

Everything You Need to Know to Get Your Clients

Roth-Ready for 2010!

by

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“¶” references refer to sections of the author’s book *Life and Death Planning for Retirement Benefits*, which can be purchased for \$89.95 plus shipping through www.ataxplan.com, through Amazon.com, or by calling 800-247-6553.

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Abbreviations Used in this Document

In this paper, section references (“§”) refer to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

AMT	Alternative minimum tax. § 55.
Code	Internal Revenue Code of 1986, as amended through August 2009.
EGTRRA	The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16).
HEART Act	The “Heroes Earning Assistance and Relief Tax Act” of 2008 (Pub. L. 110-245, enacted 6/17/08).
IRA	Individual retirement account or individual retirement trust under § 408.
IRD	Income in respect of a decedent. § 691.
IRS	Internal Revenue Service
MRD	Minimum required distribution under § 401(a)(9).
NUA	Net unrealized appreciation.
PPA '06	The Pension Protection Act of 2006 (Pub. L. 109-280, enacted 8/17/06).
QRP	Qualified retirement plan under § 401(a).
Reg.	Treasury Regulation.
RBD	Required beginning date for MRDs. § 401(a)(9)(A).
TAPRA	The Taxpayer Relief Act of 1997 (Pub. L. 105-34, enacted 8/5/97).
TIPRA	The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109-222, enacted 5/7/06).
WRERA	The Worker, Retiree, and Employer Recovery Act of 2008 (Pub. L. 110-458, enacted 12/23/08).

5.1 Introduction to Roth Retirement Plans

“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 taxes up front on the plan contributions. In addition to tax-free distributions, the Roth IRA offers two other advantages over traditional IRAs: no minimum required distributions during life (§ 5.1.03(A)); and no maximum age for making contributions (§ 5.3.03(B)). Over the years, Congress added another type of Roth plan (the “designated Roth account”; § 5.7) and expanded the number of ways to acquire a Roth plan (§ 5.3, § 5.9).

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 means having (modified) adjusted gross income of \$100,000 or less (and not using the married-filing-separately filing status). Starting in 2010 (unless Congress changes the law), EVERYONE who owns a traditional retirement plan or IRA will be eligible to convert to a Roth IRA, *regardless* of income or filing status. § 5.4.02.

5.1.02 *What practitioners must know*

Estate planners need to know:

- ✓ The differences between Roth IRAs and traditional IRAs. § 5.2.
- ✓ The income tax treatment of qualified and nonqualified Roth IRA distributions. § 5.2.03–§ 5.2.08.
- ✓ The eight ways to fund a Roth IRA. § 5.3.01.
- ✓ How to fund a Roth IRA with annual (regular) 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, and how DRACs differ from Roth IRAs. ¶ 5.7.
- ✓ Which clients should consider Roth IRAs and DRACs. ¶ 5.8.01–¶ 5.8.09.
- ✓ How to prepare for the unlimited availability of Roth conversions in 2010. ¶ 5.8.10.
- ✓ How to handle Roth benefits in a client’s estate plan. ¶ 5.8.11.
- ✓ Which Roth IRA transactions are abusive. ¶ 5.1.04.

5.1.03 *History of Roth retirement plans*

Roth IRAs came into existence in 1998, when § 408A (added to the Code by TAPRA) became effective. Final regulations for Roth IRAs were issued February 3, 1999, effective for taxable years beginning after 1997. TD 8816, 64 FR 5597. The IRS Restructuring and Reform Act of 1998 made certain retroactive changes.

From 1998 through 2005, the only ways to contribute to a Roth IRA were by making nondeductible contributions from earnings (these are called “regular” contributions, and are subject to the usual limits on annual IRA contributions, plus additional eligibility requirements, but without any age limit; see ¶ 5.3.02) or by “rolling over” (converting) funds from a traditional IRA (again, subject to certain eligibility requirements) (see ¶ 5.4). A “Roth IRA conversion” causes the converted amount to be taxed as if it were a distribution from the traditional IRA, though for conversions in 1998 the income could be spread over two years (see ¶ 5.4.05).

In 2001, EGTRRA added two more “Roth” retirement plans, the “deemed Roth IRA” (effective in 2003 and later years; ¶ 5.2.01) and the “Designated Roth Account” (DRAC), beginning in 2006 (¶ 5.7). Most provisions enacted as part of EGTRRA were scheduled to expire after 2010, but PPA ’06 repealed this “sunset” for EGTRRA’s pension and IRA provisions. Thus, as a result of PPA ’06, DRACs are now a permanent part of the Code.

Regulations regarding the conversion of an IRA-owned annuity contract to a Roth IRA were issued in proposed form effective 8/19/05 (T.D. 9220, 70 FR 48868, August 22, 2005) and in final form on 7/29/08 (T.D. 9418, 73 Fed Reg. 43,860). See ¶ 5.4.06.

The IRS also issued proposed regulations on contributions to DRACs in 2005. In 2006, the IRS issued *final* regulations on DRAC contributions and *proposed* regulations on DRAC distributions and reporting rules. See T.D. 9237, 2006-6 I.R.B. 394, containing Preamble and final regulations; proposed amendments to Reg. § 1.402(g)-1, § 1.403(b)-3, § 1.403(b)-5, and § 1.403(b)-7; and Prop. Regs. § 1.402A-1, § 1.402A-2, and § 1.408A-10. The 2006 proposed regulations were adopted with few changes as final regulations in 2007. See T.D. 9324 (4/27/07) and T.D. 9340 (pertaining to 403(b) plans) (7/23/07).

So, for the years 2006 and 2007, there were three ways to contribute to a Roth IRA: annual contributions from earnings (as before), rollover from a traditional IRA (as before), and rollover from a DRAC (new).

Prior to 2008, only IRAs, and not other kinds of retirement plans, could be “converted” (rolled over) into Roth IRAs. So, to “convert” money in a qualified plan to Roth status, the participant first had to move the money from the QRP into a traditional IRA, because direct transfers to a Roth IRA from a QRP were not permitted. PPA '06 amended § 408A to add another way to contribute to a Roth IRA, namely, by rollover of an eligible rollover distribution from a 401(a), 403(a) or (b), or governmental 457(b) plan (¶ 5.4.01, #1). § 408A(e)(1)(B). See ¶ 5.4. This method is effective for 2008 and later years. On 3/24/08, the IRS issued Notice 2008-30, 2008-12 I.R.B. 638, Section II of which (Questions 1–7) provides guidance on plan-to-Roth-IRA conversions.

As originally enacted, § 408A(e)(1)(B) was overly broad, and unintentionally applied the \$100,000 income-ceiling test (see ¶ 5.4.09) to rollovers from a DRAC to a Roth IRA. WREERA fixed this glitch by adding the following sentence to § 408A(c)(3)(B), effective for the years 2008 and 2009: “this subparagraph shall not apply to a qualified rollover contribution from a Roth IRA or to a qualified rollover contribution from a designated Roth account which is a rollover contribution described in” § 402A(c)(3)(A). Accordingly, a participant in a designated Roth account can now roll that money directly to a Roth IRA regardless of his or her income level or filing status.

TIPRA (P.L. 109-222) was enacted on May 17, 2006. Among its “revenue offset” provisions is § 512, which is designed to encourage Roth IRA conversions after 2009 by two means. First, § 408A(c)(3)(B) originally provided (and still provides, through 2009) that a taxpayer may not convert a traditional IRA to a Roth IRA if his AGI exceeds \$100,000 or if his filing status is married filing separately. TIPRA *repeals* § 408A(c)(3)(B) effective in 2010. Thus, after 2009, individuals will be eligible to convert their IRAs to Roth IRAs regardless of how much income they have, and even if they are married filing separate returns. See ¶ 5.8.10. Second, converting a traditional plan to a Roth IRA is treated as a deemed distribution of the traditional plan, resulting in the inclusion of the converted amount in the participant’s gross income for the year of the conversion. Under TIPRA, for conversions in 2010 only, the deemed distribution is included in the participant’s gross income in two equal shares in 2011 and 2012 (none in 2010), unless the participant elects otherwise. See ¶ 5.4.05.

The HEART Act (2008) added the ability to contribute “qualified reservist distributions” to a Roth IRA for up to two years after the end of active duty. See ¶ 5.3.01 for this and other permitted Roth IRA contribution methods.

5.1.04 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 future (even existing) gains and income in the tax-exempt Roth.

In Notice 2004-8, 2004 I.R.B. 333, the IRS declared war on these devices, attacking them as disguised IRA contributions (in violation of the limits on annual IRA contributions and in violation of the requirement that only cash may be contributed to an IRA); 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). 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. All I can say is...I told you so! See my article “Retirement Benefits: Unexpected Drama,” 143 *Trusts & Estates* 1 (Jan. 2004), p. 40, in which I predicted this development.

See also ¶ 5.4.06 regarding an annuity arrangement the IRS found abusive.

5.2 Understanding Roth IRAs

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.
- ✓ “Qualified” distributions from a Roth IRA are income tax-free, whereas traditional IRA distributions are generally taxable (¶ 2.1.02). See ¶ 5.2.04–¶ 5.2.05 for the definition of qualified distribution.
- ✓ As with a traditional IRA, the participant’s own (already-taxed) contributions from 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 whether a particular distribution consists of the participant’s own contributions. See ¶ 5.2.06–¶ 5.2.07.
- ✓ There are several differences in eligibility requirements for making contributions to a Roth versus a traditional plan. See ¶ 5.3, ¶ 5.4.

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). The separate account must meet the requirements of § 408 (traditional IRA) or § 408A (Roth IRA). The separate account (the deemed traditional IRA or deemed Roth IRA) is then treated in all respects the same as a traditional IRA or Roth IRA, as the case may be, 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 Chapter about Roth IRAs applies equally to deemed Roth IRAs.

5.2.02 *Roth IRAs and the minimum distribution rules*

The minimum distribution rules (Chapter 1) 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 apply to the Roth IRA beneficiary, with distributions being computed as if the participant died "before his required beginning date."

Here are the details regarding how the minimum distribution rules apply to Roth IRAs:

- A. No lifetime required distributions.** The lifetime minimum required distribution (MRD) rules (§ 1.3) 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 (§ 1.4.06) do not apply to Roth IRAs. There is no "required beginning date" (RBD; § 1.4) for a Roth IRA. Therefore, a person who reaches age 70½ does not have to start taking distributions from his Roth IRA as he does from his traditional IRA. This is a major advantage of the Roth IRA; see § 5.8.08(A).
- B. Post-death MRD 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 MRDs from a Roth IRA after the participant's death, see § 1.5.03.
- C. Roth distributions, conversions, do not fulfill MRD requirement for traditional IRA.** Distributions from a Roth IRA cannot be used to fulfill a distribution requirement with respect to any other kind of IRA. Reg. § 1.408A-6, A-15. A Roth IRA conversion may not be used to fulfill the distribution requirement for a traditional IRA, because the conversion is considered a rollover, and as such it cannot take place until *after* the MRD for the year of the conversion has been distributed from the traditional IRA to the participant. § 2.6.04.

5.2.03 *Tax treatment of Roth IRA distributions: In general (and miscellaneous)*

Not all Roth IRA distributions are automatically tax-free; only "qualified distributions" from a Roth IRA are income tax-free. 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 MRDs 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).

It is relatively easy to qualify for “qualified” distributions; see ¶ 5.2.04–¶ 5.2.05.

Nonqualified distributions from Roth IRAs are not necessarily tax-free, but do get favorable treatment compared with distributions from traditional IRAs. See ¶ 5.2.03.

The basis of property distributed from a Roth IRA (for purposes of computing gain or loss when the recipient later sells such property) is its fair market value on the date of the distribution. Reg. § 1.408A-6, A-16.

§ 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). However, a Roth IRA that an individual holds *as beneficiary* is NOT aggregated with the individual’s own Roth IRA(s) for this purpose; it is aggregated only with other inherited Roth IRAs the individual holds as beneficiary of the same decedent. Reg. § 1.408A-6, A-11.

If a Roth IRA is worth less than the participant’s basis in the account, see ¶ 5.2.08.

For which events may cause a “deemed” distribution of the account without an actual distribution, see ¶ 5.8.11 and ¶ 2.1.03.

5.2.04 Qualified distributions: Definition, tax treatment

Qualified distributions are distributions that occur after a five-year waiting period has elapsed *and* a “triggering event” has occurred. The Five-Year Period begins (for all Roth IRAs the individual may ever own) on January 1 of the first year the individual opens *any* Roth IRA; see ¶ 5.2.05. The most common “triggering events” are attaining age 59½ and death. So, for example, once an individual has had a Roth IRA for more than five years and is over age 59½, all his subsequent Roth IRA distributions will be tax-free “qualified” distribution.

More precisely, a qualified distribution is one that is made after the Five-Year Period 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); or
4. Is a “qualified special purpose distribution,” i.e., a distribution of up to \$10,000 for certain purchases of a “first home” (see ¶ 9.4.09). § 408A(d)(5); § 72(t)(2)(F), (t)(8).

These conditions for a qualified distribution from a Roth IRA resemble the requirements for avoiding the premature distributions penalty of § 72(t) (Chapter 9), 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 a traditional IRA would be exempt from the 10 percent penalty (§ 9.4.08).

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

- **Corrective distributions.** A regular Roth IRA contribution may be returned to the owner before the due date of the owner's income tax return for the year of the contribution, and if it is returned by the proper due date along with the "net income" earned on the contribution, the contribution is treated as if it had not been made in the first place. See § 5.6.01(A). The net income distributed along with such a returned contribution apparently cannot be a qualified distribution. Reg. § 1.408A-6, A-1(d).
- **Prohibited transactions.** Engaging in a prohibited transaction with a Roth IRA causes the account to lose its exempt status. Reg. § 1.408A-1, A-1(b). This causes an immediate deemed distribution of the entire account. See § 8.6.06. Since the deemed distribution is coming from an account that is no longer a Roth IRA, it is presumably not a qualified distribution, even though the regulations do not explicitly say that. Compare Reg. § 1.402A-1, A-4(g) (§ 5.7.04(C)) which does explicitly say that the deemed income resulting from engaging in a prohibited transaction with a designated Roth account cannot be a qualified distribution.

