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ROTH IRA CONVERSIONS: BENEFITS AND PLANNING OPPORTUNITIES

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By now, everyone knows the benefits of making contributions to an Individual Retirement Account ("IRA") as well as taking advantage of an employer's 401(k) plan. To sum it up in one phrase, "tax-free compounding." The ability to grow an investment account tax-deferred over the course of twenty, thirty, or even fifty years exponentially increases the amount a person can accumulate, whether it is for retirement or to leave to his or her heirs.

For certain individuals, a Roth IRA, as opposed to a traditional IRA, may be more beneficial to meet that individual's goals. This article examines the potential benefits of converting a traditional IRA (or an employer-sponsored retirement plan) to a Roth IRA and the possible ways in which a person can convert his or her traditional IRA into a Roth IRA.

Traditional IRA vs. Roth IRA

There are two types of IRAs, the traditional IRA and the Roth IRA. Contributions to a traditional IRA are made with pre-tax dollars. Money contributed to the traditional IRA is, therefore, deductible on the taxpayer's individual income tax return.[1] Because the contributions to the traditional IRA are made with pre-tax dollars, distributions received from a traditional IRA are taxable as ordinary income.[2]

By contrast, contributions made to a Roth IRA are made with after-tax dollars and are not deductible.[3] As a consequence, qualified distributions received from a Roth IRA are not subject to income tax.[4] Because a Roth IRA is made up of after-tax dollars as opposed to pre-tax dollars, a Roth IRA is worth more than a traditional IRA with the same account balance. The easiest way to look at this concept is by viewing it as if the government actually "owns" a portion of a traditional IRA because the distributions are taxable. The exact percentage of the traditional IRA that the government "owns" depends on the individual's marginal income tax rate when distributions are made from the traditional IRA. The government, however, has no stake in any portion of the Roth IRA because the qualified distributions are wholly exempt from income taxes. Thus, someone with a traditional IRA with a balance of $100,000 actually has an after-tax interest in the traditional IRA of something less than $100,000. Whereas an individual who has a Roth IRA with a balance of $100,000 has an after-tax interest in the Roth IRA of the full $100,000.

The traditional IRA and the Roth IRA have the same annual contribution limits. For 2009, an individual under 50 years of age can contribute up to $5,000 per year into either a traditional or a Roth IRA, while an individual age 50 years and over can contribute up to $6,000 per year.[5] For a traditional IRA, an individual who is over 70.5 years of age cannot make any additional contributions, however, an individual can continue to make contributions to his or her Roth IRA after the age of 70.5, subject to the annual contribution limits.[6]

Although the contribution limits are the same for traditional and Roth IRAs, not all taxpayers qualify to make contributions to a Roth IRA. For single taxpayers, the amount that may be contributed to a Roth IRA is phased-out once their modified adjusted gross income is $105,000, and no contributions to a Roth IRA are allowed once their modified adjusted gross income is $120,000.[7] For married taxpayers, the phase-out begins when their combined, modified adjusted gross income reaches $166,000 and if their combined modified adjusted gross income exceeds $176,000, then no Roth IRA contributions are allowed.

A substantial difference between the traditional IRA and the Roth IRA is the distribution requirements. For a traditional IRA, the IRA owner must start taking distributions from the IRA by April 1st of the year following the year in which the taxpayer becomes 70.5 years old.[8] The amount of the required minimum distribution is determined based upon the IRA owner's life expectancy. Thus, it is likely that a large portion of a traditional IRA will be distributed to the original IRA owner during his or her life.

Unlike a traditional IRA, a Roth IRA has no required minimum distributions during the participant's lifetime.[9] Thus, if the participant does not need to take distributions from the Roth IRA during retirement, the Roth IRA can continue to grow, tax-free, over the remainder of his or her lifetime. These additional years of tax-free compounding could provide for a substantial amount of growth, which could either be used by the participant later in retirement or passed on to the participant's heirs.

Another benefit of a Roth IRA is the potential estate tax savings. For IRA owners who are likely to have a taxable estate, using a Roth IRA can result in a lower estate tax liability because the income tax paid on the contributions to the Roth IRA will reduce the participant's gross estate.

