IRA, the participant can withdraw his own contributions income tax-free anytime he wants to.

Does this marvelous asset have any known drawbacks? There theoretically could be some drawbacks that would make a Roth IRA "worse" to own than a traditional IRA: For example, it's possible that some states' laws haven't caught up with the Roth idea yet, so that a Roth in such a state would be more vulnerable to state taxes and/or creditors' claims. Also, some planners speculate that a Roth is an "inferior" inheritance vehicle because beneficiaries are more likely to cash it out quickly because it's tax free, whereas they might go along with deferring distribution of a traditional plan that they would have to pay income tax on if they cashed it out. And (even aside from the income tax cost) the bump in taxable income generated by a Roth IRA conversion could "look bad" on an application for college financial aid or other means-tested benefit. But these drawbacks are speculative or applicable to few people.

The only *significant widely-applicable* drawback of a Roth plan is the cost. Generally, the price is payment of income taxes on the amount going *in* to the Roth retirement plan—taxes that could have been deferred (via a traditional retirement plan) until the money was taken *out* of the retirement plan. The debate is not whether a Roth IRA is a good type of retirement plan to own. It

IS a good plan to own. The debate is all about the price tag: How much do you have to pay to get a Roth plan, and is it worth it, and can you afford it?

Which is better: to pay the taxes up front and get tax-free distributions later or to defer the taxes?

A. Analyzing the cost and benefits of a Roth conversion. Professionals who have crunched the numbers for many clients generally conclude that the following factors will result in a Roth conversion's being profitable for the converting participant and/or his beneficiaries:

1. The income tax payable on the conversion will be less than would otherwise apply to withdrawals from the account if it stayed in traditional form.

2. The funds stay in the Roth account for some number of years, the longer the better. This factor could mean (depending on the planner) that the money stays in the Roth IRA for some absolute certain number of years to achieve a "break even point," or simply that it stays in the Roth account longer than it would have been allowed (by of the minimum distribution rules) to stay in a traditional plan.

3. The income tax resulting from the conversion is paid with assets that are not inside any retirement account.

4. The Roth investments do not decline in value.

Not all professionals agree on the relative weight of these factors, and not all advisors even agree that all of these factors are even relevant to the decision. Also, if one factor is positive enough, that factor alone may make the Roth approach profitable even if the other factors are not present. For example, work done by IRA expert Bob Keebler, CPA, and his firm has shown that prepaying a 35 percent tax (via a 2010 Roth conversion) on retirement assets that would otherwise be taxed at 43.6 percent (see ¶ 2.1.02) can produce a profit for the client in just 10 years (compared with leaving all the money in a traditional IRA) even if the account itself must be depleted to pay the conversion income tax—i.e., factor #1 trumps factor #3 if the rate increase is substantial enough.

For an excellent article on the pros and cons of Roth conversions, see "To Convert or Not To Convert—That Is The Question!" by Robert S. Keebler, CPA, and Stephen J. Bigge, *Journal of Retirement Planning* (CCH, May–June 2007 issue). This article is posted at http://www.ataxplan.com/bulletinBoard/pdfs/JORP_100307_KeeblerBigge.pdf, with permission of the authors and CCH.

B. What goes into the spreadsheet. Should *your client* convert to a Roth IRA? A spreadsheet cannot give "the answer." A spreadsheet just regurgitates the inputs you give it. Computer projections of the benefits of a Roth conversion are based on assumptions as to future tax rates, investment returns (inside and outside the IRA), and withdrawal amounts. Different professionals running different computer programs may reach different conclusions regarding the profitability of converting to a Roth IRA. Varied inputs lead to varied results. Creating inputs *truly applicable to the client's personal situation* is a very daunting task.

✓ What income tax rates do you assume will apply to the client's traditional IRA withdrawals, Roth conversion, and outside investment income? Make sure the projections you are using are based on the actual taxes that would be payable on a specific amount of taxable income (not simply on a "marginal" tax bracket). With federal income tax law being extremely complex, and subject to rapid and substantial change, and with the client's personal circumstances being subject to changes that can affect his personal income tax picture regardless of what is happening to the Tax Code in general, how much weight or certainty can you accord to a projected income tax rate? How does any applicable state income tax affect this?

✓ When do you assume the money will be distributed? Some projections assume that all plans and Roth IRAs are liquidated at the participant's death. This approach fails to evaluate the potential advantage of paying the benefits out gradually to a younger generation beneficiary after the participant's death. Also consider the possibility that the money may unexpectedly need to be withdrawn sooner due to illness or other setbacks.

✓ Do you assume the same investment returns for assets inside a Roth IRA, inside a traditional plan, and outside a plan?

You can not know for sure what the client's future tax rates, spending needs, or investment results will be. If the client's tax rate and investments go up, and his spending needs stay level or decline, the Roth conversion could be very profitable. If the client's tax rate and investments decline and/or spending needs accelerate, a Roth conversion could be a costly mistake. The future is unknowable. Unless the conversion is free (see ¶ 5.8.02(A)), the client might be best advised to convert some but not all of his plans to a Roth, and to considering converting more next year or the year after that.

C. Beyond the spreadsheet. One might conclude that financial projections regarding the profitability of a Roth contribution are too speculative to be useful, or the projections may indicate that the Roth choice is financially neutral. There can be factors that incline a client towards or away from a Roth plan without regard to what the spreadsheet says; see ¶ 5.8.02, ¶ 5.8.03.

Also, for some (many?) clients, personality outweighs computer projections: Some individuals are constitutionally attracted to Roth conversions, others are instinctively repelled by them. There can be a tendency (among advisors as well as clients) to use the computer projections and other factors not to help decide what to do, but to justify what has already been decided.

Another regrettable tendency is to regard the Roth conversion decision as an all-or-nothing proposition. There are advisors who push all their clients towards Roth conversions and advisors who practically forbid their clients to convert. Clients want to convert everything or they want to convert nothing. Perhaps Roth lovers and Roth haters should both consider partial Roth conversions.

5.8.02 *Factors that incline towards doing a Roth conversion*

Here are factors that can tilt the balance in favor of a Roth conversion.

A. If conversion is "cheap" or "free." Whether a Roth conversion will "make a profit" involves a cost-benefit analysis. If the cost is zero the decision is easy—there are only benefits. Similarly, if the cost is very low, the benefits do not have to clear a very high hurdle for the Roth conversion to win the contest. This factor makes the Roth conversion decision easy for an individual who is in a zero tax bracket temporarily (due, for example, to a net operating loss from a business). This factor also tends to make the Roth conversion favorable if the plan to be converted consists substantially of "after-tax money."

B. Future tax rate expected to be higher. This factor favors a Roth conversion for a person whose personal tax rate is likely to go higher in the foreseeable future, either because of changes in his personal circumstances or because a general future tax increase is likely to apply to him.

For example, a retiree whose annual gross income (including investment income and retirement plan distributions) is likely to exceed $250,000 (in the case of a married individual; $200,000 for a single person) in future years will be subject to the 3.8 percent surtax on investment income after 2012 (see ¶ 2.1.02), resulting in a marginal tax rate of 43.6 percent on such income. A Roth conversion at the 2010 top marginal rate of 35 percent could benefit this client. Since Roth IRA distributions do not increase gross income, converting to a Roth could help keep the client's future gross income below the threshold that would trigger the expected top future tax rate.

Calvin Example: Calvin is in his 60s, single, and retired. He has a substantial traditional IRA as well as substantial investments outside of any plan. His income dropped significantly following retirement. He is living comfortably on a modest taxable income, taking no distributions from his IRA, and is now in a very low tax bracket. In a few years, when he turns 70½, he will be in a high tax bracket again, when the required minimum distribution (RMD) rules start forcing distributions out of his IRA. Now is the time to blunt the future force of RMDs (and take advantage of the low income tax brackets) by doing partial Roth IRA conversions each year. This will reduce future RMDs from the traditional IRA (thus saving income taxes in the future), allow greater in-plan asset accumulation (since Roth IRAs do not have lifetime RMDs), and give him a financial safety valve for tax-free distributions later (from the Roth IRA) for extra needs in later retirement.

Another example: When a married person dies, the surviving spouse often will continue to receive almost as much income as the couple received while both were living, but the tax rates applicable to that income will sharply increase when the surviving spouse is filing as a single individual compared with the "married filing jointly" rates that previously applied. This prospect could encourage a married couple to start doing Roth conversions while both are living, especially if one of them is not healthy.

This factor is also at work in setting up Roth IRAs for young family members (¶ 5.8.08(C)) and when a low-income parent converts to a Roth for the benefit of high-income heirs (¶ 5.8.04(B)).

C. **Participant does not want or need RMDs.** Money can stay in a Roth IRA much longer than in a traditional IRA, because of the different minimum distribution rules that apply (¶ 5.2.02(A)). Thus more tax-free compounding can occur in a Roth IRA during the owner's life than is possible with a traditional IRA, from which the owner must take lifetime distributions. This factor makes Roth IRAs attractive to individuals who would prefer to preserve their IRAs intact for heirs, or who do not want to deal with the annual hassle and penalty risk of RMDs.

D. **Spend down "outside" assets.** An individual concerned about potential creditors' claims should consider the relative vulnerability of his assets outside vs. inside an IRA. If (based on the configuration of his assets, the nature of the potential claims, and applicable state or bankruptcy exemption laws) he concludes that assets inside an IRA are better protected than "outside" assets, he can convert his IRA to a Roth IRA, thereby spending down the outside assets, and using them to beef up the relative value of the "inside" assets, by prepaying the income taxes on the IRA. A person who is concerned about his own tendency to (wastefully?) spend "outside" assets could use a Roth conversion to decrease those outside assets in a productive way.

E. **Diversification of tax risk.** The Tax Code changes constantly. Recent decades have seen changes that discriminated against retirement plan assets (such as the 15% excise tax on "excess" plan accumulations and distributions that applied under § 4980A from 1987–1996, and the low 15 percent tax rate applicable through 2010 to certain dividends and capital gains earned outside a plan); as well as changes that favor retirement benefits (for example, the 3.8% investment income surtax (¶ 2.1.02) will not apply to retirement plan distributions). A client can diversify his tax risk by placing some bets on every "box": traditional plan, Roth IRA, and outside-the-plan investments.