5.2.05 Computing Five-Year Period for qualified distributions

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 August 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.

Note the following points regarding calculation of the Five-Year Period for a Roth IRA:

- If a Roth IRA contribution is recharacterized (§ 5.6.02), it is treated as if it had never been made. Thus, in the Fred Example, if Fred had recharacterized his 1999 Roth IRA contribution, that contribution would not start the Five-Year Period running.

- ❑ The Five-Year Period is computed differently for a designated Roth account (DRAC). ¶ 5.7.04(B).
- ❑ 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. ¶ 5.7.08.
- ❑ The method of computing the Five-Year Period for a Roth IRA does not change (“is not redetermined”) just because the Roth IRA owner dies. The deceased participant’s holding period carries over to the beneficiary. If the beneficiary 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 (see ¶ 3.***). Reg. § 1.408A-6, A-7(a).

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 and daughter. The wife rolls over her 50 percent share to her own Roth IRA. For both the wife (as to her rollover Roth IRA) and the daughter (for her inherited Roth IRA), the Five-Year Period will be completed December 31, 2012, because they get to “carry over” Scott’s holding period. Accordingly, for the daughter, all distributions 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). For Scott’s wife, her rollover 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). So she for distributions after 2012 she will have met her Five-Year Period requirement but she will still not have qualified distributions until she attains age 59½ or becomes disabled.

5.2.06 *Tax treatment of nonqualified distributions*

A nonqualified distribution is one made before the Five-Year Period is up; or which is made after expiration of the Five-Year Period but not for one of the specified reasons (age 59½, disability, death, etc.; ¶ 5.2.04). 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. ¶ 2.1.07. 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 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 dies 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. Accordingly, he must start taking minimum required distributions 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 of all of the participant’s aggregated IRAs. ¶ 2.1.10. This same unfavorable proportionate rule also applies to nonqualified distributions from DRACs. ¶ 5.7.05.

5.2.07 *The Ordering Rules*

Any distribution from a Roth IRA (*except* a “returned contribution”—see ¶ 5.6.01(A); Reg. § 1.408A-6, A-9(e)) 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 Chapter as the **Ordering Rules**.

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) and “rollover” (conversion) (¶ 5.4) contributions, the distributions are deemed to come, first, from the regular contributions (with no rule specifying in what order contributions made in different years are deemed distributed), 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 (¶ 5.4.07) are deemed distributed first; 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 distribution is NOT taxable until all contributions have been distributed.
- ❑ 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 before reaching age 59½. The Ordering Rules will apply in determining whether the 10 percent penalty applies to the distribution. See ¶ 5.5.02.

5.2.08 *Tax treatment of Roth IRA losses*

This section deals with a Roth IRA that is worth less than the taxpayer's "basis" in the account. For a loss that occurs upon the conversion of a traditional IRA into a Roth IRA, see ¶ 5.4.03.

The participant typically has a high tax basis in his Roth IRA, especially shortly after creating it, because he has paid income tax on all his contributions to the account. If the Roth IRA subsequently declines in value, the participant now has a built-in loss in his account. There are three ways the participant can deal with this inherent loss:

- ✓ If he is still within the time deadline for recharacterizing his Roth contribution, he can reverse the contribution, effectively erase his Roth IRA, and get a fresh start. See ¶ 5.6.02 for how to do this.
- ✓ If the recharacterization deadline has passed (and he is not a candidate for "9100 relief," see ¶ 5.6.04(B)), or if he just doesn't believe the decline in value is permanent, he can keep the Roth IRA alive and hope it recovers its value.
- ✓ The final choice is to distribute everything out of all Roth IRAs that he owns within one taxable year (and not roll over the proceeds). This ¶ 5.2.08 deals with that option.

An individual is allowed an income tax deduction for a loss "incurred in any transaction entered into for profit."

To obtain a loss deduction in connection with a decline in value of a traditional IRA or of a Roth IRA, three things are clear under the tax law. First, the individual must close out the Roth account, or the traditional IRA account as the case may be, because there must be a "closed and completed transaction" to incur a loss. Reg. § 1.165-1(b). Second, the individual actually must close out *all* of his Roth IRAs (or all of his traditional IRAs), in order to claim a loss on the Roth IRAs (or traditional IRAs) because all Roth IRAs are treated as a single account for income tax purposes, and all traditional IRAs are treated as a single account for income tax purposes. § 408(d)(2)(A); § 408A(a); § 408A(d)(4)(A). Third, the amount of the loss is limited to the participant's basis in the Roth IRAs (or traditional IRAs as the case may be). Reg. § 1.165-1(c)(1).

Beyond those principles, however, the authority for how such losses are to be deducted is nonexistent. The only authority is IRS Publication 590, which cannot be cited as legal authority. According to IRS Publication 590, the loss is deductible only as a miscellaneous itemized deduction, meaning that it is subject to the reduction of itemized deductions under § 68 as well as the "two percent floor" rule of § 67 (miscellaneous itemized deductions are deductible only to the extent the total of such deductions exceeds two percent of adjusted gross income).

An individual's "basis" in his Roth IRAs may be a bit tricky to determine: if the Roth IRA contained any rollover from a DRAC, and the DRAC was worth less (at the time it was rolled to a Roth IRA) than the participant's basis in the DRAC, then the higher original basis may carry over to the Roth IRA. See ¶ 5.7.08.

5.2.09 *Investment management fees for Roth IRAs*

§ 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 to high-income individuals under § 68.

The IRS acknowledges in Publication 590 (IRAs) that “Trustees’ administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions. However, they 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. § .265-1(b)(1). Though there is as yet no IRS pronouncement or other authority on the subject, it would appear that investment management fees allocable to a Roth IRA *distributions from which would be qualified distributions* would be nondeductible under this provision.

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 (see ¶ 5.***). Also, if the account is earning sufficient unrelated business taxable income (UBTI; see ¶ 8.5.01) to generate a tax, then its income is not tax-exempt, so the no-deduction-for-expenses-attributable-to-tax-exempt income rule might not apply.

5.3 Eight Ways to Fund a Roth IRA

5.3.01 *The eight ways (I know of) 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. Here are the methods I’ve discovered so far. If you find more, please email me at author@ataxplan.com.

- Any individual who has compensation income can make nondeductible “**regular contributions**” to a Roth IRA. See ¶ 5.3.02.
- 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.
- For the ability of a **surviving spouse** or **designated beneficiary** to transfer funds from an inherited plan to a Roth IRA, see ¶ 5.9.

- Certain **U.S. military death gratuities** can be contributed to a Roth IRA. For details, see § 408A(e)(2) and IRS Publication 590. This type of contribution was added by the HEART Act. This type of contribution 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. There is no tax deduction for this type of contribution, so it should always be contributed to a Roth IRA (where it will hopefully generate future tax-free income) rather than being made as a nondeductible contribution to a traditional IRA. § 72(t)(2)(G)(ii). For definition of qualified reservist distribution, see § 72(t)(2)(G)(iii). See also ¶ 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 (regardless of income) or other eligible retirement plan. Eligible individuals include both plaintiffs in the Exxon Valdez lawsuit and any individual who is the spouse or immediate relative of a plaintiff and 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 ¶ 5.9.) 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 due date of the tax return for that year). If made to a Roth IRA or DRAC, 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. This type of contribution is not covered in the Internal Revenue 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 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, not to any other type of retirement plan. For details, see § 125 of the Worker, Retiree, and Employer Recovery Act of 2008 and IRS Publication 590. This type of contribution is treated as a qualified rollover contribution to the Roth IRA (see ¶ 5.4), and is not covered in the Internal Revenue 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. 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 ¶ 5.6.02 for how to change your mind about which type of IRA you want to contribute to after you’ve already contributed.

As with traditional IRAs, **only cash** may be contributed. § 408A(a), § 408(a)(1). See ¶ 5.6.03 regarding the **deadline** for making a regular Roth IRA contribution.

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).

“**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. 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 on the definition. See also ¶ 5.8.07.

5.3.03 *Applicable dollar limit on regular contributions*

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 the applicable dollar limit or the individual's compensation income (¶ 5.3.01) 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).

So, an individual who has compensation income (¶ 5.3.01), 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), provided that the total contributed to both types of accounts for the year does not exceed the lesser of (1) the applicable dollar limit or (2) the individual's compensation income (¶ 5.3.02) for the year.

Contributions made on the individual's behalf to a SEP-IRA or a SIMPLE are ignored for this purpose; these are considered employer contributions, and as such have no effect on the maximum the individual may contribute to a traditional or Roth IRA. § 408A(f).

The applicable dollar limit (ADL) was \$2,000 for the years 1998–2001. § 219(b)(1)(A) (pre-2002). Under § 219(b)(5), the ADL is the sum of the basic dollar limit and (if the participant has attained age 50 by the end of the taxable year) an add-on (“catch-up contribution”) of \$500 (2002–2005) or \$1,000 (2006 and later). § 219(b)(5)(B). After 2008, § 219(b)(5)(C) applies a cost-of-living adjustment (COLA) to the basic dollar limit (but NOT to the over-50 add-on amount) in \$500 increments. As a result of PPA '06, the above contribution limits will not “sunset” after 2010, even though they were enacted as part of EGTRRA. See ¶ 5.1.03.

See Table 1 at the end of this Chapter for the Applicable Dollar Limits for various years in light of the COLAs.

5.3.04 *Who may make a “regular” Roth IRA contribution*

Any individual who has compensation income (¶ 5.3.02), regardless of his or her age, and regardless of whether he or she participates in a workplace retirement plan, may make a “regular” contribution to a Roth IRA,—*provided* that his or her 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 participates in a “workplace” retirement plan in the same year.
- C. Income must be below certain levels.** Only individuals with income 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 applies (through 2009) to determine eligibility to convert a traditional plan to a Roth IRA (§ 5.4.09). To be eligible to contribute the full dollar limit to a Roth IRA, “adjusted gross income” (see § 5.4.04) may not exceed \$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). Under PPA ’06, these dollar amounts are adjusted upwards, after 2006, for post-2005 inflation. The 2009 limits are \$105,000 (single) and \$166,000 (joint).

The Applicable Dollar Limit (ADL; amount the individual may contribute to a Roth IRA from his/her compensation income; see § 5.3.03) is phased down if AGI exceeds these levels. The ADL goes to zero if AGI exceeds the ADL by \$15,000 (single) or \$10,000 (married). § 408A(c)(3)(A), (C)(ii). Note that the phase-out applies to the *entire* ADL (including the over-50 add-on amount), not just to the basic dollar limit.

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 “normal” ADL to a traditional IRA (assuming he is under age 70½). Reg. § 1.408A-3, A-3(d), Example 4.

- D. Definition of MAGI.** “Adjusted gross income” (AGI) is a defined term in the Code (§ 62); however, for purposes of determining eligibility to contribute to a Roth IRA you do not simply look at the AGI line on the person’s Form 1040. Rather, the definition of “modified” adjusted gross income (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). § 408A(c)(3)(C)(i).

The § 219(g)(3) definition of AGI includes the individual’s taxable Social Security benefits (§ 86), and takes into account the disallowance of “passive activity losses” (§ 469) if applicable, then requires the following further adjustments:

1. Certain income normally *excluded* from AGI is added back in, namely: income resulting from redemption of U.S. savings bonds to pay higher education expenses (§ 135); qualified adoption expenses paid by the individual’s employer (§ 137); the deduction for domestic production activities (§ 199); and foreign earned income and housing costs (§ 911).

2. Certain deductions otherwise allowed for purposes of computing AGI are not allowed for this purpose, namely the deductions for: education loan interest expenses (§ 221); tuition expenses (§ 222); and IRA contributions (§ 219).

However, MAGI does not include the deemed distribution amount (§ 5.4.03–§ 5.4.04) that results from converting a traditional retirement plan to a Roth IRA. § 408A(c)(3)(C)(i). So, if, in the year being tested, the participant converts a traditional IRA to a Roth IRA, resulting in the inclusion of some or all of the conversion amount in his gross income, the gross income resulting from the 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*.

This aspect of Roth IRA conversions is the downfall of many taxpayers and tax preparers. Determining AGI is no easy task because it involves many interrelated computations, such as how much of the individual’s Social Security payments are taxable, and how much passive activity loss is deductible. Yet all these computations must be done twice: First, for purposes of determining the individual’s eligibility to contribute to a Roth IRA, all gross income resulting from traditional-to-Roth IRA conversions is ignored (and all adjustments dependent on AGI are determined in accordance with this reduced income figure). This fictional AGI has *no relevance* to the taxpayer’s actual tax burden—it is a pro forma number used solely to determine eligibility to contribute to a Roth IRA. Reg. § 1.408A-4, A-9.

Then, for purposes of determining the individual’s *actual* tax owed, income resulting from conversions to a Roth IRA *is* included in gross income; and all computations dependent on AGI—such as taxability of Social Security benefits, deductibility of medical expenses, etc.—are redetermined based on this true AGI figure.

5.4 Conversion of Traditional Plan to Roth IRA

The other main way to create a Roth IRA is to transfer funds to it from a traditional IRA or plan. The amount so transferred is generally included in the participant’s gross income as if it had been distributed to him. § 5.4.03–§ 5.4.04. Thereafter the account will enjoy the favorable tax treatment afforded to Roth IRAs. § 408A(d)(3)(A)–(C). Since there is no limit on the amount that can be converted from a traditional 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 premature distributions. See § 5.6.03 regarding the deadline for completing a Roth conversion.