Conversions to a Roth IRA

Under current law, certain individuals with a traditional IRA can convert their traditional IRA into a Roth IRA. To be eligible to make this conversion, the individual's adjusted gross income cannot exceed $100,000.[10] However, this income limitation doesn't apply for taxable years beginning after December 31, 2009.[11] Thus, an IRA conversion will be available for high income individuals beginning in 2010.

Effective as of 2008, it also is possible for participants in an employer-sponsored retirement plan (such as a 401(k) plan) to roll over their retirement funds directly into a Roth IRA.[12] Thus, persons who have an employer-sponsored retirement plan may also be able to take advantage of converting their qualified plan to a Roth IRA. Whenever an employer-sponsored plan participant can make an eligible withdrawal, that participant has the option of rolling over the withdrawal into an IRA. To determine when a participant may make an eligible withdrawal from an employer-sponsored retirement account, a review of that specific plan is needed. Some

employer-sponsored plans allow participants to make a withdrawal from their retirement account as soon as age 59.5, even if the participant is still employed, while other plans are more restrictive on when eligible withdrawals may be made.

When a traditional IRA (or an employer-sponsored retirement plan) is converted to a Roth IRA, the amount converted into the Roth IRA will be included in the individual's income.[13] For taxable years after December 31, 2009, unless elected otherwise, the individual will be required to include the amount converted as income over a two year period.[14] If the individual feels that his or her tax rate is going to increase over the two years after the conversion (either from having additional income or from a change in tax law), he or she may want to consider electing out of this two year income realization period and pay all of the tax immediately.

If the IRA owner wishes to pay the income tax liability from the traditional IRA, the IRA owner may be subject to a 10% penalty on the amount of IRA funds used to pay the tax if he or she is under the age of 59.5 at the time of the conversion. Thus, it is important to consider how the income tax will be paid if a traditional IRA owner is considering a conversion to a Roth IRA so as to avoid any penalties. If at all possible, the income tax liability generated on the conversion should be paid from funds outside of the IRA, even if the IRA owner is over 59.5 years of age, because this has the effect of an additional contribution to the IRA and will result in a higher after-conversion balance in the new Roth IRA (thus achieving more tax-free compounding).

Reconversions

An individual is currently allowed to change his or her mind after a conversion from a traditional IRA to a Roth IRA and reconvert the Roth IRA back to a traditional IRA.[15] However, the IRA owner cannot convert a traditional IRA to a Roth IRA, reconvert back to a traditional IRA, and then make another conversion to a Roth IRA within the same taxable year.[16] Additionally, the reconversion must be made before the due date of the tax return, including extensions, for the year of the conversion.[17] Thus, an individual could potentially reconvert back to a traditional IRA up until October 15 of the year following the year of original conversion. If the taxpayer reconverts back to a traditional IRA, the taxpayer must wait for thirty (30) days after the reconversion to make another conversion to a Roth IRA. For example:

> John converts his traditional IRA into a Roth IRA on January 1, 2010. John changes his mind and reconverts his IRA back to a traditional IRA on September 1, 2010. John must wait until January 1, 2011 before he can again convert his traditional IRA into a Roth IRA.

The ability to reconvert back to a traditional IRA can be a very useful tool in maximizing the benefit of a conversion as discussed below.

Reasons to Convert Now

When considering whether or not a conversion to a Roth IRA is appropriate, it is important to consider the IRA owner's current tax bracket as well as his or her expected tax bracket during retirement. Currently, the top marginal income tax rate is at a relatively low rate of 35%. With federal budget deficits nearing $2 trillion dollars and given the current political climate, this top marginal rate will almost certainly increase in the future. For taxpayers who will continue to work into their retirement or who will have a substantial amount of taxable income, it appears

advantageous to pay the income tax now at the relatively low income tax rates rather than in the future, when those rates are likely to increase. Of course by paying taxes now from funds outside of the IRA, the taxpayer would be losing the use of those funds.

For traditional IRA owners who do not anticipate having a substantial amount of taxable income during retirement, it may be advantageous not to make a conversion to a Roth IRA because their tax bracket may be lower in retirement.