F. **Control of taxable income levels.** To control levels of taxable income, ideally, a retiree would have a combination of traditional and Roth retirement plans and outside investments. That way, taxable income can be increased (to use up deductions or take advantage of lower tax brackets) by taking more from the traditional plans, or spending can be financed without increasing taxes by withdrawing from a Roth IRA or outside investments. A large slug of income in the conversion year could result in many later years of lower income for purposes of graduated income tax brackets, Medicare "Part D" premiums, and the taxability of Social Security benefits (§ 86).

G. **Longevity insurance.** Roth IRAs have appeal for retirees who expect to live beyond the average life expectancy due to their genetic heritage and/or health. A traditional IRA participant approaching age 70½ faces forced distributions that may substantially diminish the account over a long life span. With a traditional IRA, the way to maximize tax deferral is to die prematurely, leaving benefits to a young beneficiary. By converting the traditional IRA to a Roth IRA, this person can eliminate the forced lifetime distributions and reverse the usual rule of thumb: The way to minimize taxes with a *Roth* IRA is to live as long as humanly possible, deferring the commencement of ANY distributions until that way-later-

than-normal death (and then leave the benefits to a young beneficiary to get the long life expectancy payout).

*5.8.03 **Factors that incline against a Roth conversion***

Here are factors that tilt in favor of not spending money to convert existing traditional plans to a Roth IRA.

A. **Investment risk.** If the client's investments decline in value, that is a "bad thing" regardless of whether the investments were held in a traditional or a Roth plan. Nevertheless, it is financially worse when the decline occurs inside a Roth plan, because the client has also lost the income tax money he paid for the conversion. At least when investments tank inside a traditional plan, Uncle Sam is sharing the loss.

Ruby Example: Ruby has a $1 million IRA and $350,000 of cash outside her IRA. She converts the IRA to a Roth and spends the $350,000 of cash paying the income tax on that conversion. Then the IRA's value declines to $700,000. Ruby ends up with $700,000 of after-tax money (inside the Roth IRA). If she had *not* converted, the IRA would have shrunk to $700,000 and she would still have the outside cash; she could then have cashed out the $700,000 IRA, paid tax of only $245,000 on that distribution, and been left with $755,000 of after-tax money instead of $700,000.

This factor would be of less concern to someone whose IRA investments are in cash or some type of guaranteed-return annuity product.

B. **Future tax rate lower.** The Roth deal is unfavorable if the benefits would be subject to income taxes at a lower rate when they come out than the rate the participant paid to convert the plan to a Roth. For Americans (the majority?) who will be in a lower bracket after retirement than they are during their working years, the Roth conversion seems unlikely to be profitable. For an argument that Roth conversions are a bad idea for most workers, see DeFrancesco, Roccy, "Even Ed Slott is Wrong about Roth IRA Conversions" (7/1/09), at www.producersweb.com.

C. **Legislative risk.** Prepaying the income tax would also presumably turn out to be a bad deal if the income tax is replaced by a value-added tax (though that scenario seems unlikely). One skeptic won't "Roth" because he expects that retired baby boomers will use their electoral clout to cause Congress to make *all* pensions wholly or largely tax-free; that scenario also seems unlikely.

A perhaps more realistic worry is that Congress, in a desperate search for revenue, will seek ways to diminish the benefits of the Roth account, especially if there are massive conversions by "the rich" trying to keep their taxes in check. Presumably Congress would not simply declare that Roth distributions are taxable after all, but they could: make Roth IRAs subject to lifetime minimum distribution rules, or faster post-death minimum distribution rules; mandate that all of a Roth's earnings accrued after a certain date would be taxable; subject Roth distributions to income tax, with a credit being given for taxes previously paid; and/or count Roth IRA distributions as income for

purposes of Medicare premiums, the taxability of Social Security benefits, the alternative minimum tax, or the "threshold" for the post-2012 surtax on investment income (¶ 2.1.02).

The question is, how much weight should be given to these prospective scenarios? Should a client bet everything on these possible outcomes and convert nothing to a Roth IRA, despite a projection that (if these negative rule changes do NOT occur) the Roth conversion would be favorable for him?

5.8.04 ***How participant's conversion helps beneficiaries***

Beneficiaries of a traditional IRA can NOT convert that inherited IRA to a Roth. ¶ 4.2.05 [Appendix A]. If the participant converts his IRA to a Roth IRA prior to death, that conversion can benefit his beneficiaries:

A. **Reduce estate taxes.** Converting to a Roth IRA can reduce the participant's *estate taxes* by removing the income taxes due on the Roth conversion from the gross estate. Unlike gift taxes payable on gifts made within three years of death, income tax paid (or due) on a Roth conversion that occurs within three years of death is NOT brought back into the estate for purposes of computing estate taxes. If the participant dies owning a traditional retirement plan, and the estate is subject to estate taxes, the plan beneficiaries do get an income tax deduction for the federal estate taxes paid (the "IRD deduction"; see § 691(c) and ¶ 4.6.04). However the IRD deduction often does not fully eliminate the "double tax" effect, because (1) the beneficiaries get no income tax deduction for *state* estate taxes and (2) as an itemized deduction, the IRD deduction may be reduced if the beneficiary has a high income (see § 68).

For individuals with estates under $5.34 million (as of 2014), there is no federal estate tax to worry about, but many states still have death taxes. Reducing the state death tax by means of a Roth conversion prior to death is tax efficient, because otherwise the beneficiaries will have to pay both the state death tax *and* (later, when they withdraw the benefits) federal and state (if any) income taxes on the benefits.

Assuming the federal estate tax is reinstated at some point, paying the income tax on the benefits prior to death has the effect of reducing the federal estate tax. If this has the effect of reducing the estate below the federal "exemption" amount, it could save the estate money in the cost of preparing a federal estate tax return.

B. **Low bracket parent, high bracket children.** A participant may do a Roth conversion to save *income taxes* for his beneficiaries:

Rhonda Example: Rhonda is a widow, age 65, living happily on her Social Security payments plus $50,000 a year withdrawn from a substantial traditional IRA. Her children are all in the highest income tax bracket, and some day those high brackets will apply to distributions the children take from the traditional IRA they inherit at her death. She can convert some of the traditional IRA to a Roth IRA each year to use up her lower income tax brackets. The high-bracket children will pay no income tax on distributions from the inherited Roth IRA.

C. Simplify beneficiaries' lives. Even if the pure mathematics indicate no advantage to having the participant pay the income tax on the retirement benefits now by converting to a Roth (rather than having the beneficiaries pay it later by inherited a traditional plan), it would be a convenience to the beneficiaries to inherit a Roth IRA (distributions from which are tax-free) rather than a traditional IRA, so they do not to have to wrestle with the valuable but complicated IRD deduction every year (see "A").

*5.8.05 **Annual contributions: Traditional vs. Roth plan***

This section discusses the choice between contributing to a Roth IRA vs. contributing to a traditional IRA, and contributing to a DRAC vs. a traditional 401(k) or 403(b) account.

A. Traditional vs. Roth IRA. An individual who has compensation income, and whose AGI is under the limits described at ¶ 5.3.04(C), has the option to contribute to a Roth IRA. If he is under age 70½ (as of the end of the tax year) he also has the option to contribute to a traditional IRA instead of to a Roth IRA, or to contribute part of his maximum permitted regular contribution amount (¶ 5.3.03) to each type of IRA. Assuming he wants to contribute to an IRA, and is eligible to contribute to either type, which type should he contribute to?

The decision is easy if the choice is between a Roth contribution and a *nondeductible* contribution to a traditional IRA. If there is no tax deduction for the IRA contribution, then the Roth option is "free." A Roth IRA is always better than a traditional IRA if it's free. See ¶ 5.8.01. A traditional IRA contribution is either totally or partially nondeductible if the individual and/or his or her spouse participates in a workplace retirement plan and had modified adjusted gross income (AGI) in excess of certain amounts. § 219(g)(3)(B). Similarly, the decision is easy if the individual's taxable income is so low he is not subject to income tax, since, again, he gives up nothing by opting to contribute to the Roth IRA.

If neither the individual (nor his spouse) is an active participant in an employer plan; or, if he (or his spouse) is an active participant in an employer plan, but his (or their) AGI is low enough that he can get a tax deduction for a contribution to a traditional IRA; *and* his (or their) tax bracket is higher than zero; then his choice is between a *deductible* traditional IRA contribution (which could save him some current income taxes) and the nondeductible Roth IRA contribution. He should consider the factors discussed at ¶ 5.8.01–¶ 5.8.04 in making this choice.

B. Traditional 401(k)/403(b) vs. DRAC. Which 401(k) participants should choose the DRAC (¶ 5.7)? By choosing the DRAC, the individual gives up the immediate tax savings of having the contribution excluded from his income. The savings could be as high as 39.6%/43.4% of the contribution amount (maximum federal income tax rates as of 2014). The choice could be made considering whichever of the factors listed in ¶ 5.8.01–¶ 5.8.04 are applicable.

Bunny and Honey Example: Bunny and Honey are both 55-year-old lawyers with incomes over $500,000, looking to maximize savings for a planned retirement in five to ten years. Both are in 401(k) plans that offer DRACs.

Bunny is a partner in large firm. The only tax-deferred retirement savings plan she has is the firm's 401(k) plan, where her account is now worth $600,000. Her only "tax shelter" is her annual

401(k) salary deferral contribution. She does not want to give up the tax deduction. She does not bother to get a projection of her present vs. future tax rates; she opts for a traditional 401(k) contribution.

Honey is a solo practitioner with a defined benefit pension plan now worth $1 million. She also has a self-employed 401(k) plan worth $50,000 and a traditional IRA worth $600,000. Her contribution to the defined benefit plan in 2014 will be $120,000, tax deductible. She feels that the tax-deferred side of her balance sheet is already large enough and it will only get larger through internal growth and future plan contributions. She opts for a DRAC, to start building up a different type of tax-advantaged retirement plan.