Caution: This § 5.4 deals with Roth IRA conversions by the participant. For the ability (or inability) of a beneficiary to effect a Roth conversion of inherited benefits, see § 5.9.

The term **conversion** of a traditional plan to a Roth IRA includes a rollover from a traditional plan to a Roth IRA. In this Chapter, conversion contributions and rollover contributions to Roth IRAs mean the same thing: a transfer, rollover, or conversion of funds from a traditional IRA or other traditional retirement plan to a Roth IRA.

Traditional plan distributions cannot be rolled or converted to a designated Roth account (§ 5.7); a Roth IRA is the only possible destination for “conversions.”

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

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 and ¶ 5.4.07.

However, an *inherited* IRA may NOT be converted to a Roth IRA. § 408(d)(3)(C). See ¶ 5.9.

A SEP-IRA (§ 408(k)) or SIMPLE IRA (§ 408(p)) cannot be “redesignated” as a Roth IRA (§ 408A(f)). However, an eligible individual (¶ 5.4.02) can roll a distribution from either of these types of IRAs into a Roth IRA, subject to one limit: 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). Once a SEP or SIMPLE IRA account has been converted to a Roth IRA, the account is not eligible to receive further contributions under the SEP or SIMPLE plan. Reg. § 1.408A-4, A-4(c).

Prior to 2008, the Code permitted rollovers into Roth IRAs only from “individual retirement plans” or (after 2005) DRACs. 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 rollover into Roth IRAs directly from the following *additional* types of eligible retirement plans, eliminating the necessity of the two-step process:

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. Note that this change rendered Reg. § 1.408A-4, A-5, obsolete.

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

Age: 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 premature distributions applies. See ¶ 5.9 regarding beneficiary conversions.

Also, beginning in the year the participant reaches age 70½, he will not be able to convert a traditional plan to a Roth IRA until *after* he has withdrawn the minimum required distribution (MRD) for the year of the conversion from the traditional plan, because of the rules explained at ¶ 2.6.04. This is true even though, in the year he reaches age 70½, he normally would not be required to take any MRD from his IRA until April 1 of the following year. Thus, if a participant wants to convert his entire traditional IRA to a Roth without ever having to take an MRD from the IRA, he needs to take full distribution of the IRA either (1) no later than the year he reaches age 69½ (and complete the rollover/conversion within 60 days thereafter), or (2) in calendar 2009 (the year for which no minimum distribution is required; see ¶ 5.4.09(D)).

Plan participation: Participation in any other retirement plan is irrelevant; it has no effect on the ability to convert to a Roth IRA.

Prior conversions: There is generally no limit on the number of times a participant can convert all or part of any traditional plan to a Roth IRA. The only exception applies in the case of someone who has *unconverted* then wants to *reconvert*; see ¶ 5.6.07.

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/her income tax filing status. For years prior to 2010, see ¶ 5.4.09(A).

Income: For conversion of plan distributions made in 2010 and later years, there is no income test; anyone can convert regardless of his/her income level. For years prior to 2010, see ¶ 5.4.09(B).

5.4.03 *Tax treatment of converting 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.

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). Thus, whatever amount of a traditional IRA is converted or rolled over to a Roth IRA is taxed just as if it had been distributed from the traditional IRA and not rolled over, with two exceptions:

- For conversions in 1998 or 2010, special “income spreading” treatment is allowed; see ¶ 5.4.05.
- If the converted property includes an annuity contract, a special valuation rule applies; see ¶ 5.4.06.

Generally, IRA distributions are taxed under the rule Ed Slott has christened the “cream-in-the-coffee rule”: An IRA distribution is treated as coming, proportionately, from the pre- and after-tax portions of the individual’s IRA, with all of the individual’s IRAs being aggregated and treated as a single IRA for the purpose of determining that proportion. See § 408(d) and ¶ 2.1.07–¶ 2.1.11. The Code provides exceptions to the cream-in-the-coffee rule for certain IRA distributions (qualified health savings account funding distributions, and rollovers from an IRA to a qualified plan, for example), but those exceptions would never be involved in a Roth IRA conversion from a traditional IRA.

Since conversion of a traditional IRA to a Roth IRA is treated (for income tax purposes) as a distribution of the converted amount (¶ 5.4.07), 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. To the extent the amount converted represents the participant’s basis in the traditional IRA it is nontaxable; see ¶ 2.1.10. Reg. § 1.408A-4, A-7(a).

Whit Example: Whit’s only IRA is a traditional IRA worth \$70,000. He has made a total of \$6,000 of nondeductible contributions to his traditional IRA over the years and has never taken a distribution from any IRA. If he converts the entire traditional IRA to a Roth IRA in 2009, he will have to include only \$64,000 in gross income on account of the conversion (\$70,000 total IRA value minus \$6,000 basis).

In determining the proportion of any distribution (or Roth conversion) that is taxable vs. after-tax money, the distributed or converted amount is multiplied by a fraction. The numerator of the fraction is the total amount of after-tax money the participant has in all of his or her IRAs. The denominator is the total value of all the participant’s IRAs (including SEP-IRAs and SIMPLE IRAs); all the IRAs are aggregated and treated as one. See ¶ 2.1.10. For planning implications, see ¶ 5.8.10.

Someone with after-tax money in an IRA who also participates in a QRP and who is able to roll money from his IRA to his QRP account, can use the sequence described at ¶ 2.1.11 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.

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: In preparation for 2010, Tucker made nondeductible contributions totaling \$20,000 to a traditional IRA in the years leading up to 2010. He had no other IRAs; this contributory account was his only IRA. Unfortunately for him, his investment results were not good. On January 1, 2010, when he does his conversion to a Roth, the account has declined in value to \$17,000. What becomes of his “missing” \$3,000 of basis?

The Code tells us that 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 (according to the IRS) a miscellaneous itemized deduction. See IRS Publication 590, 2008 edition (Individual Retirement Accounts), pages 41–42 (“Recognizing Losses on Traditional IRA Investments”). 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. See also IRS Publication 529 (“Miscellaneous Deductions”), which lists IRA losses among the types of “expenses” that are deductible as expenses paid “To manage, conserve, or maintain property held for producing” income.

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, 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.

IRS Notice 2008-30, 2008-12 I.R.B. 638 (3/24/08) Section II, questions 1–7, deals with plan-to-Roth-IRA conversions.

For plan-to-Roth-IRA conversions in 2010, special “income spreading” treatment is allowed; see ¶ 5.4.05.

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. However, any distributee and plan administrator can arrange for voluntary withholding even for a direct rollover. IRS Notice 2008-30, A-6. It would presumably not be advisable to arrange for such withholding, since it would reduce the amount going in to the Roth IRA. It is generally more favorable to pay the income tax resulting from a Roth conversion from funds held outside any retirement plan.

The conversion of funds from a qualified retirement plan (QRP) to a Roth IRA presents special planning opportunities if the participant’s account contains after-tax money (basis or “investment in the contract”; ¶ 2.1.08).

A. If the plan contains after-tax money

Myron Example: Myron is retiring. His profit sharing plan “Employee Contribution Account” at Acme Widget consists of \$50,000 of after-tax money (all post-1986) and \$100,000 of pre-tax money. He also has an “Employer Contribution Account” of \$200,000 which is all pre-tax money. The two accounts can be treated as separate accounts for purposes of § 72 (¶ 2.1.08(A)). Therefore he can direct the plan to transfer the Employer Contribution Account (\$200,000) by direct rollover to a *traditional* IRA (this is a typical tax-free rollover—really a tax-*deferred* rollover), and can direct the plan to transfer the Employee Contribution Account (\$150,000) to a Roth IRA (in a *taxable* rollover).

Even though Myron’s “Roth conversion” of his \$150,000 Employee Contribution Account is taxable, the conversion will be “cheap” because only the \$100,000 of pretax money in the account is included in his gross income as a result of the conversion. He gets a \$150,000 Roth IRA but only has to pay income tax on \$100,000. He’s not “getting away” with anything, because he already paid tax on the \$50,000 of after-tax money in the employee contribution account.

Suppose Myron says he only wants to convert *part* of the Employee Contribution Account to a Roth IRA. Specifically, he wants to convert only the \$50,000 of after-tax money to a Roth IRA.

He wants to transfer the rest of the Employee Contribution Account (i.e., the \$100,000 of pre-tax money in that account) to a traditional IRA tax-free. Can he do this? If you can figure out a way to convert only the after-tax portion of a QRP account directly to a Roth IRA, please let me know (email author@ataxplan.com). I haven't found such a way.

If Myron directs his employer to transfer \$50,000 from the Employee Contribution Account to a Roth IRA, and leaves the rest in the QRP, the \$50,000 would be treated as a distribution from the account. It would be subject to the same “cream-in-the-coffee rule” that applies to IRAs. ¶ 5.4.03. The distribution (conversion) would be deemed (under the cream-in-the-coffee rule) to consist of proportionate amounts of pre- and after-tax money, so the distribution would be one-third includible in Myron's gross income. The result is presumably the same whether the \$50,000 distribution is distributed to Myron and not rolled over, or is converted into a Roth IRA. § 72(e)(2)(B), (5)(A), (5)(D)(iii), and (8)(B); § 408A(d)(3).

What if Myron takes a distribution of the *entire* \$150,000 Employee Contribution Account and rolls only \$50,000 of it to a Roth IRA? Can he then claim that he rolled over the after-tax money, tax-free? No. The last sentence of § 402(c)(2) provides that when funds are rolled over from a QRP to an IRA, the transfer “shall be treated as consisting first of the portion of the distribution that is includible in gross income” (if it were not rolled over). This sentence seems to mean that, when there is a distribution, and *only part of the distribution is rolled over*, the rolled-over part is deemed to come *first* from the portion of the distribution that would have been taxable if not rolled over. Thus, the partial rollover to a Roth IRA would have exactly the *opposite* effect of what Myron wants. The rolled over amount would be deemed to come first out of the taxable portion of the account, and the part distributed to him would be deemed the after-tax money.

Myron can use the last sentence of § 402(c)(2) to isolate the after-tax money and get it *out of the plan tax-free* if he chooses to do so; employees have been doing this for years. He does this by (1) requesting a total distribution of his entire Employee Contribution Account (\$150,000), with (2) \$100,000 of the distribution to be transferred via direct rollover to a traditional IRA and (3) \$50,000 to be distributed outright to him. With this scenario, the last sentence of § 402(c)(2) operates to cause the pretax money to be rolled over “first” to the traditional IRA, so Myron receives a tax-free distribution of his after-tax money.

The next question is what happens if Myron takes another step: After receiving the \$50,000 cash distribution from the plan, but within 60 days, he rolls that \$50,000 into a Roth IRA. Now his entire \$150,000 distribution has been rolled over; does this negate the last sentence of § 402(c)(2), so that *both rollovers* are deemed to consist proportionately of pre- and after-tax money (meaning part of Myron's Roth conversion would be taxable)? Or does § 408A(d)(3) “trump” § 402(c)(2), so the Roth conversion is taxed just as if Myron had not contributed that \$50,000 to an eligible retirement plan (meaning the conversion is tax-free)? You tell me!

B. Roth conversion of NUA stock. Mike Jones, CPA, chair of the retirement benefits editorial advisory board of *Trusts & Estates* magazine, pointed out that the way these QRP-to-Roth-IRA direct rollovers are taxed could create a windfall for an employee with NUA stock. See Jones, Mike, “Do Roth IRA Conversions Offer a Brand-NUA Opportunity?,” *Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter* (see “Resources,” p. 3 of this outline), Archive Message #390, 11/1/2006.

The idea was that a retiring employee (who has modified adjusted gross income of less than \$100,000, if the conversion is before 2010) requests, from his employer's qualified plan, a lump sum distribution that includes appreciated employer stock (see ¶ 2.5 of *Life and Death Planning for Retirement Benefits*). Rather than taking the distribution outright, he directs that the lump sum distribution be rolled directly into a Roth IRA, as permitted by § 408A(e). If the effect of this Roth conversion is that he is taxed as if he took the distribution outright, he would be liable for current tax on only the plan's "basis" in the stock. The NUA would be transferred into the Roth IRA without current tax...and then it would NEVER be taxed, assuming that later distributions from the Roth IRA were taken only in the form of tax-free qualified distributions.

Based purely on the words of the Code, this appears to work. However, the IRS says it does not work. The IRS says this transaction would be treated "as if" the employee FIRST transferred his lump sum distribution from the qualified plan into a traditional IRA, and THEN rolled it from the traditional IRA into a Roth IRA—even though in fact it is rolled directly from the qualified plan to the Roth IRA. The effect of the "deemed" rollover into a traditional IRA is to cause the ultimate "deemed" transfer from the hypothetical traditional IRA into the real Roth IRA to be a distribution that is not eligible for the special NUA treatment. (IRA distributions are never eligible for the special NUA deal.) To avoid getting tangled up in basis problems, the hypothetical intermediary traditional IRA would be deemed to be the only IRA owned by the participant. IRS Notice 2009-75, 2009-39 I.R.B. *** (9/9/09).

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. § 408A(d)(3)(A)(iii). For details on this election, and on the acceleration of taxation in case of actual distributions prior to 2001, see "1998 Conversions: The Four-Year Spread," in Chapter 5 of the 1999 edition of this book.

The income resulting from a Roth conversion in **2010** (only) can be reported in two equal instalments in 2011 and 2012 instead of being reported in 2010. Here is § 408A(d)(3)(A)(iii) as amended by TIPRA effective for years after 2009:

"(iii) unless the taxpayer elects not to have this clause apply, any amount required to be included in gross income for any taxable year beginning in 2010 by reason of this paragraph shall be so included ratably over the 2-taxable-year period beginning with the first taxable year beginning in 2011."