Another reason that it may be wise to make a conversion to a Roth IRA now is that retirement account balances are likely to have dropped anywhere from 30% - 50% over the past year. If an IRA owner makes a conversion now, he or she would be paying the income tax on a greatly decreased IRA account balance and thus owe less income tax on the conversion. Whereas if the IRA owner either waits until the market recovers to make a conversion or never makes a conversion at all, then he or she will be paying income taxes on the increased value of the IRA.

Also, if the IRA owner is not planning on using the IRA during retirement, but would rather leave the IRA to his or her descendants, the traditional IRA owner may want to consider converting to a Roth IRA so that no distributions will be required to be made during his or her lifetime. As discussed below, leaving an IRA to descendants will allow the IRA to continue to grow tax-free for a much longer period of time.

Ways to Maximize the Benefit of a Conversion
The simplest way to make a Roth conversion would be to do a lump-sum conversion by which the IRA owner converts his or her entire IRA into a single Roth IRA. If, at some time before the IRA owner files his or her income tax return for the year of the conversion, the new Roth IRA declines in value, the IRA owner can elect to reconvert the Roth IRA back to a traditional IRA. He or she can then wait for at least thirty (30) days and do another conversion to a Roth IRA in the next taxable year. Using this reconversion technique can help to minimize the income tax consequences as a result of the conversion. For example:

> On January 1, 2010, Tom converts his traditional IRA worth $1,000,000 to a Roth IRA, incurring a potential tax liability of $350,000. On December 1, 2010, the value of the Roth IRA had declined to $800,000 and Tom elects to reconvert the Roth IRA conversion back to a traditional IRA. On January 1, 2011, when the IRA still has a value of $800,000, Tom, again converts his traditional IRA into a Roth IRA, incurring a potential income tax liability of $280,000. By reconverting the Roth IRA to a traditional IRA and then doing another conversion, Tom was able to save $70,000 in income tax liability and delay the paying of that tax for another year.

A more complicated, but potentially much more beneficial, method to convert a traditional IRA to a Roth IRA would be to split up the traditional IRA into multiple accounts. All of the traditional IRAs could be converted to Roth IRAs in year 1. Each of the Roth IRAs would be invested differently. At the end of year 1, the taxpayer can review the accounts and decide to reconvert some or all of the Roth IRAs back into traditional IRAs based upon their value at that time. For example:

> Tom has a traditional IRA worth $1,000,000. Tom splits the IRA into five separate IRAs worth $200,000 each. On January 1, 2010, Tom then converts all five of his IRAs into Roth IRAs and invests each of the Roth IRAs differently. Tom incurs a potential tax liability of $350,000 on these conversions. As of December 1, 2010, the five Roth IRAs have a balance of $100,000, $250,000, $300,000, $150,000, and $200,000, respectively. Tom reconverts the Roth IRAs that have declined in value back to traditional IRAs. On January 1, 2011, Tom again converts his traditional IRAs into Roth IRAs. By using this reconversion technique, even though the total value of all of his IRAs did not change, Tom would have reduced his overall income tax liability by $52,500.

Estate Planning with an IRA

Both traditional IRAs and Roth IRAs require distributions to be made to the designated beneficiaries of the IRA after the death of the original IRA owner. If the designated beneficiary of the IRA is an individual, a group of individuals, or a "see through" trust, then the required distributions can be stretched out over the life expectancy of the designated beneficiary. Taking distributions over the designated beneficiary's lifetime will allow the IRA to continue to grow tax-free. For a traditional IRA, the designated beneficiary will be required to include the distributions received into his or her income. In contrast, the distributions made to the designated beneficiary from a Roth IRA will not be included in his or her income for income tax purposes.

If the designated beneficiary is an individual, then that individual will have the ability to withdraw more than the minimum required distribution. By taking more than the minimum required distributions from an IRA, the beneficiary will be wasting the years of tax-free compounding that the IRA would generate. Thus, the original IRA owner may wish to leave the IRA to a trust which qualifies as a "see through" trust. Doing so would allow the trustee to determine if distributions in addition to the required minimum distribution should be taken.