Eric Example: Eric has a choice of building his savings either inside or outside retirement plans. He prefers to maximize his savings inside tax-favored retirement plans, because he believes such savings are safer from potential creditors and from his own tendency to overspend. He also finds investing easier inside a retirement plan, because there is no need to track the cost basis and holding period of each investment in a plan. He figures that by contributing $15,000 to a traditional 401(k) he's really only stashing away about $10,000 in the plan, because (based on his income tax bracket) the plan "owes" the government roughly 33 percent income tax on the contribution. He will have to pay that "debt" when he withdraws money from the traditional 401(k) plan. With a Roth account, he is in effect increasing his plan contribution. Contributing $15,000 to a Roth plan is equivalent to contributing $22,500 to a traditional plan.

5.8.06 ***Roth conversion tips from all over***

Here are matters and ideas to consider for clients contemplating or proceeding with a Roth conversion, including ideas from various advisers on how to make the conversion process easier and more profitable. Those with a ★ are strongly recommended for most if not all clients. The rest are presented for the planner's consideration; they may be valid for some clients. For ideas specifically NOT recommended (☹) see ¶ 5.8.07 and ¶ 1.5.13.

A. ★**Everyone should open a small Roth IRA.** Regardless of what gut instinct or the spreadsheet says, everyone who does not already have a Roth IRA, and who has a traditional plan or IRA that could be converted to a Roth, should open a Roth IRA as soon as possible, by converting at least a small amount from a traditional plan or IRA. This step is recommended even for someone who is not ready to commit to a larger conversion.... even for those who are sure they never want to do any conversion! This will get the client's five-year clock started (see ¶ 5.2.05), which will be beneficial if the client ever later decides to do a larger Roth conversion or needs to roll funds from a DRAC to a Roth IRA (see ¶ 5.2.05(C)). This will also make future conversions easier because the client will already have a Roth IRA open; the future conversion will involve nothing more than transferring more money from the traditional plan into the already-opened Roth IRA (but see "P").

B. **Convert everything now, analyze later.** Usually we think the process is, analyze the Roth conversion strategy and if it looks like it might make sense, convert. An alternative approach is for the client to convert every traditional plan and IRA he owns to a Roth IRA as early as possible, and wait until September of the following year (just before the client has to decide

whether to "unconvert") to analyze whether the conversion is beneficial. If it is, keep it. If it appears not beneficial at that time, recharacterize it. The pitch to the client is, "Don't analyze now! There's no point! The success or failure of your Roth conversion depends on future tax rates, spending needs, and investment results, which are unknowable now. You get to 'undo' (recharacterize; see ¶ 5.6) the conversion as late as October 15 of the year after the conversion, and by then we'll know a lot more." See *The Gospel of Roth* by John D. Bledsoe, http://www.johnbledsoe.com/books.html.

C. ★**For the cheapest conversion, avoid "diluting" basis.** A client who has after-tax money in a qualified plan or 403(b) plan and who wants to do a Roth conversion should convert directly from that plan to a Roth IRA, rather than rolling the money to an IRA first (if he has any preexisting IRAs that contain pretax money).

Susan Example: Susan has $200,000 in her company's 401(k) plan, of which $50,000 (25%) is after-tax money (basis). She is retiring in 2010. She also owns an IRA worth $400,000, all of which is pretax money. By converting directly from the 401(k), she can get a "cheap" Roth conversion—she can create a $200,000 Roth IRA while paying tax on only $150,000. If she rolls the money into an IRA then converts $200,000 of the IRA to a Roth, only about 8.3 percent of the conversion ($50,000 ÷ [$200,000 + $400,000] = 8.333%) will be tax-free; see ¶ 2.2.08 [Appendix A]. Combining the plans has diluted the value of her after-tax money. Of course if she wants to convert the entire $600,000 it doesn't matter whether she rolls the 401(k) into a traditional IRA before converting.

For the same reason, a client who is converting an IRA that contains substantial after-tax money should avoid rolling over additional pretax funds into an IRA later in the conversion year: See "Ted Example," ¶ 2.2.08(G) [Appendix A].

D. **For a "free" conversion, isolate basis.** An individual who wants to convert ONLY the after-tax money in his plan should read ¶ 5.4.03(B) and ¶ 5.4.04(B).

E. ★**Consider whether to increase basis.** If a client *already has* after-tax money in his IRA, making nondeductible contributions will increase the proportion of the client's Roth IRA conversion that will be "tax-free." A few retirement plans permit employee after-tax contributions, including catch-up contributions, that can occasionally be substantial. Making such contributions, then rolling the plan directly to a Roth IRA, would be a good cheap way to get a Roth IRA. See PLR 2009-09074, in which an employee was allowed to make various contributions to the employer plan then roll over his account to a Roth IRA. But if the client's existing IRAs consist entirely of pretax money, and are worth more than he is likely to want to convert, the client should not make small nondeductible contributions prior to the Roth conversion:

Archie Example: Archie has a $1 million IRA, all of which is pretax money. He would like to convert $100,000 of this to a Roth IRA in 2010. He is considering making a $6,000 nondeductible IRA contribution in 2010 "to make part of his Roth conversion tax-free." Following this contribution, his IRA will be worth $1,006,000. If he then converts $100,000 of the IRA to a Roth,

only $596 of the conversion ($6,000 ÷ $1,006,000 X $100,000) will be "tax-free"…and he will be forever stuck with having to compute the minuscule nontaxable portion of every IRA distribution he later takes (under the "cream-in-the-coffee rule"; see ¶ 2.2.02). He cannot eliminate this "dilution" problem by putting his after-tax contributions into a separate IRA, because all IRAs are treated as a single account for purposes of applying the fraction used to determine which portion of any distribution (or conversion) is tax-free (¶ 2.2.08) [Appendix A].

F. ★**Consider state tax impact.** Do not overlook the state tax impact of a conversion, especially if the client is considering changing domicile to a state with higher or lower income taxes, or to a state that would not give him "credit" for plan contributions that were not eligible for a state income tax deduction; or if the client is planning to leave the retirement plan at his death to beneficiaries who are in a state that has higher or lower income taxes than would apply to the client's conversion. If the conversion generates a substantial state income tax, choose carefully the year in which the state tax is paid. If a large state tax bill is not matched to a large federal income in the same year, the alternative minimum tax (AMT; § 55) may eliminate the benefit of the deduction for the state tax. This book does not cover state taxes.

G. ★**Keep a Roth and traditional IRA open at same firm.** Open the client's Roth IRA at the same firm that already holds the client's traditional IRA. Then the conversion will be easy and instantaneous. Moving money from one firm to another takes much longer than moving money between two accounts at the same firm. Also leave a small traditional IRA open at this firm even if the client is converting "everything" (else) to a Roth IRA; doing so will make it much easier to recharacterize (by moving money out of the Roth IRA into the already-open traditional IRA) should that be necessary. Verify that the IRA provider can handle recharacterizations; anecdotal evidence indicates that not all IRA providers are prepared to do so.

H. ★**Take RMD before converting.** A person who is attaining age 70½ in the year of the proposed Roth conversion, or who attained that age in an earlier year, must take his RMD for the conversion year out of his traditional IRA BEFORE he converts all or part of the rest of the account to a Roth IRA. ¶ 5.2.02(E).

I. **Consider whether conversion tax can be reduced.** Since a large Roth conversion will typically produce a higher-than-normal income tax, clients may want to seek appropriate ways to reduce that one-time tax hit. Various advisors recommend generating a large charitable deduction (such as by making a gift to a donor-advised fund (¶ 7.5.03) or a charitable lead trust (¶ 7.5.09)) in the year of the conversion, or any investment that provides a large up-front tax deduction.

J. ★**Opt out of tax withholding on the conversion.** The client must check a box on the request form to avoid having the transferring plan withhold income tax on the conversion. If income tax is withheld, the withheld portion of the distribution will be subject to income tax (and 10% penalty, if the participant is under age 59½, unless an exception applies), but

will not end up inside the Roth IRA (unless the converter manages to complete the rollover of the withheld funds within 60 days using substituted funds; Reg. § 1.402(c)-2, A-11).

K. ★**Name a beneficiary for the Roth IRA.** Don't forget this vital step! See ¶ 5.8.08(A).

L. ★**Provide guidance in case of client's death, disability.** See ¶ ¶ 5.8.08(B).

M. ★**Fulfill estimated tax obligations.** A Roth conversion will usually increase the client's income (and income tax) for the conversion year. The exceptions are, if the conversion consists primarily of after-tax money; or if the entire conversion is recharacterized, or if the conversion-income is totally offset by some type of loss deduction.

Normally income tax (if not withheld) must be paid in the form of four equal estimated tax payments throughout the year, but there is a safe harbor escape hatch: As long as an individual pays100 percent of his *prior year's tax* in the form of quarterly estimated taxes (or 110%, in the case of high-income taxpayers), the individual is "excused" from paying the full estimated tax. Most people should use this exception to avoid paying the estimated income tax on the conversion before they have to. As a reminder, any later increase in the "prior year's tax" (as a result of an audit for example) could cause loss of the client's qualification for this exception.

Another approach to the estimated tax obligation is to pay the tax not in level quarterly instalments, but in instalments that vary in amount depending on the individual's actual income and deductions during the period covered by the instalment. If using this method, this author assumes that the income resulting from a Roth conversion would be deemed "received" in the month that the distribution that was converted is made, but some advisors treat it as received ratably throughout the year. Finally, if the Roth conversion results in a big one-year "bump" in income, it will be very expensive in the year *following* the conversion to use the 100%/110%-of-prior-year's-tax approach to paying estimated taxes.

N. ★**Extend the return (but pay tax by April 15th).** It is recommended that the client get an extension of time to file the income tax return (Form 1040 or Form 1041) for the conversion year to October 15 (instead of April 15) of the year following the conversion year, to make recharacterization easier. The client does not have to actually get an extension of time to file the tax return in order to be entitled to recharacterize as late as October 15 (see ¶ 5.6.06); but recharacterizing after the return has already been filed necessitates filing an amended return. Even if an extension of time to file the return for the conversion year is obtained, the *tax* is still due on April 15th of the following year.

O. ★**File the tax return on time.** Everyone says "the client has until October 15 of the year after the year of the conversion to decide whether to recharacterize a Roth conversion." That is not strictly speaking true. The recharacterization deadline is October 15 of the year after the year of the conversion *if and only if the tax return for the year of the conversion is filed on time*. See ¶ 5.6.06.