5.4.06 Conversion of annuity contract

If an IRA is being converted to a Roth IRA, and one of the IRA assets being converted is an annuity contract, 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. ¶ 2.1.06(G). 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, qualified 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, 2005-39 I.R.B. 596, “Explanation of Provisions.” See T.D. 9418, 73 Fed. Reg. 43,860 (7/29/08) for final regulations.

To stop such abuses, the IRS adopted a regulation providing that the fair market value (FMV) of the annuity contract (not cash surrender value or any other value) must be used to determine the participant’s gross income resulting from conversion of an IRA-owned annuity contract to a Roth IRA. Reg. § 1.408A-4, A-14. This is not the same valuation rule that applies when an annuity contract is simply distributed to the IRA owner (§ 2.1.06(G)), nor is it the same as the special rule for valuing annuity contracts for purposes of the minimum distribution rules (§ 1.2.07(A))!

The FMV of the contract may be determined using one of the methods set forth in the regulation (“gift tax method”; “accumulation method”), unless “because of the unusual nature of the contract” the value determined by these methods “does not reflect the full value of the contract.” Also, the IRS may issue further guidance, including formulas, for these valuations in the future. Reg. § 1.408A-4, A-14(b).

If the annuity contract is in fact surrendered to the insurance company in exchange for cash, so that all rights under the contract are extinguished, and then the cash is converted, the conversion amount is the cash, not the FMV of the annuity contract. Reg. § 1.408A-4, A-14(a)(2).

Reg. § 1.408A-4, A-14, generally applies to annuity contracts converted out of IRAs and SIMPLE IRAs where the contract is distributed, or treated as being distributed, *on or after August 19, 2005*. However, for any conversion of an IRA-owned annuity contract that occurs on or before December 31, 2008, the taxpayer may instead value the annuity contract using the method contained in Temp. Reg. § 1.408A-4T “as it appeared in the April 1, 2008 edition of 26 CFR part 1” and Rev. Proc 2006-13, 2006-1 CB 315.

This regulation applies to conversions of annuities held in IRAs; it does not seem to have been extended to cover the conversion of a *plan-owned* annuity contract to a Roth IRA.

5.4.07 Mechanics of traditional-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. § 408(d)(3)(A)(i); see ¶ 5.6.03 regarding the deadline.
2. Assets in a traditional IRA may be transferred in a plan-to-plan transfer directly from the trustee (or custodian) of the traditional IRA to the trustee (or custodian) of the Roth IRA.
3. All or part of a traditional IRA can simply be “redesignated” as a Roth IRA maintained by the same trustee or custodian. 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”). Reg. § 1.408A-4, A-1(c). Prior to the arrival of Roth IRAs, “rollovers” were always tax-free, and most people still associate that word with tax-free transfers from one retirement plan to another (¶ 2.6). In contrast, the rollover of funds from a traditional IRA to a Roth IRA is taxable. 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.

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 “unconverted”; see ¶ 5.6.07.

The one-rollover-per-year limitation in § 408(d)(3)(B) (¶ 2.6.07) does not apply to a conversion to a Roth IRA, so such 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).

See ¶ 5.8.12 for planning considerations regarding which and how many Roth IRAs a traditional IRA should be converted into.

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 (¶ 5.4.01, #1) to a Roth IRA either by direct rollover or by 60-day rollover. IRS Notice 2008-30, 2008-12 I.R.B. 638, A-1.

A direct rollover is a trustee-to-trustee transfer from the trustee or custodian of the 401(a), 403, or governmental 457(b) plan directly to the trustee or custodian of the Roth IRA. A 60-day rollover is a distribution from the original plan to the participant, followed by the participant’s contributing part or all of the distribution to the Roth IRA. The direct rollover is preferable because it avoids the otherwise-mandatory 20 percent withholding for federal income taxes. ¶ 2.2.02(C).

Generally, the plan MUST offer employees the option of 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. IRS Notice 2008-30, 2008-12 I.R.B. 638, A-4. (There are exceptions for certain small distributions and multiple distributions.)

These plan-to-Roth IRA rollovers, along with the previously-permitted and still-permitted 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. However, in this book, “conversion” is used 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. The 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 to the penalty, 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 forbidden to distribute the employee's elective deferral account in the plan prior to age 59½ or termination of service. There is a hardship exception to that rule, but hardship distributions cannot be rolled over to a Roth IRA or at all. Plans that do permit "in-service distributions" generally restrict such distributions to employees over age 62. So, realistically, the planner is likely to encounter the opportunity for plan-to-Roth conversions only when the participant is leaving the service of the employer that sponsors the plan.

See ¶ 5.8.12 for planning considerations regarding which and how many Roth IRAs a traditional plan should be converted into.

5.4.09 *Pre-2010 income, filing status, tests for conversion eligibility*

Certain eligibility requirements apply to Roth conversions in years prior to 2010 that do not apply to Roth conversions in years after 2009. This is a permanent change in the Tax Code (as permanent as anything is in the Tax Code; in other words, as it is now written, it applies to 2010 and all later years). The following eligibility requirements apply to pre-2010 conversions by participants and by beneficiaries, and to pre-2010 conversions from traditional plans as well as IRAs.

- A. Filing status:** For years prior to 2010, generally, no conversion is permitted if the taxpayer is *married filing a separate return* for the year. See § 408A(c)(3)(B), as in effect prior to amendment by TIPRA.

However, if a "married individual has lived apart from his or her spouse for the entire taxable year, then such individual can treat himself or herself as not married for purposes of...[the filing status and income tests], file a separate return and be subject to the \$100,000 limit on his or her separate modified AGI." Reg. § 1.408A-4, A-2(b). If a person converts his traditional plan to a Roth IRA prior to 2010 and does not meet the filing status test, see ¶ 5.6.02 for consequences and remedies.

- B. Income test: \$100,000 limit:** For years prior to 2010, no conversion is permitted (from any traditional plan) if the taxpayer's modified adjusted gross income (MAGI) exceeds \$100,000 for the taxable year. See § 408A(c)(3)(B), as in effect prior to amendment by TIPRA.

In the case of a *married couple filing jointly*, the \$100,000 limit applies to the MAGI of the *couple*, not of each *spouse*. Reg. § 1.408A-4, A-2(b).

The year you look at for applying this income limit is the year in which the distribution from the traditional plan occurs (*i.e.*, the distribution that is rolled over to a Roth IRA), *not* the year that the contribution to the Roth IRA occurs. Reg. § 1.408A-4, A-2(a). Normally, the distribution from the traditional plan and its recontribution to the Roth IRA occur more or less simultaneously; this rule covers the case of a distribution from the traditional plan or IRA that occurs in one taxable year, and is rolled over in the *next* taxable year (but still within 60 days of the distribution; ¶ 2.6.06).

- C. Income test: Definition of MAGI.** For the years 1998–2004, the definition of MAGI was the same for purposes of determining a person’s eligibility for both regular Roth IRA contributions (§ 5.3) and Roth IRA conversions (§ 5.4), though the maximum permitted *amount* of MAGI has always differed depending on which type of Roth IRA contribution you’re talking about; compare § 5.3.04(C) with § 5.4.09(B).

For the years 2005–2009, an additional adjustment is required for purposes of the *conversion eligibility test* that does not apply for purposes of *regular contribution eligibility*: For the years 2005–2009, some MRDs are excluded in determining MAGI for purposes of determining eligibility for Roth conversion. For example, if a 72-year old person has AGI of \$110,000 in 2005, but that AGI includes \$15,000 of MRDs from her IRA, her MAGI is only \$95,000, and she qualifies to do a Roth conversion. In 2004, she would not have qualified on these facts, because (prior to 2005) the MRD would have been included in her MAGI. Note:

1. The participant is not exempted from taking the MRD. She still must still *take* all MRDs from her traditional IRA and every other applicable plan, and she must still *pay tax on* all such MRDs that she has taken.
2. This exclusion applies only for the \$100,000 income ceiling test for determining eligibility to do a Roth IRA conversion (§ 408A(c)(3)(B)(i)). It does NOT apply to the income test for determining eligibility to make a “regular” Roth IRA contribution! § 408A(c)(3)(C)(ii); see § 5.3.04(D). Since conversions no longer will have an “income test” after 2009, the exclusion of MRDs ceases to be relevant after 2009.

The big question is: Exactly *which* MRDs are excluded? The statute (§ 408A(c)(3)(C)(i)(II)) is ambiguous. The legislative history published at the time the statute was enacted suggested that Congress was thinking of lifetime MRDs from every type of plan, but not necessarily MRDs from an *inherited* plan. Then the Joint Committee on Taxation published a revised legislative history, indicating that only MRDs from IRAs were intended to be excluded. Reg. § 1.408A-3, A-6, specifically mentions only MRDs from *IRAs*.

- D. Effect of One-Year Suspension of MRDs.** WREERA added a new subparagraph (H) to § 401(a)(9), entitled “Temporary waiver of minimum required distribution.” The new subparagraph provides that “The requirements of this paragraph shall not apply for calendar year 2009 to” any defined contribution plan under § 401(a), § 403(a) or § 403(b); any governmental 457(b) plan (§ 5.4.01, #1); or “an individual retirement plan” (IRA).

Since in 2009 there will be no “required distributions” from a taxpayer’s IRA, this element of the determination of “MAGI” for Roth conversion purposes is nugatory for 2009 for any IRA that has not been annuitized. Does this create a hardship for someone who was planning to convert in 2009 but still needs to take those (formerly) required IRA distributions for living expenses? No, because the problem is easily avoided:

Ruth Example: Ruth’s AGI in 2009, before she does a Roth IRA conversion and before taking any distributions from her IRA, will be \$90,000. Her minimum required IRA distribution in 2009 would normally be \$30,000. She needs that \$30,000 IRA distribution, because she’s planning to live on that plus her \$90,000 of other income. She also wants to convert \$500,000 of her \$2 million IRA to a Roth IRA in 2009.

In a “normal” year, she could take the \$30,000 MRD and her AGI (for Roth conversion purposes) would still be only \$90,000, because the \$30,000 IRA MRD would be disregarded. But in 2009, if she takes \$30,000 out of the traditional IRA it is NOT going to be “disregarded” for Roth conversion purposes because it is no longer a REQUIRED distribution. So what she should do instead is this: Convert \$530,000 of her IRA (instead of \$500,000) to a Roth. That generates \$530,000 of gross income, but that income is disregarded for purposes of determining her Roth-conversion eligibility. Then she can take \$30,000 out of the Roth IRA tax-free for her living expenses.

5.5 10% Penalty For Pre-Age 59½ Distributions

This section discusses the 10 percent penalty on “premature distributions” as it applies to Roth IRAs; for background and all other details on the penalty, see Chapter 9.

5.5.01 *Penalty applies to certain Roth plan distributions*

The 10 percent penalty applies to pre-age 59½ distributions from Roth IRAs the same as 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 from the 10 percent penalty.

- A. **Distribution eligible for exception.** If the distribution is eligible for any exception from the penalty (§ 9.2–§ 9.4), there is no 10 percent penalty. If no exception applies, then:
- B. **Qualified distributions.** A qualified distribution is excluded from gross income. Since the penalty only applies to amounts includible in gross income (with one exception noted at “E” below), the penalty does not apply to any qualified distribution. See § 9.1.03.
- C. **Nonqualified distributions.** 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 be subject to the penalty. Reg. § 1.408A-6, A-5(a).
- D. **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.

- E. 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 (¶ 5.4.03–¶ 5.4.04) that results from converting a traditional retirement plan to a Roth IRA. § 408A(d)(3)(A)(ii); Reg. § 1.408A-4, A-7(b); IRS Notice 2008-30, A-3. Thus a young person who meets the eligibility requirements (¶ 5.4.02) 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.

A person who is under age 59½, although he can convert to a Roth IRA without penalty, has to come up with the money to pay the income tax on the conversion from some source *other* than the Roth IRA, because he will owe the penalty to the extent he taps his newly-converted Roth IRA for this 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 and that 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 the distribution (unless an exception applies; see last paragraph below). Reg. § 1.408A-6, A-5(b); § 408A(d)(3)(F); IRS Notice 2008-30, A-3.

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.*, 288 F. 3d 1355 (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., before the end of the Five-Year Period, 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 gross income, and therefore it is subject to the 10 percent penalty in 2002.

“The exceptions under § 72(t) also apply to such a distribution,” so there should be no penalty if the distribution is made after the death (or on account of the total disability) of the participant, for example. Reg. § 1.408A-6, A-5(b). See ¶ 9.2–¶ 9.4 for the exceptions.

5.5.03 *Roth Conversion Pre-Age 59½: More explanation and examples*

Roth conversions before age 59 ½ are so confusing that even the best and the brightest get muddled up. The following appeared as a “column” at the MorningstarAdvisor.com website in September 2009. Sign up at www.MorningstarAdvisor.com to receive the author’s free monthly column and podcast on retirement benefits.

Question: If you convert to a Roth IRA before age 59½, then withdraw from the account after you reach age 59½ but within five years of the conversion, do you owe a 10 percent penalty? What about the other way around—it’s been more than five years since you converted to a Roth, but you are still under age 59½—can you withdraw from the account without penalty?

Answer: The reason this topic is so confusing is that there are TWO of everything:

- There are TWO separate parts of your 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!

So let’s begin at the beginning. When you convert your traditional IRA to a Roth IRA, the amount “converted” is includible in your gross income just the same as if it had been distributed to you. So let’s say you convert a \$100,000 traditional IRA to a Roth IRA and your traditional IRA is all pretax money.

Income tax on conversion (age irrelevant)

You now have \$100,000 of gross income. You pay income tax on that in the year of the conversion, regardless of how old or young you are.