To qualify as a "see through" trust, (i) the trust must be valid under state law; (ii) the trust must be irrevocable or will, by its terms, become irrevocable upon the death of the participant; (iii) the beneficiaries of the trust must be identifiable; (iv) certain documentation must be provided to the plan administrator; and (v) all of the beneficiaries of the trust must be individuals.[18]

As stated above, when a trust is a "see through" trust, the payouts on the IRA (traditional or Roth) can be stretched over the lifetime of the oldest beneficiary of the trust, which greatly increases the benefit of the IRA because the IRA can continue to grow tax-free over a longer period. For instance, if the trust is for the benefit of a grandchild, the IRA could potentially have forty or more years of additional tax-free compounding since the minimum required distributions are based upon the life expectancy of the beneficiary.

Of the requirements necessary for a trust to qualify as a "see through" trust, being able to identify all of the trust's beneficiaries can be most complicated. The reason that all of the trust's beneficiaries must be identifiable is because the required minimum distribution is based upon the life expectancy of the oldest trust beneficiary. If the oldest beneficiary cannot be identified, then it is impossible to determine the required minimum distribution and the entire IRA balance will

have to be distributed no later than December 31 of the year which contains the fifth anniversary of the original IRA owner's death.[19] If, pursuant to the terms of the trust, all of the IRA distributions payable to the trust are required to be distributed from the trust to a certain beneficiary of the trust, then only that beneficiary will count when identifying the trusts beneficiaries for purposes of the IRA rules.[20] This type of trust is called a "conduit" trust because the trust acts merely as an intermediary beneficiary of the IRA. When a conduit trust receives IRA distributions, the trustee then passes those distributions on to the beneficiary. The only benefit of using a conduit trust versus naming a designated beneficiary outright is the fact that the trustee can control whether IRA distributions in excess of the required minimum distribution are made.

It also is possible for a "see through" trust to accumulate the minimum required distributions, although these types of accumulation trusts must be drafted very carefully in order to comply with the "see through" trust rules. Thus, if the participant doesn't want the trust beneficiary to begin to receive distributions immediately, the trust could be drafted to accumulate the distributions from the IRA until the beneficiary reaches a certain age.

The ability to continue to hold funds in an IRA throughout the lifetime of a beneficiary, thereby increasing the number of years that the IRA grows tax-free, makes an IRA a very valuable estate planning tool. Because Roth IRAs do not require distributions to be made during the lifetime of the original Roth IRA owner, converting a traditional IRA to a Roth IRA would provide for a much larger estate planning opportunity.

Conclusion

Historically low income tax rates, greatly lowered IRA account balances, no required minimum distributions, potentially reduced estate taxes, and estate planning possibilities are all reasons why owners of traditional IRAs (and employer-sponsored plan participants) should consider converting to a Roth IRA. The rules regarding IRAs can be confusing and adverse tax consequences can result if the rules are not followed. If properly done however, the benefits of converting a traditional IRA into a Roth IRA can be great.

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Dean Mead is a commercial law firm that provides full-service legal representation to businesses and individuals throughout Florida. The firm has 47 lawyers practicing in Orlando, Fort Pierce and Viera.

[1] IRC §219
[2] IRC §408(d)(1)
[3] IRC §408A(c)(1)
[4] IRC §408A(d)(1)
[5] IRC §219(b)(5)(A); §408A(c)(2)
[6] IRC §219(d)(1); §408A(c)(4)
[7] IRC §408A(c)(3)
[8] IRC §401(a)(9)(C)
[9] IRC §408A(c)(5)
[10] IRC §4008A(c)(3)(C)
[11] IRC §408A(c)(3)(B)
[12] See IRS Notice 2008-30
[13] IRC §408A(d)(3)(A)
[14] IRC §408A(d)(3)((A)(iii)
[15] Treas. Reg. §1.408A-5 Q&A-6
[16] Treas. Reg. §1.408A-5 Q&A-9
[17] IRC §408A(d)(6)
[18] Treas. Reg. §1.401(a)(9)-4, A-5(b)
[19] Treas. Reg. §1.401(a)(9)-3, A-2
[20] Treas. Reg. §1.401(a)(9)-5, A-7