P. **Put each year's conversions into a separate Roth IRA.** This choice faces someone who, at the time he is converting a traditional plan or IRA to a Roth IRA, already has one or more

Roth IRAs in existence. The question is whether the current year's Roth conversion should be made into a new separate Roth IRA, or whether it should be rolled into one of the individual's existing Roth IRAs.

The advantage of rolling into an existing Roth IRA is simplicity of administration of the account—it's easier to have just one Roth IRA rather than multiple Roth IRAs. The advantage of creating a brand new separate Roth IRA for the current year's conversion is that having a separate Roth IRA makes it much easier to recharacterize the amount converted, if that is later desired. If the "new" conversion is made into its own separate Roth IRA, recharacterization involves simply closing that account and transferring the entire amount to a traditional IRA. If the new conversion money is commingled with a pre-existing account, then later recharacterizing would involve apportioning post-conversion (pre-recharacterization) earnings between the new and the old money, which is more complicated. See ¶ 5.6.02.

Q. **Convert different asset classes to different Roth IRAs.** Once the Roth conversion is done, investments made within the new Roth account might go up or down. The participant has a period of time to recharacterize and undo the Roth conversion; see ¶ 5.6. If only some of the assets in the converted IRA declined and others appreciated, the participant would like to undo the conversion only as to the assets that declined in value—but the tax law does not let him "cherry pick" in that way. See ¶ 5.6.04. However, if he converted his IRA to *multiple* Roth IRAs, the law does allow him to "unconvert" one or more of the multiple Roths without undoing all of them. See Reg. § 1.408A-5, A-2(b), (c)(5), and (6), Example 2.

Thus, a client might consider converting his IRA into several Roth IRAs, with portfolio assets whose values are less likely to move in tandem placed into separate Roth IRAs. That way, if one asset class declines in value prior to the deadline for recharacterizing the account, he can recharacterize just the Roth IRA that holds that asset class, and leave the other Roth IRAs alone. For more detail on this idea, and illustrations, see Keebler, R.S., *et al.*, "Roth Segregation Conversion Strategy," *Taxes* (CCH), June 2003, page 3.

If using this strategy, the assets can be moved directly from a single traditional IRA into the multiple destination Roth IRAs; it is not necessary to first divide the assets into multiple traditional IRAs then convert those.

R. ★**Keep the tax money in a safe place.** Once a client does a Roth conversion, the client has incurred a debt to Uncle Sam for the income tax on that conversion. The money to pay that debt should be set aside in a very safe place such as insured CDS, or perhaps even be sent to the IRS as estimated taxes. The client should not spend the money, give it away, or invest it in such a way as to risk losing it. It's true the client has a certain period of time to undo the conversion by recharacterization (¶ 5.6), but he should not want to risk being forced to recharacterize because he "blew" the income tax money.

5.8.07 ***Roth planning ideas that do not work***

Here are some bright ideas about how to make money on a Roth conversion that all have one thing in common: They don't work.

1. ☹"Since I have to take an RMD from my traditional IRA anyway, and pay tax on it, I might as well convert the RMD to a Roth IRA so I at least get some benefit." Sorry, you cannot convert an RMD to a Roth IRA. See ¶ 5.2.02(E).

2. ☹"I'll convert everything in my traditional IRA except the RMD; I'll leave that in the traditional IRA for now, in hopes that Congress renews the qualified charitable distribution (QCD; see ¶ 7.6.07) for 2010, so I can use a QCD to satisfy the RMD." This doesn't work because the first dollars out of the IRA in any year ARE the RMD, so you can't leave the RMD in and convert the rest.

However, there's a grain of a good idea here: A client could just transfer his RMD to charity NOW, and then convert the rest of the account. If later in the year Congress renews QCDs retroactive to the beginning of the year (as they did in 2006, 2008, etc.), then the client will have made his tax-free QCD. If Congress doesn't do that, he's no worse off because he would have had to take that RMD and pay tax on it in any case.

3. ☹"I'll convert everything to a Roth IRA right now, then I'll 'recharacterize' in September next year by transferring the contribution back to a traditional IRA just before the recharacterization deadline. In the meantime, I will have invested for a profit and I'll leave those profits inside the tax-free Roth IRA, but will have no tax on the conversion because I've returned the contribution to the traditional IRA." This doesn't work: To recharacterize, you must transfer both the contribution AND the earnings thereon back to the traditional IRA. See ¶ 5.6.03(A).

4. ☹"I'll transfer my NUA stock in a lump sum to a Roth IRA, pay tax on only the plan's basis, and the NUA will later be distributed tax free from the Roth IRA." Forget it. The IRS treats this as if you transferred the stock to a traditional IRA FIRST, meaning you pay ordinary income tax on the entire conversion. Furthermore you lose your NUA deal permanently (even if you later recharacterize the Roth conversion). See ¶ 5.4.04(A).

5. ☹"I'll just convert my contributory IRA. It is mostly after-tax money, so the conversion will be almost tax-free. I'll leave my rollover IRA as is, because it's all pretax money." Out of the question. Both accounts are aggregated for purposes of applying the cream-in-the-coffee rule. See ¶ 5.4.03(B).

6. ☹"I'll convert my entire IRA to a Roth this year, so my traditional IRA balance is zero on December 31, then recharacterize the conversion next year. That way I will owe no income tax on the conversion (because I recharacterized it) but also will have no RMD for next year (because the prior year-end balance of the traditional IRA was zero)." Guess what: They thought of that. If a conversion is recharacterized after the end of the conversion year, the

recharacterized amount is added back to the traditional IRA's year-end balance (for the year of the conversion) for purposes of computing the following year's RMD. See ¶ 1.2.07.

7. ☹"My kids are in a lower tax bracket than I am. I'll leave them my IRA and they can convert it to a Roth after I die." No, they can't convert an inherited IRA (but they could convert an inherited QRP benefit if you left them that instead). See ¶ 4.2.05 [Appendix A].

5.8.08 ***Roth plans and the estate plan***

Here are matters the estate planner needs to consider in connection with a client's Roth plans or conversions.

A. Choice of death beneficiary. Roth benefits generally should not be left to charity; there is no point in prepaying the income taxes on money being left to a tax-exempt entity. This principle may require an individual who participates in a 401(k) or 403(b) plan to designate different beneficiaries for his DRAC and traditional 401(k)/403(b) accounts, if the plan permits such split beneficiary designations.

A Roth plan substantially eases the problems of leaving retirement benefits to a noncitizen spouse. The surviving noncitizen spouse, as beneficiary of the Roth IRA, can roll the account into a trusteed Roth IRA that is both "her own" Roth IRA and a "qualified domestic trust" (QDOT; § 2056A). Many of the problems of leaving traditional retirement benefits to a noncitizen spouse arise from the fact that such benefits are taxable as income in respect of a decedent and subject to minimum required distributions during the spouse's overlife, even if she rolls them over to her own IRA; see § 691 and the author's Special Report *Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*, available through www.ataxplan.com. The trusteed Roth IRA that is also a QDOT eliminates these problems; the hardest problem is finding a trustee!

By leaving Roth plan death benefits (rather than traditional plan death benefits) to his grandchildren (or to a "see-through trust" for their benefit), the participant gives his beneficiaries the advantage of long-term tax-free investment accumulations and does not "waste" any of the GST exemption (see ¶ 6.3.17) paying income taxes. For economic advantages of a "stretch" payout of a retirement plan to young beneficiaries, see ¶ 1.1.03; for how to achieve a stretch payout for a trust named as beneficiary, see ¶ 6.2–¶ 6.3.

Whenever a client is leaving retirement benefits to a trust that is likely to accumulate some of the plan distributions, be aware that a trust goes into the highest income tax bracket (and will become subject to the 3.8% investment income "surtax"; ¶ 2.1.01) at a very low level of taxable income (about $12,000 as of 2014). If the client can prepay the income tax at a lower rate by converting the plan to a Roth IRA that option should be considered.

Using a Roth IRA to fund a credit shelter trust for the life benefit of the participant's surviving spouse, or a QTIP trust, does not make best use of the Roth IRA, for the following reason. The way to maximize the tax-free accumulation in a Roth IRA is to leave it outright to the participant's surviving spouse, who then rolls it over to her own Roth IRA and takes no distributions from it during her lifetime. At her death she leaves it to a young generation beneficiary for a stretched-out tax-free life expectancy payout. This approach allows total accumulation of all

earnings inside the tax-free Roth as long as either spouse is living, with a life expectancy payout to a younger beneficiary after both spouses' deaths.

In contrast, the longest distribution period possible for a Roth IRA left to a *trust* for the benefit of the spouse is the spouse's life expectancy; the account will be distributed over her life expectancy (not accumulated during her lifetime), and be reduced to zero at the end of her life expectancy (instead of at the end of the life expectancy of a younger-generation beneficiary). See ¶ 3.3.02.

B. Document changes needed to anticipate Roth conversion. The client's durable power of attorney should give the power-holder the power to convert any traditional plan or IRA to a Roth IRA and to recharacterize any IRA contribution made by the client.

Since the client's executor will have the power to recharacterize Roth conversion made by the client (assuming the client dies during the time window for recharacterizations), the client's estate plan should anticipate this possibility. See ¶ 4.1.02(C) regarding the conflict of interest between the Roth IRA beneficiary and the beneficiaries of the probate estate with respect to the question of whether the decedent's Roth conversion should be recharacterized by the executor (if the Roth and estate beneficiaries are not the same people in the same proportions). The estate planner could recommend such steps as:

✓ Including in the will an equalizing bequest to the Roth IRA beneficiary to compensate him for loss of the account's tax-free status if the executor recharacterizes.

✓ Including in the beneficiary designation form language that will prevent the Roth IRA beneficiary from blocking the executor's recharacterization of a Roth conversion.

✓ Giving the executor instructions, guidance, and/or protection regarding the recharacterization decision. Approaches that various practitioners have suggested include requiring recharacterization if the account value drops by more than certain percentage (and forbidding it otherwise), or requiring recharacterization if requested by certain beneficiaries.