Contribution can be withdrawn income tax-free

That \$100,000 you paid income tax on is considered your “contribution” to the Roth IRA. You can withdraw your contribution amount ANY TIME YOU WANT TO, free of income tax, because you already paid tax on it. It doesn’t matter how old you are when you converted, or how old you are when you withdraw the contribution, or whether it has been in the account for five years or five minutes, you can withdraw your contribution income tax-free *anytime* (but you may still have to worry about the 10% penalty...read on!).

Roth conversions and the 10 percent penalty

As everybody knows, if you take money out of your retirement plan while you are younger than age 59½, you will owe a 10 percent penalty (extra tax) on the taxable portion of the distribution, in addition to whatever income tax you owe, unless you qualify for one of the 13 exceptions to the penalty.

Normally, the penalty follows the income tax. Normally, if you owe income tax, you owe the penalty too. Normally, if you DON'T owe income tax (for example, to the extent you are withdrawing your own after-tax money from the account) you don't owe the penalty either, because the penalty is NORMALLY assessed only on the amount that is includible in your gross income. (And of course you only owe a penalty if you are under age 59½ and don't qualify for one of the 13 exceptions!)

But the NORMAL rules get bent two ways for Roth conversions:

- First, when you convert your traditional IRA to a Roth IRA, the conversion amount is included in your gross income, but you do NOT have to pay the 10 percent penalty. So a Roth conversion is one of the 13 penalty exceptions—there's no penalty for a Roth conversion even though it generates taxable income, even if the converter is under age 59½ and doesn't qualify for any of the usual exceptions.
- Second, to prevent abuse, the Tax Code puts a little restriction on under-age-59½ converters. If you convert while under age 59½, and then you turn around and *withdraw* any or all of that conversion contribution from that Roth IRA less than five years after the conversion, *and* while you are still under age 59½, you will owe a 10 percent penalty on the withdrawal. Note that this five-year waiting period is measured from the conversion that created *this particular Roth IRA*. **This is the only case in the Code where you can owe a 10 percent penalty on an amount that is not includible in gross income.** You are withdrawing from your original contribution (so the distribution is not income-taxable), but you still owe a penalty (even though the penalty NORMALLY only applies to income taxable amounts). If they didn't put in this little restriction, bad people would convert their IRAs to a Roth penalty-free, then cash out the account the next day income tax-free and penalty-free. That would be abusive, so therefore you can't do it.

So how do you avoid paying a 10 percent penalty on your own conversion-contribution to the Roth IRA? Don't withdraw from it until five years after the conversion or until you reach age 59½, whichever comes first.

Now, what if the under-age-59½ Roth-converter *also* makes an annual-type contribution of \$5,000 to the same Roth IRA that he converted his traditional IRA into? Good news: He can withdraw that \$5,000 “regular” contribution tax- and penalty-free any time, even while still under age 59½, because when you withdraw money from a Roth IRA you are deemed to be withdrawing *first* from your “regular” (annual-type) contributions, until those are all used up, before you are deemed to be withdrawing from any conversion contribution. Unlike with under-age- 59½ conversion contributions, there is no retroactive 10 percent penalty applied to withdrawal of an under-age- 59½ “regular” contribution.

And more: What if the under-age-59½ Roth-converter did *two* Roth conversions while under age 59½, one within the last five years and one that was more than five years ago? Good news: He can withdraw from the older conversion contribution tax- and penalty-free any time, because the five-year period is over, even if he is still under age 59½. Why? Because when you withdraw money from a Roth IRA which contains conversion contributions from more than one year, you are deemed to be withdrawing *first* from the older contribution.

Are you having fun yet? Remember so far we've still only talked about what happens to the CONTRIBUTION to the Roth IRA! Now let's look at the earnings:

Earnings on the contribution

Let's say your \$100,000 Roth IRA that you created by converting your \$100,000 traditional IRA to a Roth grows in value to \$120,000. The \$20,000 excess over the original contribution amount is called the "earnings." Nobody (*regardless* of how old they were when they converted to a Roth IRA) can withdraw the *earnings* from a Roth IRA tax-free unless they have met a two-part test, involving a five-year holding period and a triggering event:

- ✓ First, the individual must have had a Roth IRA for at least five years. Any Roth IRA, not this particular Roth IRA. Anyone who first opened a Roth IRA in 2004 or earlier has passed this five-year test as of 2009, for all Roth IRAs he now owns or may ever own.
- ✓ Second, the individual must be (at the time of the withdrawal) either over age 59½, completely disabled, or dead.

If you withdraw earnings from a Roth IRA before you meet BOTH of the above tests, then you will owe income tax on those earnings, AND you will also owe a 10 percent penalty if you are under age 59½ (unless some exception applies).

In the following examples, assume there are no available exceptions to the 10 percent penalty:

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 either of the two tests (five-year holding period, triggering event). 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 within 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 two tests (five-year holding period plus triggering event; he has met the five-year test but not the triggering event test because he is under age 59½ and not disabled). He owes the 10 percent penalty on \$20,000. He does not owe the 10 percent penalty on the original \$100,000 contribution because he cashed it out more than five years after his penalty-free conversion (even though he is still under age 59½). He owes the 10 percent penalty on the earnings because he withdrew them before reaching age 59½.

Bobby Example: Bobby, age 57, 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. Suppose the Roth IRA grows in value to \$120,000 and Bobby then cashes it out.

- ❑ If the cashout occurs in 2012, when Bobby is 60, he owes income tax on \$20,000 (the earnings), because he is withdrawing the earnings before he has met either of the two tests (five-year holding period, triggering event). He does not owe the 10 percent penalty on any amount because he is over age 59½.
- ❑ If the cashout occurs in 2014, when Bobby is 62, he owes no income tax on \$20,000 (the earnings), because he is withdrawing the earnings after he has met both of the two tests (five-year holding period, triggering event). He does not owe the 10 percent penalty on any amount because he is over age 59½.

Resources: For the “ordering rules,” see Internal Revenue Code § 408A(d)(4)(B) and Treas. Reg. § 1.408A-6, A-9. For full details on Roth plan rules, see Chapter 5 of the author’s book *Life and Death Planning for Retirement Benefits* (6th ed. 2006; www.ataxplan.com).

5.5.04 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; ¶ 9.2). If a participant who is receiving such a series of payments 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 (¶ 9.3.01) 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 [sic] 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 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 Corrective Distributions; Recharacterizations

A taxpayer who is unhappy with the IRA contribution choices 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 *How to undo a regular Roth IRA contribution; penalty on excess contribution*

There is an excise tax of six percent imposed on contributions to Roth IRAs in excess of the applicable limits, just as there is for excess contributions to traditional IRAs. § 4973; Reg. § 1.408A-3, A-7. This excise is imposed *annually* on the excess contribution. § 4973(a).

There are two ways to make an excess “regular” Roth IRA contribution. One is by contributing an amount to the account that is in excess of the limits on IRA contributions (§ 5.3.03). This type of excess contribution can be corrected by means of a corrective distribution (“A”) or by “absorption” (“B”).

The other way to make an excess regular Roth IRA contribution is to contribute to a Roth IRA an amount that could legally have been contributed to a traditional IRA, but that is not eligible to be contributed to a Roth IRA because the participant’s income is too high (§ 5.3.04(C)). This type of excess contribution can be corrected by corrective distribution (“A”), “absorption” (“B”), or recharacterization (§ 5.6.02).

- A. Return the contribution.** One way to correct mistakes (or simply act on a change of heart) is for the participant to distribute the contribution back to himself. If any Roth IRA contribution (together with its net income; § 5.6.06) is distributed before the extended due date (§ 5.6.04) of the tax return for the year for which the contribution was made, then (1) the contribution is treated, for purposes of the six percent penalty, as not having been contributed, and (2) the net income on the contribution is “includible in gross income for the taxable year in which the contribution is made....” Reg. § 1.408A-3, A-7, § 1.408A-6, A-1(d); see also § 408(d)(4).

This book refers to IRA and Roth IRA contributions that are returned to the participant prior to the due date of his tax return as **corrective distributions**, regardless of the reason for the return.

Wayne Example: Wayne contributed \$3,000 to a new Roth IRA in 2004. By 2005, the investments in the Roth IRA had earned \$75 of interest, so the account was worth \$3,075. Wayne then changed his mind and decided he would rather spend the money on a new gas grill. He closes the account, and the \$3,075 is distributed to him in 2005. The \$75 of taxable income is included in his gross income for the year of the contribution (2004). If Wayne is under 59½, see § 9.1.03(B). If cashing out the Roth IRA resulted in a loss, see § 5.2.08.

- B. Absorbing the contribution.** Once the deadline for a returned contribution (see “A”) has passed, if the participant did not withdraw the excess contribution and its associated income, the participant owes the six percent penalty for the year for which the excess contribution

was made. The penalty will continue to accrue annually until the excess contribution is either withdrawn from the account or “absorbed” (treated as a proper contribution for a later year—to the extent the participant is eligible to make a contribution in a later year but does not do so). Reg. § 1.408A-3, A-7.

5.6.02 *How to recharacterize any Roth IRA contribution*

The regulations provide broad relief to taxpayers who wish to “amend” their IRA contributions by switching the contribution from a Roth IRA to a traditional IRA or vice versa. This relief is called “recharacterizing” an IRA contribution, and it is available to anyone who changes his mind about which type of IRA he wants his contribution to go to, as well as for those who need to correct Roth IRA conversions for which they were ineligible (§ 5.4.02). Reg. § 1.408A-5, A-10, Example 2.

For partial recharacterizations, see § 5.6.06.

A regular contribution (§ 5.3.02) to either type of IRA may be recharacterized as a contribution to the other type (by transferring it to the other type) at any time up to the “extended due date” (§ 5.6.04) of the person’s tax return for such year (assuming the individual is eligible to contribute the amount to the other type). § 408A(d)(6), (7).

If a person converted a traditional IRA to a Roth IRA but was not eligible to do so, the result is a “failed” conversion. A failed conversion would be treated as a taxable distribution from the traditional IRA (subject to the 10% penalty if the individual is under 59½; see PLR 2001-48051), followed by an excess contribution to the Roth IRA, generating a six percent penalty under § 4973 (§ 5.6.01). PLR 2001-48051. To avoid the penalties, the person would have to recharacterize the contribution by the applicable deadline. § 5.6.04.

A timely corrective distribution (§ 5.6.01(A)) can be useful for undoing *regular* Roth IRA contributions, but it is not much help for someone who has *converted* a traditional 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, he just wants to restore the pre-conversion status quo. His Roth IRA contribution may be recharacterized by transferring it back to a traditional IRA before the “extended due date” (§ 5.6.04) of his tax return for the year the distribution from the traditional IRA occurred. The Roth IRA contribution will then be treated as a contribution to the *transferee* (traditional) IRA for tax purposes. § 408A(d)(6), (7).

For example, if a person converts a traditional IRA to a Roth IRA in 2009, and then discovers that his income for 2009 exceeded the \$100,000 limit so he was ineligible to do that conversion, he can move the money back to a traditional IRA before the extended due date of his tax return for 2009, and it will be treated as a rollover contribution to the traditional IRA. In effect, the Roth conversion is “undone,” so the taxpayer does not realize any income on account of the Roth conversion.

Here are the significant requirements for effecting a recharacterization:

1. The transfer from the Roth IRA back to the traditional IRA (or vice versa) must be by plan-to-plan transfer, *not* by a “60-day rollover.” Reg. § 1.408A-5, A-1(a). See § 2.6.01 for the difference.

2. Not only the original contribution but “any net income allocable to such contribution” must be retransferred. See ¶ 5.6.06.
3. The election to recharacterize is made by providing notice and directions to the IRA sponsors involved. The election to recharacterize “cannot be revoked” after the transfer back to the traditional IRA has occurred. Reg. § 1.408A-5, A-6(b).

A recharacterized contribution will be treated for Federal 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. A recharacterization is “never treated as a rollover for purposes of the one-rollover-per-year limitation of § 408(d)(3)(B) [¶ 2.6.07], 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.

5.6.03 *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!

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 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 later if April 15th falls on a weekend or holiday. § 7503. Also, the deadline may be extended (by IRS proclamation) for individuals in an area affected by a natural 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.”

Conversions are slightly more complicated. Because the conversion is technically a “rollover” (¶ 2.6), 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 2009 must be

tioned to a *distribution that occurred in the calendar year 2009*. The due date of the 2009 return is *irrelevant*.

A distribution made from a traditional plan in the calendar year 2009, 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). January 1, 2009, would be the first date in 2009 on which an amount could be distributed out of a traditional IRA; therefore the earliest possible date for a “2009 Roth conversion” would be January 1, 2009 (same-day conversion of a January 1 distribution). The last possible date in calendar 2009 on which an amount could be distributed out of a traditional plan would be December 31, 2009; therefore the last possible date for a “2009 conversion” would be the 60th day after December 31, 2009 (the deadline for rolling over a distribution made on December 31, 2009; § 408(d)(3)(A)(i)). ¶ 2.6.06.

Note that:

- A. Roth conversions are usually accomplished by transferring sums directly from a traditional plan or IRA to 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.
- B. The IRS can extend the 60-day rollover deadline in cases of hardship. ¶ 2.6.06. To date there are no PLRs in which this provision has been used to allow a longer period to complete a Roth IRA conversion.

5.6.04 Recharacterization deadline: Meaning of “extended due date”

Generally, the deadline for recharacterizing an IRA contribution is the due date of the tax return for the year of the contribution that is being recharacterized, *including extensions*. § 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 conversion contribution to a Roth IRA that was made within 60 days after a distribution from a traditional plan may be recharacterized by the extended due date of the return for the taxable year in which the distribution 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 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. § 1.6081-4T.

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 on or before April 15 (*or* getting an extension of time to file from the IRS and then filing the return on or before 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 (§ 5.6.02) 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 obtained 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 a later date he qualified for by requesting an extension from the IRS), he must complete the recharacterization by April 15 of Year 2.

For the unfortunate taxpayer who converts to a Roth IRA, then belatedly discovers that he was not eligible to convert to a Roth IRA, but 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.* 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 \$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 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 more recent examples, see PLRs 2008-50052, 2008-26040, 2009-09073, 2009-21036, and 2009-28044.

Betty Example: Betty made \$2,000 contributions to a Roth IRA annually for the years 2007–2009, before discovering (in 2010) that she was not eligible for that type of IRA because her income was too high. She did have compensation income, and so she could have contributed to a regular IRA.

Betty needs to “recharacterize” her Roth IRA contributions for 2007–2009 as contributions to a “regular” IRA. For 2009, the deadline for recharacterizing the contributions is 10/15/2010, so it’s not too late for 2009. There is no taxable income involved and no penalty; she is just changing the Roth IRA to a regular IRA.

For 2007–2008, the deadline has passed. Betty would have to get IRS permission for a “late recharacterization,” using the private letter ruling procedure. While the IRS has been generous in granting these deadline waivers, the process is expensive.

The alternative is to remove the 2007–2008 contributions (and earnings thereon) from the account; pay income taxes (and 10% penalty, if Betty is under 59½) on the earnings portion of the distribution; *and* pay an annual 6% penalty per year for the excess IRA contributions.

5.6.05 *Confusion: Conversions vs. recharacterizations*

While it is nice that taxpayers have been given a way to undo Roth IRA conversions, so they need not be punished for (*e.g.*) making an incorrect prediction of their income, the addition of the recharacterization option is bound to create confusion. Here are some points that will need to be constantly restated:

First, the ability to recharacterize a “Year 1” IRA contribution until October 15 of “Year 2” 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 properly converted to a Roth IRA, there is nothing to “recharacterize.”

Second, not every type of contribution to a *traditional* IRA may be recharacterized—only “regular” contributions (§ 5.3) may be. A tax-free rollover from an employer plan (or from another traditional IRA) to a traditional IRA may not be recharacterized as a Roth IRA conversion or contribution, because “an 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 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 roll over the SEP or SIMPLE account to a Roth IRA; ¶ 5.4.01.

5.6.06 *Income attributable; partial recharacterizations*

To effect a recharacterization, not only the original contribution but also any net income attributable to such contribution must be transferred to the other type of IRA. Reg. § 1.408A-5, A-

2(a). This requirement may be met in one of two ways. Note that the “net income” may be a negative amount—a loss, in other words. See ¶ 5.2.08.

Method 1: If the contribution in question was made to a separate Roth IRA that contained no other funds, *and* there have been no other contributions to or distributions from that separate Roth IRA, *and* the entire contribution is being recharacterized, then simply transferring the entire account balance to a traditional IRA satisfies the requirement. Reg. § 1.408A-5, A-2(b). This method being so much simpler than Method 2, there is an advantage to keeping each year’s Roth IRA contributions in a separate Roth IRA account (not commingled with any pre-existing Roth IRA), until the period has expired for recharacterizing such contributions.

Method 2: If Method 1 is not available, then the net income attributable to the contribution must be calculated by a formula that is contained in Reg. § 1.408-4(c)(2)(ii), Reg. § 1.408A-5, A-2(c), or Notice 2000-39, 2000-2 C.B. 132.

Partial recharacterizations are permitted. However, you cannot “cherry pick” which assets you recharacterize. 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. But the regulation’s definition of the “income” on the account (the income that must be “recharacterized” right along with the contribution that earned the “income”) 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.

5.6.07 *Same-year reconversions outlawed*

The IRS has imposed various limits on the ability to use the recharacterization rules to flip back and forth between traditional IRA and Roth IRA status. For the limits applicable to reconversions in 1998 and 1999, see “*Limit on the number of ‘reconversions’ in 1998 and 1999: IRS Notice 98-50*” at page 225 of the 1999 edition of this book.

In Reg. § 1.408A-5, A-9, the IRS banned same-year IRA-to-Roth-IRA reconversions, effective in 2000 and later years. 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*. If the individual defies this rule and attempts to reconvert before the prescribed time period ends, the result is a failed conversion (¶ 5.6.02).

The meaning of “that amount” is not clear. Some people interpret it to mean that some *other* amount from the same traditional IRA involved in the original conversion *could* be converted to a Roth IRA within the same year. It certainly suggests that a conversion could be done in the same year from a traditional IRA that was not involved in the original conversion.

Brittany Example: In 2009, Brittany converts some Acme stock from her traditional IRA #1 to Roth IRA #1, then a month later (still in 2009) recharacterizes the conversion by moving the Acme stock back to traditional IRA #1. Traditional IRA #1 also holds some Omega stock. Can Brittany,

in 2009, convert the Omega stock to a Roth IRA, because it is not the same “amount” that she converted before? Can she do a Roth conversion in 2009 from another IRA entirely?

Another unclear point: A Roth conversion made by transfer from a nonIRA plan can be recharacterized under § 408A(d)(6), according to IRS Notice 2008-30, 2008-12 I.R.B. 638, A-5. The rule banning same-year reconversions, however, seems to apply only with respect to conversions originally made from an IRA to a Roth IRA, not to conversions from a nonIRA plan.

5.7 Designated Roth Accounts

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 salary in cash or to have such amount contributed to a vested account for his benefit in a retirement plan. See ¶ 10.1.02.

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; ¶ 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).

Starting in 2006, the participant has an additional option for his elective deferrals under a 401(k) or 403(b) plan: Instead of deferring income tax on the deferred compensation income, he can pay tax on the deferred compensation currently and have the deferred compensation contributed to a **designated Roth account (DRAC)** within the plan, later qualified distributions from which 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). DRACs are also called “Roth 401(k)” or “Roth 403(b)” plans. This Chapter 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).

5.7.02 *DRAC contributions: Who, how much, how, etc.*

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 go into a DRAC, provided his employer’s plan permits designated Roth contributions. 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), ¶ 5.4.09(B)), there is no income ceiling above which the participant is not allowed to make designated Roth contributions. § 402A. This is the first Roth retirement plan that does not 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. 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 is the 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 2006 and later years is \$15,000, plus an additional \$5,000 “catch-up” contribution if the participant is 50 or older by the end of the year. § 402(g)(1)(B), (C). Cost-of-living adjustments will increase both the base amount (§ 402(g)(4)) and the maximum permitted 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 long-term employee in a 403(b) plan may have even higher limits.

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 into a DRAC, or into a “regular” 401(k) account, or partly into each. For example, in 2009 an over-50 participant with sufficient compensation can (if permitted by his plan) contribute \$22,000 to his regular 401(k) account, or \$22,000 to a DRAC; or he can send part of his elective deferrals to a DRAC and part to a regular account, as long as the combined total so contributed does not exceed \$22,000.

As a reminder, as is true for a “regular” 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.

C. Election is irrevocable once the money is contributed. The election to have part of one’s compensation contributed to a DRAC is irrevocable. Thus, a participant cannot retroactively designate a DRAC contribution as a regular contribution or vice versa. Reg. § 1.401(k)-1(f)(1)(i).

In this, the decision is the same as the decision to make a “regular” elective deferral contribution to a 401(k) plan has always been: The decision is made in advance, prior to earning the money, and is irrevocable. This is unlike a Roth IRA, contributions to which can be withdrawn (¶ 5.6.01) or recharacterized (¶ 5.6.02) for a certain period of time, if the contributor changes his mind.

Under the typical 401(k) plan, an employee would elect in advance to have a particular dollar or percentage amount of his paycheck (or all or part of a forthcoming bonus) contributed to the plan. Though this election is irrevocable, the employer may permit the employee to change the election *prospectively* at one or more times during the year. For plan years beginning after 2005, the plan *must* permit the employee to change his election *prospectively* at least once each plan year. Reg. § 1.401(k)-1(e)(2)(ii).

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. Only elective deferrals may be contributed to a DRAC.** The ONLY contributions that can go into a DRAC are: (1) the participant's post-2005 elective deferrals and (2) certain rollovers from other DRACs (see ¶ 5.7.07).

The employer cannot make matching (or any other) contributions to a DRAC. The employer's matching contribution (if any), and any other employer contributions, must be made to the participant's regular 401(k) account, regardless of whether the participant's contribution that is being "matched" was made to a regular 401(k) account or to a DRAC. Forfeitures cannot be allocated to DRACs. Reg. § 1.401(k)-1(f)(2). Existing 401(k) balances cannot be converted to DRACs. 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.

- E. FICA taxes.** Elective deferral contributions are treated as "wages" for purposes of the Federal Insurance Contributions Act (FICA). See ¶ 10.1.02. 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 regular 401(k) account, or to himself in cash will have no effect on either the employee's or the employer's FICA tax obligations.

5.7.03 *MRDs 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 other 401(k) or 403(b) plans, except to the extent § 402A provides otherwise.

For example (unlike Roth IRAs, which are not subject to the lifetime MRD rules; see ¶ 5.2.02), DRACs are subject to the same lifetime and post-death minimum distribution rules as other 401(k) plans. Reg. § 1.401(k)-1(f)(3). Once a DRAC participant reaches age 70½, or (in the case of a non-5%-owner; ¶ 1.4.03) retires, if later, he can stop or prevent MRDs only by rolling the DRAC over to a Roth IRA; see ¶ 5.7.08.

DRAC distributions are subject to the income tax withholding rules applicable to qualified plan distributions. DRACs are also subject to federally granted spousal rights (¶ 3.4), and the rules restricting distributions from elective deferral accounts. 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–¶ 5.7.08).

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 Chapter) 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 of 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, 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) is a new Code provision 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 even if they pertain to an earlier period that was within the Five-Year Period. 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 minimum required distribution (MRD) that is taken in the year the required beginning date (RBD) occurs (after completion of the Five-Year Period) but which actually is the MRD 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 in 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 § 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 ¶ 2.1.12 of *Life and Death Planning for Retirement Benefits*.)
- 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.
- The deemed income resulting from a prohibited transaction. A-4(g). See ¶ 8.6.06.
- “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; 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.

Similarly, Congress presumably did not intend Roth IRAs to be a prohibited transaction playground, but there would be little disincentive to doing PTS with your Roth IRA if the maximum penalty were a tax-free deemed distribution of the entire account.

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, minimum

required 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. Reg. § 1.402A-1, A-4(d). If an alternate payee-spouse rolls over to his/her own account a portion of the participant's account that is payable to him/her under a QDRO, see the regulation for how to determine the qualified status of subsequent distributions, and other provisions dealing with 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 are the participant's basis in the account—the money he has already paid tax on; the IRS calls this the participant's "investment in the contract"), plus the appreciation (which is pretax money; the IRS calls this the "earnings"). Hopefully, the appreciation/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 the participant's investment in the contract (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, basis comes out first. § 5.2.06. 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 in the Code allowing the participant's basis to come out first. So, the regular rule of § 72(e)(8) will apply, under which any nonqualified distribution carries out proportionate amounts of the participant's investment in the contract (after-tax money) and earnings (pretax money). Reg. § 1.402A-1, A-3; see § 2.1.10. 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 "regular" accounts in the plan for income tax purposes. § 402A(d)(4). Thus, distributions can be taken (and taxed) from each one separately.

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 the 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; 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*

Distributions from a DRAC may be rolled over to another DRAC (§ 5.7.07) or to a Roth IRA (§ 5.7.08), either by direct rollover or within the usual 60-day deadline (indirect rollover; § 2.6.06). Reg. § 1.402A-1, A-5(a). If the distribution was not a qualified distribution (§ 5.7.04), so part of it would be includible in income if not rolled over (§ 5.7.05), and the participant rolls over only part of the distribution, the part rolled over is deemed to come first out of the *taxable* portion of the distribution. § 402(c)(2), last sentence; Reg. § 1.402A-1, A-5(b).

5.7.07 *DRAC-to-DRAC rollovers*

For general rules regarding 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) DRAC can be rolled into a 401(k) 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). (Note: This is a change from the IRS’s proposed DRAC regulations.)
- B. **Direct rollover.** The participant can do a DRAC-to-DRAC rollover by means of a direct rollover (§ 2.6.01(B)) of all or *part* of a DRAC distribution. Remember that, in case of a partial rollover, the pre-tax money is deemed rolled *first* (see § 5.7.06). If the distribution from the first DRAC was 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)). § 402A(d)(2)(B); Reg. § 1.402A-1, A-4(b). With any other type of rollover,

the years in the prior plan will not count in computing the Five-Year Period for the transferee plan; see examples at ¶ 5.7.08.

E. 60-day rollover (also called “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 plan. ¶ 2.6.06. The IRS calls this type of rollover a “60-day rollover,” or “indirect rollover,” to contrast it with a direct rollover. There are three additional rules regarding 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 rollover, the portion rolled is deemed to come first out of the part of the DRAC distribution that would be taxable if not rolled over. § 402(c)(2); Reg. § 1.402A-1, A-5(a), second sentence. See ¶ 5.7.06.
2. The nontaxable portion of a DRAC distribution cannot 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. 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 earlier contribution). Reg. § 1.402A-1, A-5(c).

5.7.08 DRAC-to-Roth-IRA rollovers

For general rules regarding 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).

Rollover from a DRAC to a Roth IRA is permitted even if the participant is not eligible to make annual contributions to a Roth IRA or to convert his traditional IRA to a Roth IRA. Reg. § 1.408A-10, A-2. Thus, he can establish a Roth IRA purely for the purpose of receiving a rollover from his DRAC, even if his income is too high to otherwise allow him to contribute to a Roth IRA.