C. Gifts with Roth IRAs. Depositing money in a Roth IRA for a teenage child, grandchild, etc., has great appeal as a gifting technique. Typically these young family members have summer or after-school jobs that generate compensation income on which an IRA contribution can be based. The projections of what a humble $5,500 contribution will grow to by the time the 15-year-old reaches age 65 can be staggering. What gives pause is that there is no way to prevent the donee from taking the money out of the account once he reaches the age of majority.

For this idea to work, the child must have compensation income. ¶ 5.3.02. Gifts are not compensation. If a parent pays his toddler a salary for performing household chores, the IRS might

maintain that the child has received a gift, not compensation, and that Roth IRA contributions based on this "compensation" are excess contributions subject to a penalty (¶ 5.3.05).

Donating cash to another individual's Roth IRA is a cash gift and does not create any particular problems. However, if the participant assigns *his own* Roth IRA by lifetime gift "to another individual," the gift causes the Roth IRA to be "deemed" distributed to the owner-donor, and accordingly it ceases to be a Roth IRA. Reg. § 1.408A-6, A-19. Needless to say, this treatment eliminates the advantages of such a gift.

Appendix A: Sections from other Chapters of *Life and Death Planning for Retirement Benefits* (7th ed. 2011)

These are sections of other Chapters of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) that contain information about Roth plans and Roth conversions.

Regarding partial Roth conversions of QRP distributions that contain after-tax money:

2.2.05 ***Partial rollovers and conversions: QRP distributions***

This ¶ 2.2.05 explains what happens to the pre- and after-tax portions of a distribution made to the participant if only *part* of the distribution is rolled over to an IRA (or the distribution is rolled into multiple recipient IRAs). Since Roth conversions are considered "rollovers" from the QRP to a Roth IRA (¶ 5.4.04), this ¶ 2.2.05 also applies to partial Roth conversions.

This section does not tell you *what constitutes a "distribution."* For that question, and for how to determine how much of any particular QRP distribution *is* after-tax money, see ¶ 2.2.04. Once you have identified a particular "distribution" made to the participant, *and* you have determined how much of that distribution is after-tax money, this ¶ 2.2.05 tells you what happens to the pre- and after-tax money included in that distribution if the participant (within 60 days; see ¶ 2.6.04) rolls over only part of the distribution (or rolls over all of it, partly to a traditional and partly to a Roth IRA).

A. The Myron Example. In this section, we will look at a specific example:

Myron Example: Myron is retiring. His profit-sharing plan account at Acme Widget consists of $50,000 of after-tax money (all post-1986) and $100,000 of pretax money.

As discussed at ¶ 5.4.04(B), Myron can get a "bargain" Roth IRA by converting this QRP account to a Roth IRA. If he directs the plan to transfer his entire account to a Roth IRA by direct rollover he gets a $150,000 Roth IRA but has to pay income tax on only $100,000. We now turn to the more complicated question of what happens if he rolls over or converts only *part* of his profit-sharing plan account. Here are the possible scenarios:

✓ Myron directs the plan to send $100,000 from the account to a *traditional* IRA via direct rollover and to send the other $50,000 to a *Roth* IRA via direct rollover. See "B" below.

- ✓ Myron directs the plan to distribute the entire $150,000 to him. Within 60 days after that distribution, Myron "rolls" $100,000 to a traditional IRA. He keeps the rest of the distribution ($50,000) in his taxable account. See "C" below.

- ✓ Myron directs the plan to distribute the entire $150,000 to him. Within 60 days after that distribution, Myron "rolls" $100,000 to a traditional IRA. After completing that rollover, but still within 60 days of the original distribution, he "rolls" the remaining $50,000 of the distribution into a Roth IRA. See "D" below.

B. Direct rollovers to traditional and Roth IRAs. The participant requests the plan to send part of the account to a Roth IRA, or part to a traditional IRA and part to a Roth IRA, via direct rollover in all cases.

In our "Myron" example (see "A"), suppose Myron directs his employer to "transfer the $50,000 of after-tax money in my account to my Roth IRA via direct rollover," and to leave the $100,000 of pretax money in Myron's QRP account. Alternatively, assume Myron directs the plan to "send the $50,000 of after-tax money in my account to my Roth IRA and send the $100,000, of pretax money to my traditional IRA, in both cases via direct rollover."

C. Partial rollover of distribution that contains after-tax money. What happens if a participant receives a distribution that is partly pretax money and partly after-tax money, and the participant rolls over *part* of that distribution within 60 days?

Using the "Myron" example (see "A"), Myron directs the plan to distribute his entire $150,000 account to him. Within 60 days after that distribution, Myron "rolls" $100,000 (equivalent to the pretax money in the account) to a traditional IRA. He keeps the rest of the distribution ($50,000, equivalent to the after-tax money) in his taxable account.

The Code has a specific rule, in § 402(c)(2), dealing with the partial rollover of a QRP distribution that contains both pre- and after-tax money. The rule is a little convoluted, but the bottom line is that, where there is a partial rollover, the pretax money is deemed to be rolled over "first."

Here is how we reach that conclusion. § 402(a) tells us that distributions from QRPs are includible in gross income. ¶ 2.1.01. § 402(c)(1) then tells us that § 402(a)'s general rule of income-inclusion does *not* apply to the "portion" of any eligible rollover distribution that is transferred to another retirement plan. In other words, amounts properly "rolled over" to another plan are excluded from gross income despite § 402(a).

Then comes the mysterious and convoluted § 402(c)(2). This section seems to be trying to say that, notwithstanding § 402(c)(1), the participant cannot roll over any after-tax money that was included in his plan distribution; except that (A) he *can* even transfer after-tax money to a nonIRA plan *if* such transfer is accomplished via direct rollover, and (B) he *can* roll over after-tax money to an IRA. The last sentence of § 402(c)(2) then says that "in the case of a transfer described in subparagraph (A) or (B)" (i.e., *any* rollover to an IRA, or a *direct rollover* to another QRP), the amount transferred into the plan or IRA that receives the rollover "shall be treated as consisting first of the portion of the distribution that" would have been includible in gross income if it were not rolled over.

This last sentence of § 402(c)(2) clearly says that, if the employee receives a distribution from the plan, then rolls over only *part* of the distribution, the part rolled over is deemed to come from the pretax money included in the distribution first. This rule enables the employee to isolate the after-tax money *outside* the plan, while rolling over the pretax money to keep it tax-sheltered in an IRA. The IRS agrees with this conclusion; see Regs. § 1.402A-1, A-5(b), and § 1.402(c)-2, A-8; PLR 9840041; and IRS Publication 575, *Pension and Annuity Income* (2013), p. 27, which says: "If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll is treated as coming first from the taxable part of the distribution."

The last sentence of § 402(c)(2) *also* seems to say that, when a distribution is "split" between an outright distribution to the employee and a direct rollover to another eligible retirement plan, the direct rollover is treated as part of the "total distribution" and is deemed to come out of the pretax money first.

In Myron's case, taking a total distribution of $150,000 from the plan would make him subject to mandatory income tax withholding of 20 percent of the taxable portion. The taxable portion of the distribution is $100,000, so the withheld income tax would be $20,000, leaving Myron with $130,000 of cash. He then could roll $100,000 of this into a traditional IRA. If that is all he does, he would be deemed to have rolled the pretax money entirely into the traditional IRA. He will then be left with zero tax on the distribution, $30,000 in is taxable account, and a $20,000 credit for the withheld tax on his income tax return for the year of the distribution. Using a direct rollover instead would avoid the mandatory income tax withholding.

D. **Successive 60-day rollovers.** What if the participant, having taken a total distribution of his account, then rolls over the entire distribution in two stages—*first* he rolls the pretax money into a traditional IRA, *then* he rolls the after-tax money into a Roth IRA, all within 60 days after the original distribution?

In the "Myron Example" (see "A"), suppose Myron, after receiving the $150,000 cash distribution from the plan (minus $20,000 mandatory income tax withholding), and after rolling $100,000 over into a traditional IRA within 60 days (see "C"), later (but still within 60 days after the original distribution) rolls the final $50,000 of the distribution into a Roth IRA. (Because $20,000 of his distribution was sent to the IRS as withheld income taxes he will have to make up that $20,000 using "substituted funds" in order to complete a rollover of the entire distribution; see Reg. § 1.402(c)-2, A-11.)

Now his entire $150,000 distribution has been rolled over. Did he succeed in rolling the pretax money to a traditional IRA and the after-tax money into a Roth IRA? Or has he simply rolled proportionate amounts of each into each IRA? Experts disagree on the answer to this question. The IRS has not given its opinion. Accordingly, it is preferable to use the split-direct-rollover procedure blessed by the IRS in Notice 2014-54 (see ¶ 5.4.04(B)) and avoid these conundrums.

One expert says: The amount includible in income on account of a Roth conversion of a QRP distribution is, whatever would have been included if the amount contributed to the Roth had NOT been rolled over at all. § 408A(d)(3)(A)(i). If Myron had *not* rolled over the final $50,000 of the distribution he received, even the IRS agrees it would have been tax-free, because of the final sentence of § 402(c)(2) (see "C" above). That amount would not have been taxable if it had NOT been rolled over, therefore § 408A(d)(3)(A)(i) says it is not taxable when it IS rolled over to a Roth IRA.

But another expert says: The concept of the "tax-free" second rollover (transferring the after-tax money into a Roth IRA) depends on the last sentence of § 402(c)(2). The last sentence of § 402(c)(2) tells us what happens when only PART of a particular distribution is rolled over. In this case, the ENTIRE distribution has been rolled over within 60 days. Therefore the "partial rollover" rule is irrelevant. There is one distribution, and if the entire distribution was rolled over within 60 days it doesn't matter how many IRAs that distribution was rolled into or in what sequence. § 402(c)(2) simply doesn't apply, so both rollovers will carry proportionate amounts of the pre- and after-tax money (and the Roth conversion is not "tax-free").

Regarding partial Roth conversions from traditional IRAs that contain after-tax money:

2.2.08 ***How much of a traditional IRA distribution is basis?***

Distributions from traditional IRAs are taxed under the cream-in-the-coffee rule of § 72 (¶ 2.2.02). § 408(d)(2); § 72(e)(2)(B), (5)(A), (5)(D)(iii), and (8)(B). For taxation of distributions from a *Roth IRA*, see ¶ 5.2.03.