A glitch in Code section § 408A(c)(3)(B), as amended in 2006 effective for years *after 2007*, effectively prohibited an individual with MAGI in excess of \$100,000 (or whose filing status was married filing separately) from rolling money over from a DRAC to a Roth IRA. The provision was intended to prohibit Roth “conversions” for those individuals in the years 2008–2009, but was written so broadly that it managed to prohibit *all* rollovers to Roth IRAs by members of that group. WREDA amended § 408A effectively for 2008 and 2009 to fix this glitch. As a result, there is no income limit or filing status test for rolling money from a DRAC to a Roth IRA by either a direct or indirect rollover.

Rolling over from a DRAC to a Roth IRA has several effects. One advantage is that the rollover will end the requirement of lifetime minimum required distributions. ¶ 5.7.03. Another is

that the Roth IRA has more favorable rules for recovery of basis than a DRAC. Compare ¶ 5.2.06 with ¶ 5.7.05.

Another effect of such a rollover, if it occurs after the participant's Required Beginning Date (RBD; ¶ 1.4), is to change the method of computing the Applicable Distribution Period that will apply to the participant's beneficiaries from the "death post-RBD rules" (¶ 1.5.04) to the "death pre-RBD rules" (¶ 1.5.03). For other pros and cons of rolling from any qualified plan to an IRA, see ¶ 2.7.03.

A disadvantage of rolling from a DRAC to a Roth IRA is that the participant may have to start the Five-Year Period all over again. 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). 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.

The Five-Year Period for a Roth IRA begins January 1 of the first year the individual 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.

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 was rolled over to the Roth IRA was *itself* a qualified distribution, 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. ¶ 5.2.03. 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 2011 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 2016. Any distributions he takes from the Roth IRA before 2016 will be nonqualified distributions. 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 2016.

- B. Rollover to a pre-existing 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 already completed towards the Roth IRA Five-Year Period. If the participant has already fulfilled the 5-year requirement for his Roth IRA, 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 2008 she makes a \$20,000 DRAC contribution to her proprietorship's "self-employed 401(k) plan." In 2009 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 met the 5-year requirement for any Roth IRAs she may ever own. Since she is over 59½, she can withdraw as much as she likes from the Roth IRA tax-free at any time.

C. Danger: Rolling a nonqualified distribution to a new Roth IRA. The person who is hurt by this rule is the person who had no prior Roth IRA, and had completed one or more years in his DRAC at the time he rolls a nonqualified 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 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 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.

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). Presumably this ability to preserve “excess basis” also applies 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), but the regulation for some reason specifically mentions only partial 60-day rollovers.

Why is it important to preserve “excess basis?” Preserving the excess basis could be important in two situations. One is if the participant or beneficiary later takes *nonqualified* distributions from the Roth IRA. Such distributions would be includible in income only to the extent the distributions exceeded the participant’s basis. 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 ¶ 5.2.08.

5.7.09 Employer obligations; other DRAC details

A designated Roth contribution 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 Roth and “regular” accounts. § 402A(b)(2). The separate accounting must be maintained until the DRAC has been completely distributed by the plan. 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 unduly 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).

Regarding accounting for Roth accounts versus nonRoth accounts, “In the case of an annuity contract which contains both a designated Roth account and any other accounts, the Commissioner may prescribe...additional rules for allocation of income, expenses, gains and losses among the accounts under the contract.” Reg. § 1.402A-1, A-13(b).

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; see that Regulation for details on reporting requirements.

The reporting requirements generally are effective starting in 2007. The rest of the regulations became effective variously in 2006 and 2007, but most purported to be effective for 2006 and later years. The proposed regulations may be relied upon for periods prior to final regulations.

5.8 Putting it All Together

¶ 5.8.01 discusses the Roth decision process generally. ¶ 5.8.02 lists factors that favor adoption of a Roth plan. ¶ 5.8.03 lists contrary factors. ¶ 5.8.04–¶ 5.8.09 look at how the Roth decision applies in some particular typical client situations. Finally, ¶ 5.8.10 discusses how to deal with Roth accounts in the client’s estate plan.

5.8.01 *Which is better, a Roth plan or a regular plan?*

A Roth retirement plan 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. The Roth IRA offers the additional advantage of no required distributions during the participant's life.

The question is, what price must be paid to acquire this wonderful asset? 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 in question was taken *out* of the retirement plan.

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

One thing is sure: If you take \$A, pay income tax on it at B percent, deposit the net after-tax amount in a Roth IRA, earn an investment return of C percent and withdraw the accumulated funds (\$D) on date E, the amount of money you will have (\$D) will be *exactly the same* as if you had deposited \$A in a traditional IRA, earned a return of C percent, withdrawn the accumulated funds on date E, and paid income tax on that distribution at B percent. For the Roth approach to *produce more dollars* than the traditional plan one or more of the factors in the equation must be different as between the Roth and traditional options. See ¶ 5.8.02(A)–(D), ¶ 5.8.08, ¶ 5.8.09.

Some clients considering a Roth plan will evaluate the financial impact using computer projections. Computer projections of the benefits of converting an existing IRA to a Roth IRA are based on assumptions as to future tax rates, investment returns, and withdrawal amounts. Most such projections assume a constant rate of investment return; that today's tax rates will last forever; and that participants and beneficiaries will withdraw from the account no more than required by today's minimum distribution rules. Other possible scenarios should be considered; see ¶ 5.8.03.

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 or even negative. There are several reasons one might choose a Roth despite the lack of a clear projected profit. See ¶ 5.8.02(E)–(F), ¶ 5.8.05, ¶ 5.8.09(C).

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.

5.8.02 *Reasons to adopt a Roth retirement plan*

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

- A. Best: Pay taxes neither now nor later.** If you can duck the “pay now or pay later?” question by not paying taxes *either* when the money goes into the Roth plan *or* when it comes out, then you can get the advantages of a Roth retirement plan “free.” That deal is irresistible. An otherwise eligible individual can get that deal if he is in a zero tax bracket, either “naturally” (see ¶ 5.8.07) or temporarily (due, for example, to a net operating loss from a business); or in some cases through a series of rollovers leaving after-tax money as the only money in his traditional IRA (see ¶ 5.4.03).

- B. Future tax rate expected to be higher.** Someone convinced that income tax rates must go up in the future to finance the retirement benefits and medical expenses of poverty stricken aging baby boomers will want to pay taxes at today's "cheap" rate and get it over with. This factor is also at work in setting up Roth IRAs for young family members (§ 5.8.07) and when a low-income parent converts to a Roth for the benefit of high-income heirs (§ 5.8.09(B)).
- C. No required lifetime distributions.** 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). 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; § 1.3). This factor makes Roth IRAs attractive to individuals who would prefer to preserve their IRAs intact until extreme old age or until death.
- D. Pay tax with assets outside the plan.** Since taxes on a Roth plan contribution can be paid with money that is not in a retirement plan, outside assets can in effect be used to increase the amount inside the retirement plan.

Eric Example: Eric wants to maximize his retirement savings. He figures that by contributing \$15,000 to a "regular" 401(k), he's really only stashing away about \$10,000 in the plan, because (based on his personal income tax bracket) the plan "owes" the government roughly 33 percent income taxes on the contribution. He'll have to pay that "debt" when he withdraws money from the regular 401(k) plan. With a Roth account, he's in effect increasing his plan contribution. Contributing \$15,000 to a Roth plan is equivalent to contributing \$22,500 to a regular plan.

- E. Diversification:** "A" has substantial funds accumulated in several traditional retirement plans. He wants to hedge his bets. Since he is already heavily weighted in pretax retirement plans, he wants to place a bet on the Roth.
- F. Cash flow:** "B" has her retirement income (including income taxes) carefully projected for the next 10 years. If she needs a chunk of extra cash, it would be nice to be able to take it out of a Roth plan tax-free so as not to upset the income tax projections.

5.8.03 *Risks, drawbacks, of Roth retirement plans*

It would be a shame to pay income tax on today's stock values, only to find out later that this was the all-time market high. This scenario happened to many who converted to Roth IRAs in the halcyon investment era of 1998–1999, or 2005–2007, then endured the stock market declines of 2000–2001 or 2008–2009.

The Roth deal also turns bad if the benefits would be subject to income taxes at a substantially lower rate when they come out than the rate the participant paid when he contributed to the plan. 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. 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.

Also, Congress could change the minimum distribution rules to require that all benefits be distributed within some much shorter period of time after the deaths of the participant and spouse. Or Congress could decide that the Roth IRA was too good a deal, and take away some of its favorable tax features (presumably only prospectively).

For an argument that Roth conversions are a bad idea for most retirees, see DeFrancesco, Rocco, “Even Ed Slott is Wrong about Roth IRA Conversions” (7/1/09), which may be read online at www.producersweb.com.

5.8.04 Annual contributions: Traditional IRA 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, which type should he contribute to?

The decision is easy if the individual (or his spouse) is an active participant in an employer plan, and his (or their) AGI exceeds the amounts specified in § 219(g)(3)(B); then his only choice is between a nondeductible traditional IRA and a Roth IRA. Since he can’t get a tax deduction for his contribution no matter which kind of IRA he contributes to, he gives up nothing by choosing the Roth IRA. The decision is also 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, considering the factors discussed at ¶ 5.8.02–¶ 5.8.03.

5.8.05 Choosing between a DRAC and a regular 401(k)/403(b)

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 35 percent of the contribution amount (maximum regular federal income tax rate as of 2009). If the individual is subject to the alternative minimum tax (AMT; § 55), contributing to a regular 401(k) plan saves income taxes at the AMT rate (26%–28%) rather than at the individual’s theoretical usual tax rate.

However, for many, the choice will not be based on elaborate projections regarding whether taxes are higher or lower now than they will be later. Rather, the choice will be based on how badly the individual wants a Roth account versus an immediate tax deduction:

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, which will be \$22,000 in 2009. She does not want to give up the tax deduction. She opts for a regular 401(k) account 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 2009 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.

5.8.06 Clients who may profit from Roth conversion

The client most likely to profit from converting to a Roth IRA is one who: has sufficient other wealth that he will never need to draw from the account during life (not drawing anything out of the account is the way to maximize the tax-free accumulations of the Roth IRA); plans to leave the account to young generation beneficiaries, to be drawn down over their life expectancy after the client's death (again, the long life expectancy payout available for distributions to a young designated beneficiary maximizes the tax-free build-up of the Roth IRA); and can afford to pay the income tax on the conversion, and the estate tax on the account's date-of-death value, from other assets, without sacrificing other goals such as his own financial security (so that the income tax-free Roth IRA is not depleted by paying tax bills). Add steady to rising income tax rates, no negative tax law changes, and positive investment returns and the conversion is a definite winner.

5.8.07 Establishing Roth IRAs for low-income relatives

Establishing a Roth IRA for teenage children, grandchildren, etc., has great appeal. Typically these young family members have summer or after-school jobs that generate compensation income on which an IRA contribution can be based, but have little enough income that they are in a low or zero tax bracket. The projections of what a humble \$5,000 contribution will grow to by the time the 15-year-old child 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 the six percent excise tax (¶ 5.6.01).

5.8.08 How Roth conversions can help retirees

- A. Take advantage of lower brackets; reduce future MRDs.** This is an idea for the retired individual who has not yet reached age 70½ and has a substantial IRA; whose income dropped significantly following retirement; and who is living comfortably on his Social Security benefits or other minuscule taxable income.

This person 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 minimum required distribution (MRD; Chapter 1) rules start forcing distributions out of his IRA. He will not be happy when his IRA starts shrinking (and his

taxable income skyrockets) once MRDs start. Now is the time to blunt the future force of MRDs (and take advantage of the low income tax brackets) by doing partial Roth IRA conversions each year. For example, if the retiree's taxable income (before Roth conversion) is \$70,000, he could convert \$300,000 of his IRA to a Roth IRA without getting into the top 35 percent bracket (which applies to taxable income in excess of \$372,950). This will reduce future MRDs from the traditional IRA (thus saving income taxes in the future), allow greater in-plan asset accumulation (since Roth IRAs do not have lifetime MRDs), and give the retiree a financial safety valve for tax-free later distributions (from the Roth IRA) for extra needs in later retirement.

B. Above average life expectancy. Roth IRAs have appeal for retirees who expect to live well 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. ¶ 1.3. 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 maximize tax deferral 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).

C. Control income levels for Social Security and Medicare purpose. Under an extremely elaborate formula, part of an individual's Social Security (SS) benefits may be taxable if his "provisional income" exceeds a certain base amount. "Provisional income" means the individual's adjusted gross income (with certain modifications), plus his tax-exempt interest income, plus one-half of his SS benefits.

If provisional income exceeds \$25,000 for a single person (\$32,000 for married taxpayers filing jointly), then half of the SS benefits (or, if less, half the excess of provisional income over the base amount) must be included in the individual's gross income. If provisional income exceeds \$34,000 for a single person (\$44,000 for married taxpayers filing jointly), then 85 percent of the SS benefits (or, if less, 85% of the excess of provisional income over the base amount) must be included in the individual's gross income. MRDs from a traditional IRA can cause an individual year after year to pay more taxes on his SS benefits. If he can convert to a Roth IRA, however, he will get the income taxation of the IRA over with, and negatively impact the taxation of his SS benefits for only one year. Thereafter, he can use tax-free Roth IRA distributions for his cash needs without increasing his provisional income (and without increasing his AGI for other purposes such as deductibility of medical expenses).

Similarly, higher income taxpayers pay triple the Medicare premium paid by low-income taxpayers. Roth distributions that are excluded from gross income don't count as income for Medicare premium purposes, unlike traditional IRA distributions.