A special aggregation rule applies to IRAs that does not apply to other plans: For purposes of determining how much of any particular distribution is a return of the participant's basis, all of the participant's IRAs are treated as a single giant IRA (aggregation of accounts; see "F") and all IRA distributions during the year are treated as one distribution (see "B"). Since the conversion of funds from a traditional to a Roth IRA is treated as a distribution from the traditional IRA (¶ 5.4.03), these same aggregation rules are used to determine how much income a participant realizes when he converts funds from a traditional IRA to a Roth IRA. Reg. § 1.408A-4, A-7(a).

This section explains how to apply this "cream-in-the-coffee" formula to distributions from a traditional IRA.

A. **The cream-in-the-coffee formula.** Here is the formula for determining how much of a particular year's IRA distributions (and Roth conversions) constitutes tax-free return of the participant's investment in the contract (basis), adapted from Notice 87-16, 1987-1 C.B. 446, Part III. The total amount of the participant's IRA distributions for the year is multiplied by a fraction. The numerator of the fraction is the total of the participant's after-tax contributions. The denominator is the [total balance of all his traditional IRAs as of the end of the year in which the distribution occurs] plus [the distribution amount].

Return of Basis = [Distribution Amount] X [The Fraction]

The Fraction is:
Total Nondeductible Contributions
[Year-End Account Balance + Distribution Amount + Outstanding Rollovers]

Remember, the purpose of this formula is to determine how much of the year's Roth conversions and (nonrolled) distributions consisted of after-tax money. The following paragraphs discuss aspects of this formula. The taxable portion of distributions and of Roth conversions are figured on different parts of IRS Form 8606 using this formula. …

[formula details from *Life and Death Planning for Retirement Benefits* omitted; see the book or see IRS Form 8606 and Instructions.]

C. Year-end Account Balance. This is the total combined account balance of all of the participant's countable traditional IRAs (for excluded accounts see "F"), computed as of the end of the year in which the distribution occurs. § 408(d)(2)(C). Use IRS Form 8606 and its instructions and related worksheets to compute the Year-end Account Balance; here are some points to consider: …[details omitted]

[**D–E** omitted]…

F. The aggregation rule: Which IRAs must be aggregated. § 408(d)(2) provides that: "For purposes of applying section 72 to any [IRA distribution]...(A) all individual retirement plans shall be treated as 1 contract, [and] (B) all distributions during any taxable year shall be treated as 1 distribution...." Here are the IRAs which must be (or must not be) aggregated with each other for purposes of determining the A–E amounts above.

"Individual retirement plans"to be aggregated include the participant's traditional IRAs, individual retirement annuities, SEP IRAs, and SIMPLE IRAs. See § 7701(a)(37); § 408(k)(1), (p)(1); and Notice 87-16, Part III. All such accounts the participant owns are considered one giant IRA; then, each distribution from any such account is counted as part of the Distribution Amount. § 72(e)(2)(B), (5)(A), (5)(D)(iii), and (8)(B). However:

✓ *Inherited* IRAs held as beneficiary are *not* aggregated with the individual's own IRAs for this purpose; see ¶ 2.2.07.

✓ *Roth IRAs* are not aggregated with *traditional IRAs* for this purpose. § 408A(d)(4)(A).

✓ IRAs of *husband and wife* are not aggregated with each other. Each spouse's IRAs are aggregated only with other IRAs belonging to that spouse. See Notice 87-16, Part III, D7, and Instructions for IRS Form 8606 (2013), "Specific Instructions," first paragraph (page 6), stating that Form 8606 is completed separately for each spouse.

G. Cream-in-the-coffee formula: Examples. The following examples illustrate the formula:

Gibbs Example: Gibbs has made a total of $12,000 in nondeductible contributions to his traditional IRA at X Mutual Fund, which is now worth $30,000. He also has a traditional IRA worth $210,000 (as of the end of Year 1) at Y Mutual Fund. The larger IRA received no after-tax contributions; it contains only a rollover from a QRP maintained by Gibbs's former employer, plus some deductible IRA contributions Gibbs made prior to 1987. He has no other IRAs. In Year 1, he cashes out the $30,000 IRA. He thinks that, because that particular account contains his $12,000 of after-tax contributions, he will be taxable on only $30,000 - $12,000, or $18,000. However, because of § 408(d)(2), Gibbs's $30,000 distribution is *deemed* to come proportionately from *both* of his IRAs,

even though it *actually* came from only one of them. Here is how the cream-in-the-coffee fraction applies to Gibbs's distribution:

Distribution Amount: $30,000
Total Nondeductible Contributions: $12,000
Year-end Account Balance: $210,000
Outstanding Rollovers: zero

Return of Basis = $30,000 X [$12,000 ÷ ($210,000 + $30,000)] = $1,500

The amount of gross income Gibbs must report is therefore $28,500 ($30,000 distribution minus $1,500 basis assigned to the distribution). His remaining basis in his traditional IRA is $10,500 ($12,000 total basis, less $1,500 used up in the Year 1 distribution).

Ted Example: As of August 1, 2010, when he converts the entire account to a Roth IRA, Ted has $50,000 in his traditional IRA, $40,000 of which is after-tax money. He never recharacterizes this conversion. On December 1, 2010, he retires from his job, and gets a distribution of $450,000 from his 401(k) plan, all of which is pretax money. He rolls the $450,000 into a traditional IRA on December 2, 2010. He makes no other contributions to (and receives no other distributions from) any traditional IRA in 2010. Ted *thinks* that he has made a Roth conversion that is only 20 percent ($10,000 ÷ $50,000) taxable, but his post-conversion rollover messes up the fraction. Here is how the cream-in-the-coffee fraction applies to Ted's Roth IRA conversion:

Distribution (conversion) Amount: $50,000
Total Nondeductible Contributions: $40,000
Year-end Account Balance: $450,000
Outstanding Rollovers: zero

Return of Basis = $50,000 X [$40,000 ÷ ($450,000 + $50,000)] = $4,000

The amount of gross income Gibbs must report is therefore $46,000 ($50,000 conversion minus $4,000 basis assigned to the conversion). His remaining basis in his traditional IRA is $36,000 ($40,000 total basis, less $4,000 used up in the conversion).

2.2.09 ***Partial rollovers and conversions: IRA distributions***

This section explains how basis is apportioned in the case of a partial rollover or partial Roth conversion of an IRA distribution.

A. **IRA-to-nonIRA plan rollovers.** When a distribution from a traditional IRA is rolled over to a QRP or 403(b) plan, the rolled-over money is deemed to come entirely out of the *taxable* portion of the traditional IRA distribution. § 408(d)(3)(H) (applicable to years after 2001). This rule is necessary because the *nontaxable* portion of an IRA cannot legally be rolled into a QRP or 403(b) plan. ¶ 2.6.02(H).

As the IRS explains it in IRS Publication 590 (*IRAs*) (2013 edition, pp. 23-24): "*Tax treatment of a rollover from a traditional IRA to an eligible retirement plan other than an IRA.* Ordinarily, when you have basis in your IRAs, any distribution is considered to include both nontaxable and taxable amounts. Without a special rule, the nontaxable portion of such a distribution could not be rolled over. However, a special rule treats a distribution you roll over into an eligible retirement plan as including only otherwise taxable amounts if the amount you either *leave in your IRAs* or do not roll over is at least equal to your basis. The effect of this special rule is to make the amount in your traditional IRAs that you can roll over to an eligible retirement plan as large as possible." Emphasis added.

This exception creates the opportunity for a tax-free distribution from a traditional IRA. In the Gibbs Example (¶ 2.2.08(G)), if Gibbs participates in a QRP that accepts rollovers, Gibbs could have all or most of the pretax money in the account transferred directly to the qualified plan. He would certify to the plan that the transfer consisted entirely of pretax money. Rev. Rul. 2014-9, 2014-17 IRB 975 (4/3/14) lays out the procedures for such a direct rollover from a traditional IRA to a qualified plan. Once that transfer is completed, he is left with a "stub" IRA that is wholly or mostly after-tax money, and he can convert it to a Roth IRA with little or no resulting income tax hit.

If using this technique to isolate the after-tax money in an IRA, either for purposes of doing a "free" Roth conversion or just for purposes of getting access to the after-tax money for outside spending or investing, keep in mind that account balances are determined at the END of the calendar year for purposes of applying the cream-in-the-coffee rule (see ¶ 2.2.08(C)). So the participant must be careful not to roll any money INTO an IRA, after he has done his IRA-to-plan rollover, during the same calendar year that he uses this basis-isolating technique.

Dan Example: Dan owns a $500,000 traditional IRA of which $40,000 is after-tax money (resulting from nondeductible contributions over the years). He is also a participant in a 401(k) plan that accepts rollovers. In 2014, he transmits $460,000 directly from the IRA into the 401(k) plan, certifying to the plan (in accordance with Rev. Rul. 2014-9) that the transferred amount is all pretax money. That rollover carries all the pretax money into the 401(k), leaving only the $40,000 of after-tax money in the IRA. Dan later converts the IRA to a Roth IRA tax-free. (Dan must be careful not to take any distribution from the 401(k) plan that he plans to roll back into an IRA until after the end of the year he does the Roth conversion.)

B. Partial IRA to Roth IRA conversion. Generally, any IRA distribution consists proportionately of pre- and after-tax money, and the same is true for any transfer (conversion) from a traditional IRA to a Roth IRA. ¶ 2.2.08. If the participant takes a distribution from his IRA, and the distribution contains both pretax and after-tax money, and the participant rolls over (converts) only *part* of the distribution to a Roth IRA, the rollover would apparently consist of the same proportions of pre- and after-tax money as the distribution itself. See Reg. § 1.408A-4, A-1(b), (c), A-7(a); § 408(d)(1), (2); compare § 408(d)(3)(H). Unlike with the special rules applicable to partial rollovers of QRP distributions (¶ 2.2.05(B)), and to IRA-to-nonIRA plan rollovers (see "A" above), there is no special exception to § 72 applicable to partial IRA-to-IRA (or IRA-to-Roth IRA) rollovers that would cause the pretax money to be deemed rolled first.

The only possible exception to this conclusion arises if the partial IRA distribution occurs in a year in which a minimum distribution is required. Reg. § 1.402(c)-2, A-8, provides that, in the case of a distribution from a qualified plan, where the distribution includes both pre- and after-tax money, the after-tax money is applied first to the RMD for the year. This has the effect of making more of the pretax money eligible for rollover. It is not clear whether this same rule also applies to IRAs.

Regarding Roth IRAs inherited by the surviving spouse, the following is from ¶ 3.2.03(B):

3.2.03(B) **Spousal election for inherited Roth IRA.** If the surviving spouse as sole beneficiary of the deceased participant's Roth IRA elects to treat the Roth IRA as her own, then "the Roth IRA is treated from that date forward as though it were established for the benefit of the surviving spouse and not the original Roth IRA owner." Reg. § 1.408A-2, A-4. According to the regulation, this applies for the following purposes:

✓ **The minimum distribution rules.** There would be no further RMDs required until the spouse's death, because she now holds the account as owner rather than as beneficiary and the lifetime RMD rules do not apply to Roth IRAs (see ¶ 5.2.02(A)).

✓ **Income taxability of distributions.** This would mean that the decedent's basis in the account (his contributions) would be combined with the surviving spouse's own basis/contributions to her own Roth IRAs for purposes of applying the Ordering Rules (¶ 5.2.07) to any nonqualified distribution (¶ 5.2.06).

✓ **Early distributions penalty.** Once the spouse elects to treat the inherited Roth IRA as her own, the account ceases to be a "death benefit"; see ¶ 3.2.08.

However, there is one exception to this general rule that the elected Roth IRA becomes "indistinguishable" from any Roth IRA established by the spouse herself: She gets to "keep" the decedent's years of Roth IRA ownership, if longer than her own, for purposes of computing the Five-Year Period; see ¶ 5.2.05(B).

See also ¶ 3.2.04 below regarding the surviving spouse's ability to convert an inherited *traditional* plan or IRA to a Roth IRA.

Regarding a Roth conversion by the surviving spouse, from ¶ 3.2.04:

3.2.04 ***Roth conversion by surviving spouse***

Since the surviving spouse has, with respect to QRP and 403(b) benefits left outright to her, every option the deceased participant would have had for those benefits (see ¶ 3.2.01), the surviving

spouse can roll over the benefits into a Roth IRA just as the deceased participant could have done (see ¶ 5.4.01(B)). She can also roll traditional IRA benefits inherited from the deceased participant into a Roth IRA (see ¶ 3.2.03(F)). The recipient Roth IRA could be either her own Roth IRA or (presumably; see ¶ 3.2.07) a Roth IRA in the name of the deceased participant payable to the surviving spouse as beneficiary.

Having converted an inherited traditional plan or IRA to a Roth IRA, the surviving spouse would have the same options as other Roth-converters to (1) recharacterize the conversion (see ¶ 5.6 for how to do this) or (2) (in the case of a 2010 conversion), include the conversion income in 2011–2012 rather than in 2010 (¶ 5.4.04).

With respect to Roth conversions by nonspouse beneficiaries, see the following ¶ 4.2.05–¶ 4.2.06:

4.2.05 ***Nonspouse beneficiary Roth conversions***

This ¶ 4.2.05 explains how *certain* beneficiaries may be able to "convert" *certain* inherited traditional retirement plans to inherited Roth IRAs, using the "nonspouse beneficiary rollover" described at ¶ 4.2.04.

For how to advise a beneficiary who has inherited a Roth IRA (i.e., an IRA that is ALREADY a Roth at the time of the participant's death), see, instead, ¶ 5.2.05, "Computing Five-Year Period for beneficiaries"; ¶ 5.2.06, "Jules and Jim Example"; and ¶ 4.1.02(A).

A surviving spouse can convert an inherited traditional IRA to an inherited (or her own) Roth IRA; see ¶ 3.2.04 [above]. No other beneficiary (regardless of whether such beneficiary is an individual, a trust, or an estate) can convert an inherited IRA to a Roth IRA. See "A."

This ¶ 4.2.05 explains the legal basis for nonspouse beneficiary Roth conversions for inherited traditional nonIRA retirement plans, and why such conversions are NOT permitted for inherited IRAs. For planning implications during the participant's life, see ¶ 2.8.03.

§ 408A(c)(6)(A) provides that "No rollover contribution may be made to a Roth IRA unless it is a *qualified rollover contribution*." Emphasis added.

A. Inherited IRAs cannot be converted to inherited Roth IRAs. "Qualified rollover contribution" is defined in § 408A(e), and it includes a rollover from an individual account plan, but *only* if such rollover meets the requirements of § 408(d)(3). One of the requirements of § 408(d)(3) is that no rollover may be made from an inherited IRA. § 408(d)(3)(C)(i). An inherited IRA is defined (for purposes of this particular rule only) an IRA acquired by an individual by reason of the death of another individual who was not the acquirer's spouse. § 408(d)(3)(C)(ii).

Thus, nonspouse beneficiaries have never been, and are not now, able to "roll" money from an inherited IRA to a Roth IRA. PLR 2000-13041.

Chris Example: Chris dies, leaving his IRA in equal shares to his wife, his son, and a "see-through trust" (¶ 6.2.03). Chris's wife can roll over her share of the IRA to a Roth IRA; see ¶ 3.2. Neither

Chris's son nor the trust can roll over any distribution from this IRA to a Roth IRA (or to a traditional IRA for that matter).

But what about doing an *IRA-to-IRA transfer* of the inherited benefits from the inherited traditional IRA to an inherited Roth IRA? After all it is well known that IRA-to-IRA transfers can be used, with perfect legality and IRS blessing, to avoid a number of restrictions that apply to rollovers (see ¶ 2.6.09); why can't you use an IRA-to-IRA transfer to avoid *this* restriction?

Because the IRS's regulation on Roth IRA conversions says that any transfer from a traditional IRA to a Roth IRA will be treated as (and must meet the requirements for) a rollover, even if the "conversion" is accomplished by an IRA-to-IRA transfer or even just by "redesignating" the account as a Roth. Reg. § 1.408A-4, A-1(a), (c).

The IRS *could* change its regulation to permit Roth conversions of inherited IRAs by means of an IRA-to-IRA transfer. Perhaps the IRS *should* do so, in view of the Code provision (enacted after the IRS's Roth IRA regulation was promulgated) permitting Roth conversions of inherited nonIRA plans (see B"), which shows that Congress is apparently not fatally hostile to Roth conversion of inherited retirement benefits. A change in IRS Publication 590 (the statement that an inherited IRA could not be transferred to a Roth IRA, that appeared in the 2004–2007 editions, was not included in the 2008 and later versions) fueled speculation that the IRS *was going to* change its rule on this. But the IRS has *not* changed its rule; and in the Spring 2010 issue of its *Employee Plans News* (www.irs.gov), the IRS confirmed that "if you inherit an IRA from someone other than your spouse, you may not roll it into an inherited Roth IRA."

B. Code allows Roth conversions from other inherited plans. The definition of qualified rollover contribution (to a Roth IRA) in § 408A(e) includes a rollover from a 401(a) plan if it meets the requirements of § 402(c). *Unlike* the IRA rollover provisions, § 402(c) does *not* prohibit rollovers of inherited plans. Accordingly, a Designated Beneficiary who is entitled to a direct rollover of inherited QRP benefits (see ¶ 4.2.04) can require the QRP to transfer the inherited QRP benefits into either an inherited traditional IRA or an inherited Roth IRA.

Qualified rollover contribution as defined in § 408A(e) also includes a rollover from a 403(a) or 403(b) plan if it meets the requirements of § 403(b)(8), and a rollover from a governmental 457(b) plan if it meets the requirements of § 457(e)(16). Since § 403(b)(8) and § 457(e)(16)(B) incorporate § 402(c)(9) and § 402(c)(11), nonspouse beneficiary Roth conversions are permitted for 403 plans in the same manner as for QRPs.

C. IRS position(s) on this issue. Notice 2008-30 recognizes that the Code treats inherited IRAs and other inherited plans differently for purposes of the Roth conversion. An inherited IRA cannot be rolled over to a Roth IRA by the nonspouse beneficiary; but an inherited 401(a), 403, or governmental 457(b) plan *can* be converted (via direct rollover) to an "inherited" Roth IRA by the nonspouse Designated Beneficiary, according to Notice 2008-30, A-7. There is no apparent policy difference for this distinction, but that's how Congress has written it, and the IRS seems to generally go along.

And yet…despite the clear statement in Notice 2008-30 permitting the nonspouse Designated Beneficiary to do a Roth conversion of an inherited nonIRA plan, Notice 2009-68, 2009-39 IRB

423, seems to undermine the conclusion. 2009-68 contains forms of "safe harbor" notices that employers can use to notify plan participants and beneficiaries regarding their distribution options. The notice form tells the nonspouse beneficiary who inherits a designated Roth account "the only rollover option you have is to do a direct rollover to an inherited Roth IRA" (ok, so far so good), and tells the nonspouse beneficiary who inherits a traditional account "the only rollover option you have is to do a direct rollover to an inherited IRA," with no mention of the Roth conversion option "blessed" in Notice 2008-30! Much of Notice 2009-68 has effectively been made obsolete by Notice 2014-54 but Notice 2009-68 has not been formally withdrawn.

What makes the issue even more muddled is the IRS' general rule that a direct Roth conversion from a nonIRA plan is treated "as if" the nonIRA plan funds were first transferred to a traditional IRA and then converted from the traditional IRA to the Roth IRA; see ¶ 5.4.04(A). If that fiction were applied to the nonspouse beneficiary Roth conversion, the beneficiary would *not* be allowed to convert an inherited nonIRA plan to a Roth IRA because the rolled-over benefits would have to make a fictional first stop in a hypothetical traditional IRA…which a nonspouse beneficiary is not allowed to convert!

D. Issues in nonspouse beneficiary Roth conversions. Roth conversions of inherited plans create a number of new problems and special issues.

A beneficiary who uses the beneficiary rollover to convert a nonIRA plan to an inherited Roth IRA has the same ability as other Roth converters to "recharacterize" (undo) that conversion by transferring the contribution and earnings thereon to a traditional inherited IRA. See ¶ 5.6. However, once he recharacterizes he can never "reconvert" (¶ 5.6.07) because he can't convert an inherited IRA (see "A").

The minimum distribution rules apply to a beneficiary Roth conversion in the same manner as for other nonspouse beneficiary rollovers; see Notice 2007-7.

Computation of the Five-Year Period for a beneficiary Roth conversion is unclear. For a Roth IRA that the beneficiary *actually* inherits from the deceased participant, we know the participant's holding period "carries over" to the beneficiary; see ¶ 5.2.05(B). But when a beneficiary converts an inherited traditional plan to an inherited Roth IRA there is no "decedent's Roth IRA holding period" to carry over with respect to that account. We know inherited Roth IRAs are not aggregated with the beneficiary's "own" Roth IRAs for purposes of computing the Five-Year Period for either; see ¶ 5.2.05(B). Presumably the newly-created inherited Roth IRA could be aggregated with any Roth IRAs actually inherited from the same decedent for this purpose, but there is no IRS guidance specifically addressing this situation.

If a see-through trust named as beneficiary of the participant's retirement plan converts the inherited plan to an inherited Roth IRA, then transfers the inherited Roth IRA out of the trust to the individual trust beneficiaries (see ¶ 6.1.05), it is not clear who would then have the right to recharacterize the Roth conversion.

What if there are multiple Designated Beneficiaries, some of whom want the Roth conversion and some of whom do not? Ideally, the plan would transfer each beneficiary's share of the inherited retirement plan as directed by that beneficiary (e.g., outright to the beneficiary or to an inherited traditional or Roth IRA). However, plans may require that the entire distribution be transferred to a single IRA titled the same as the original plan account (see ¶ 4.2.04(H)).

Pater Example: Pater dies, leaving his 401(k) account to his three children, Tom, Dick and Harry. Tom wants an immediate outright distribution of his share, Dick wants his share rolled over to an inherited traditional IRA, and Harry wants his share rolled to an inherited *Roth* IRA. Ideally, the plan would just carry out each beneficiary's request. However, the plan may have the right to say it will transfer to no more than one inherited IRA and it will issue no more than one check, which must be payable to all three beneficiaries; see ¶ 4.2.04(H). If the plan has that policy, the only way all three beneficiaries can get what they want is to instruct the plan to send the distribution, via direct rollover, to an inherited Roth IRA payable to all three of them, then, after that transfer is completed, distribute Tom's one-third share of the inherited Roth IRA to him outright; split the remaining account into two inherited Roth IRAs; and have Dick recharacterize his inherited Roth IRA as an inherited traditional IRA. The distributions and rollovers should all be done in cash, and the recharacterization done as quickly as possible, so that no divergence in "earnings" will arise between Dick's and Harry's accounts (see ¶ 5.6.02). Hopefully the IRS will recognize the beneficiaries' separate accounts for income tax as well as minimum distribution purposes (see ¶ 1.7.06).

4.2.06 ***Reasons beneficiary would convert to inherited Roth (or not)***

For a nonspouse Designated Beneficiary who inherits a QRP, 403 plan, or governmental 457(b) plan, the nonspouse beneficiary plan-to-Roth-IRA rollover offers an intriguing planning possibility. Which beneficiaries if any are likely to want to take advantage of this opportunity?

A. **Reasons for beneficiary not to convert to an inherited Roth IRA.** The beneficiary may not be able to afford to, or may not want to, pay the income tax cost of a Roth conversion. If the beneficiary can afford, and wants to do, a Roth conversion, the beneficiary would usually be better off converting his *own* plan or IRA to a Roth IRA rather than converting the inherited plan:

Daphne Example: In 2014, Daphne inherits a $200,000 401(k) plan from her deceased mother (all pre-tax money). She also has a $200,000 IRA of her own. She wants to have a $200,000 Roth IRA and can afford to pay the income tax on a $200,000 Roth conversion, but cannot afford to convert *both* plans to Roth IRAs. If she converts her own IRA to a Roth, she: will not have to take any RMDs from it during her entire life (¶ 5.2.02(A)); and can leave it, at her death, to a Designated Beneficiary who can take tax-free distributions over such beneficiary's life expectancy. In contrast, if she converts the *inherited* plan to an *inherited* Roth IRA, she will have to immediately start taking RMDs, over her own single life expectancy as beneficiary; and whatever is left in it at her death, her successor beneficiary will have to withdraw over what is left of Daphne's life expectancy. So there is much more deferral potential in converting her own IRA to a Roth IRA than in converting an inherited plan to an inherited Roth IRA.

B. **Reasons a beneficiary might want to convert to an inherited Roth IRA.** Here are examples of cases where the beneficiary may want to roll an inherited plan to an inherited Roth IRA:

1. A beneficiary who is so in love with Roth IRAs that he wants to convert BOTH his own plans and IRAs AND the inherited plan to Roth IRA status.

2. If the inherited plan contains after-tax money, and the beneficiary's plan is all pretax money, it would be cheaper to convert the inherited plan than to convert the beneficiary's own plan. See ¶ 5.4.03(B).

3. If the participant's estate was subject to federal estate taxes, the beneficiary will be entitled to apply the "IRD deduction" (income tax deduction for federal estate taxes paid on the benefits) to the conversion. See ¶ 4.6.04. Like after-tax money (#2), this factor could make the conversion of the inherited plan "cheaper." Note, however, that the reduction of itemized deductions for high income taxpayers (§ 68) can reduce or eliminate the benefit of the IRD deduction, depending on the recipient's other income and deductions. § 68 does not apply to trusts, which may make Roth conversion of an inherited plan more attractive for a trust-inheritor than an individual beneficiary.

4. Any beneficiary who wants a Roth IRA, but does not have a plan or IRA of his own that he can convert:

Frank Example: Frank is age 40 and working. He has a 401(k) plan. He'd like to convert this plan to a Roth IRA in 2010, but he cannot take a distribution from his 401(k) plan (that could be rolled to a Roth) until he reaches age 59½ or terminates employment—by which time he expects to be in a higher tax bracket. He inherits a 401(k) plan from his father. He can convert that inherited plan to an inherited Roth IRA right now while he is in a low bracket.

Sarah Example: Sarah and Jane are spinster sisters who live together. Jane has a high income from her job, and substantial wealth. She supports Sarah who does not work. Jane dies in 2010, leaving her 401(k) plan and other wealth to Sarah. Sarah is in a low tax bracket; she expects her tax bracket to increase once Jane's estate is eventually transferred to her. Sarah has no plan or IRA of her own she can convert to a Roth IRA. She has Jane's 401(k) plan balance transferred directly to an inherited Roth IRA.

From Chapter 8, ¶ 8.1.04(D):

B. Deductibility of IRA/Roth IRA management expenses. § 212 allows individuals an income tax deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year…for the management, conservation, or maintenance of property held for the production or collection of income…." This is a miscellaneous itemized deduction, subject to the "two percent floor" of § 67, and to the reduction of itemized deductions applicable (through 2009 and after 2010) to high-income individuals under § 68.

The IRS acknowledges in Publication 590, "IRAs" (2013, p. 12), that "Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA…may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040)."

However, § 265 denies a deduction for otherwise-deductible expenses "allocable" to income that is tax-exempt, or, as the regulations put it, "Wholly excluded from gross income under any

provision of Subtitle A" or any other law. Reg. § 1.265-1(b)(1)(i). Though there is as yet no IRS pronouncement on the subject, it would appear that investment management fees allocable to a Roth IRA would be nondeductible under this provision once the account owner has fulfilled the Five-Year Period and triggering event requirements (¶ 5.2.04), since after that point all distributions from the Roth IRA would generally be tax-exempt qualified distributions.

The answer is less clear with respect to investment management fees incurred prior to the time the participant has met the tests necessary to have qualified distributions. Until the five-year and triggering event tests are met, income generated in the Roth IRA is not necessarily tax-exempt (because if the account were terminated at that stage the earnings would be taxable as nonqualified distributions; see ¶ 5.2.06). Also, even after the account meets the tests for qualified distributions, if the account is earning sufficient unrelated business taxable income (UBTI; ¶ 8.2) to generate a tax on that income, then its income is not "wholly" tax-exempt, so the no-deduction rule might not apply.

Appendix B
Valuation of Annuity for Roth Conversion Purposes

The following is excerpted from the author's *special Report: When Insurance Products Meet Retirement Plans*, downloadable at www.ataxplan.com. This excerpt supplements ¶ 5.4.03(A), "Tax treatment of converting traditional IRA to Roth IRA," regarding the income tax treatment if one of the traditional IRA assets converted to a Roth IRA is an annuity contract. In that case, a special valuation rule applies:

Until Roth IRA conversions came along, it made little difference how annuity contracts were valued upon distribution from a retirement plan, because distribution of an annuity contract is generally not a taxable event. Reg. § 1.402(a)-1(a)(2). The arrival of the Roth IRA conversion changed the landscape. The lower an IRA-owned annuity contract can be valued when the IRA is converted to a Roth IRA, the less income tax the participant must pay on the conversion. Subsequent distributions from the annuity contract will go into the Roth IRA, distributions from which will be tax-free. According to the IRS, "some advisers" sought to take advantage of this loophole, and marketed, to IRA owners, "a single premium annuity contract with significant artificial penalties that apply in the" early years, "causing the annuity to have a low cash surrender value...." The IRA owner would then convert his IRA to a Roth IRA, and report the contract's artificially low cash surrender value (CSV) as the gross income resulting from the conversion. T.D. 9220, 2005-2 C.B. 596, "Explanation of Provisions."

To stop such abuses, the IRS issued a temporary and proposed regulation providing that fair market value (FMV), not CSV, must be used to determine the participant's gross income resulting from conversion of an IRA-owned annuity contract to a Roth IRA, effective for conversions on or after (and perhaps even before) August 19, 2005.

Reg. § 1.408A-4 governs Roth IRA conversions. Section A-14 of this regulation provides a rule for the valuation of an IRA-owned annuity contract that is converted to a Roth IRA. It provides that the amount treated as distributed "is the fair market value of the annuity contract" on the date of the Roth IRA conversion, and provides guidelines (to be used pending IRS issuance of further more detailed guidance, probably to be similar to Rev. Proc. 2005-25, 2205-17 I.R.B. 962 (applicable to life insurance contracts distributed by qualified plans), for determining such fair market value.