5.8.09 *How participant's conversion helps beneficiaries*

Beneficiaries of a traditional IRA can NOT convert that inherited IRA to a Roth. ¶ 2.6.03. 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 just before death can reduce *estate taxes* by removing the income taxes due on the Roth conversion from the gross estate. Note that, unlike gift taxes 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.
- 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 \$25,000 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 now rather than having the beneficiaries pay it later, 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 have to wrestle with the valuable but complicated IRD deduction every year (¶ 2.3.07).
- D. **Or is a traditional IRA better?** At least one planner believes his client's children are better off inheriting a traditional IRA, distributions from which are taxable. The theory is that the income tax hit gives the children a strong incentive to delay distributions as long as possible, an incentive not present with tax-free Roth IRA distributions.

5.8.10 *Preparing for 2010*

Some high-income clients who have been barred from doing Roth conversions by the \$100,000 income ceiling test (¶ 5.4.09) are champing at the bit to convert their traditional plans and IRAs to Roth IRAs as early as possible in 2010, when the income ceiling test ceases to apply. Here are some ideas for how to prepare for the big day:

- A. **For the cheapest conversion, avoid "diluting" basis.** A client who has after-tax money in a qualified plan or 403(b) plan should consider leaving his money in that plan, so he can convert directly from that plan to a Roth IRA in 2010, rather than rolling the money to an IRA first (if has preexisting IRAs with pretax money in them).

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 2009. 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 ($\$50,000 \div [\$200,000 + \$400,000] = 8.333\%$) will be tax-free. 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.

B. For a “free” conversion, isolate basis. An individual who wants to convert ONLY the after-tax money in his plan should isolate the basis in an IRA using a series of rollovers. For details on how to do this, see ¶ 2.1.10–¶ 2.1.11.

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 2009, he rolls \$460,000 from the IRA into the 401(k) plan. Under present law, that rollover carries all the pretax money into the 401(k), leaving only the after-tax money in the IRA. In early 2010, Dan converts the IRA to a Roth IRA tax-free.

C. Create something to convert if you have nothing now. You can only convert a plan or IRA to a Roth IRA if you have a plan or IRA to convert.

Stu Example: Stu really wants to get a Roth IRA. Being only 38 years old, he cannot convert his 401(k) plan to a Roth (unless he quits his job), because he can’t get a distribution out of that plan until he reaches age 59½ or separates from service. His income is too high to permit him to contribute to a Roth IRA (see ¶ 5.3.04(C)). So in 2009 and 2010 he contributes the maximum he is permitted to contribute to a traditional IRA. These contributions are nondeductible. This gives him a small IRA that he can convert in 2010 to a Roth IRA.

D. If you already have basis, increase it. If you *already have* after-tax money in your IRA, making nondeductible contributions will increase the proportion of your Roth IRA conversion that will be “tax-free.” (Of course, if you are eligible to make your annual “regular” IRA contributions *directly* to a Roth IRA, see ¶ 5.3.04, you should do that instead.) If you do *not* already have after-tax money in your IRA, see “E” below before making such contributions now.

E. Novel ways to increase basis. A very small number of 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 if the pre-tax money in the account is not significant. 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.

- F. If you do not already have basis, don't try to get some unless you can really get a lot.** If you already have an IRA that is worth more than you are likely to want to convert, you really do not improve your tax outcome by making small nondeductible contributions in the years leading up to 2010.

Archie Example: Archie has a \$1 million IRA, all of which is pretax money. He would like to convert perhaps \$100,000 of this to a Roth IRA in 2010. He is considering making a \$6,000 nondeductible IRA contribution in 2009 “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, exactly \$600 of the conversion ($\$6,000 \div \$1,006,000 \times \$100,000$) 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. Yes he could use the rollover procedure (see “B” above) to reduce the IRA to just the \$100,000 he wants to convert, and then six percent (rather than .6%) of the conversion would be “tax-free.” But that’s an awful lot of trouble to go through for this minor tax savings. 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.

- G. Convert early in 2010!** Ed Slott suggests converting as early as possible in 2010. Although this may increase estimated taxes for some individuals earlier than is absolutely necessary, it avoids the risk that the individual will die before getting the conversion done. It also makes the conversion cheaper, IF the account value increases during 2010. The individual has until October 15, 2011, to recharacterize and unconvert if he changes his mind (see ¶ 5.6.02), so there is little risk to converting early. And the individual also has until October 15, 2011 (*if* he gets an extension on his 2010 income tax return) to decide whether to defer the income into 2011 and 2012 (¶ 5.4.05) or to take it into income in 2010.

5.8.11 *Roth plans and the estate plan*

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 regular 401(k)/403(b) accounts.

A Roth plan could ease the problems of leaving retirement benefits to a “qualified domestic trust” (QDOT; § 2056A) for the benefit of a noncitizen spouse, as compared with leaving traditional (taxable) benefits to such a trust. Many of the problems of leaving traditional retirement benefits to benefit a noncitizen spouse arise from the fact that such benefits are taxable as income in respect of a decedent (¶ 2.3). The Roth plan eliminates this problem.

By leaving Roth plan death benefits (rather than traditional plan death benefits) to his grandchildren (or to a see-through trust for their benefit; ¶ 6.2.03), the participant gives his beneficiaries the advantage of long-term tax-free investment accumulations and does not “waste” any of the GST exemption paying income taxes.

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. Needless to say, this treatment eliminates the advantages of such a gift.

5.8.12 *Practicalities: Should you roll to separate Roth IRAs?*

A Roth converter faces two choices regarding how many Roth IRAs he should convert his traditional plan into. There is no one “right answer” to these questions. The questions must be answered for each client based on that client’s asset mix, likelihood of recharacterizing, and tolerance for complications.

- A. Convert to separate Roth IRA, to make recharacterization easier?** The first question faces someone who, at the time he is converting a traditional plan to a Roth IRA, already has one or more Roth IRAs in existence. The pre-existing Roth IRA(s) could have arisen from prior years’ conversions, or from DRAC rollovers (§ 5.7.08), or from annual contributions (§ 5.3.02). The question is whether the current year’s Roth conversion should be made into a brand new separate Roth IRA all its own, or whether it should simply 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 *unconvert* (“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 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.

- B. Convert different assets into different Roth IRAs?** Once the Roth conversion is done, investments made with the newly-Roth money might go up or down. The participant has a period of time to recharacterize and undo the Roth conversion; see § 5.***. If only some of the assets in the converted IRA declined and others appreciated, the participant probably 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” and reconvert only *some* of the assets in the converted IRA. See § 5.6.06. 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. Thus, the participant might consider converting his IRA into several Roth IRAs, each of which holds a separate and distinct part of his portfolio, with portions that are less likely to move in tandem separated into separate Roth IRAs. For example, he could transfer common stocks to one Roth IRA and bonds to a different Roth IRA. That way, if one asset class substantially declines in value prior to the deadline for recharacterizing the account, he can unconvert just the Roth IRA that holds that asset class, and leave the other Roth IRAs alone.

See Reg. § 1.408A-5, A-2(b), (c)(5), and (6), Example 2. For more detail on this idea, and illustrations, see the article “Roth Segregation Conversion Strategy,” by IRA expert Robert S. Keebler, CPA, of Virchow Krause, Appleton, WI, in *Taxes* (CCH), June 2003, page 3.

5.9 Beneficiary Roth Conversions

5.9.01 *Background: Nonspouse beneficiary rollovers*

Prior to the Pension Protection Act of 2006 (PPA 2006), the Code permitted no one other than the participant and his surviving spouse to “roll over” money tax-free from one retirement plan to another. With enactment of PPA 2006, Congress for the first time allowed a type of rollover by a Designated Beneficiary other than the surviving spouse. Effective 1/1/2007, a Designated Beneficiary is permitted to transfer an inherited qualified retirement plan benefit, *by direct rollover only*, into an “inherited” IRA newly created for that purpose. See § 402(c)(11), added to the Code by § 829(a)(1) of PPA 2006. The new rule applies to 403(b) plans and governmental 457(b) plans (¶ 5.4.01, #1) as well as qualified plans. PPA 2006 § 829(a)(2)–(4). For ease of reference this section will speak mostly of qualified plans, but all statements apply equally to 403(b) and governmental 457(b) plans.

The main advantage of this new type of transfer is that it allows a beneficiary to take advantage of a deferred “stretch” payout of the benefits over his life expectancy, even if the plan he/she actually inherited permitted only a lump sum distribution form of benefit. In Notice 2007-7, 2007-5 I.R.B. 395, the IRS addressed the MRD effects and other details of nonspouse-beneficiary rollovers. Notice 2007-7 was further clarified in a special edition of the IRS’s “employee plan news” (http://www.irs.gov/pub/irs-tege/se_021307.pdf). Beginning in 2010, plans are required to offer the nonspouse beneficiary rollover. IRS Notice 2009-9, 2009-5 I.R.B. 419.

This statutory change also opened the door to nonspouse beneficiary Roth conversions.

Effective starting in 2008, there are three classes of distributees who can roll their distributions from an eligible nonIRA plan into a Roth IRA: the participant (see ¶ 5.4.08); the participant’s surviving spouse as beneficiary; and a nonspouse beneficiary. Different rules apply to the different types of distributees:

1. Participants and surviving spouses can transfer from any type of eligible plan (including a traditional IRA) to a Roth IRA; nonspouse beneficiaries can do these transfers ONLY from nonIRA plans.
2. Participants and surviving spouses can accomplish their Roth conversions by either direct rollover or 60-day rollover; a nonspouse beneficiary can use ONLY the direct rollover method.

However, *all three* types of distributees are still subject to the eligibility tests that apply through the year 2009, namely, that the distributee’s modified adjusted gross income (MAGI) must be under \$100,000 and the person must not be filing using the “married filing separately” status. § 408A(c)(3)(B); ¶ 5.4.09. The distributee, and not the plan administrator, is responsible for making sure the distributee meets the requirements. IRS Notice 2008-30, A-5.

5.9.02 *How the Code allows some beneficiary Roth conversions*

This section explains the legal basis for nonspouse beneficiary Roth conversions for inherited traditional retirement plans, and why such conversions are NOT permitted for inherited IRAs.

§ 408A(c)(6)(A) provides that “No rollover contribution may be made to a Roth IRA unless it is a qualified rollover contribution.” “Qualified rollover contribution” is defined in § 408A(e). It includes:

1. 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 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.**
2. 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. Rather, it provides for rollovers of distributions to employees (§ 402(c)(1)); surviving spouses of employees (§ 402(c)(9)); and nonspouse beneficiaries (though in this case the distribution can be rolled via *direct rollover only*, and *only* to an “inherited” individual retirement plan); § 402(c)(11)).
3. A rollover from a 403(a) or (b) plan if it meets the requirements of § 403(b)(8). § 403(b)(8) incorporates § 402(c)(9) and § 402(c)(11), so spousal and nonspouse beneficiary rollovers are permitted for 403 plans in the same manner as for 401(a) plans.
4. A rollover from a governmental 457(b) plan if it meets the requirements of § 457(e)(16). § 457(e)(16)(B) incorporates § 402(c)(9) and § 402(c)(11), so spousal and nonspouse beneficiary rollovers are permitted for governmental 457(b) plans (¶ 5.4.01, #1) in the same manner as for 401(a) plans.

Thus, IRS 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 converted to a Roth IRA by the nonspouse beneficiary; but an inherited 401, 403, or governmental 457(b) plan (¶ 5.4.01, #1) *can* be converted (via direct rollover) to an “inherited” Roth IRA by the nonspouse beneficiary. Notice 2008-30, A-7. There is no apparent policy difference for this distinction, but that’s how Congress has written it.

5.9.03 *Usual nonspouse beneficiary rollover limitations apply*

Remember, the nonspouse beneficiary rollover is available ONLY for “designated beneficiaries.” § 402(c)(11)(A). A designated beneficiary generally means an individual or qualifying see-through trust; see ¶ 1.7 of *Life and Death Planning for Retirement Benefits*. An estate,

for example, is not a designated beneficiary and thus cannot use the beneficiary rollover or the beneficiary Roth conversion.

Similarly, the minimum distribution rules apply as for other nonspouse beneficiary rollovers; see IRS Notice 2007-7, 2007-5 I.R.B. 395. Also, a nonspouse beneficiary can never “roll” an inherited plan to his/her own IRA or Roth IRA, only to an *inherited* IRA or Roth IRA. Finally, plans are not required to offer nonspouse beneficiary rollovers for years prior to 2010. See IRS Notice 2007-7, 2007-5 I.R.B. 1 (years prior to 2010).

5.9.04 *Conundrums with nonspouse beneficiary Roth conversions*

Notice 2008-30 provides that (for the years 2008 and 2009, while the income-eligibility test for Roth rollover contributions is still in effect) a beneficiary who seeks to roll an inherited nonIRA plan to a Roth IRA must meet the eligibility tests of § 408A(c)(3)(B). A-7. If the beneficiary directs the rollover to a Roth IRA, but is not eligible, the beneficiary can recharacterize the rollover contribution as a rollover to an inherited traditional IRA. A-7. See ¶ 5.6.02.

What if there are multiple designated beneficiaries, some of whom want the Roth conversion and some of whom do not? Plans that permit beneficiary rollovers may require that the entire distribution be transferred to a single IRA titled the same as the original plan account.

Example: Pater dies, leaving his 401(k) balance to his three children, Tom, Dick and Harry. Tom wants 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 say “everybody has to choose the same option. Either we cut three checks, one payable to each of you, or we cut one check, payable to a traditional or Roth IRA in the name of ‘Pater, deceased, payable to Tom, Dick and Harry as beneficiaries.’” 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 distribute Tom’s one-third share 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.

If, instead, the plan transfers all the money to a traditional inherited IRA payable to the three sons, Harry will not be able to convert his share to an inherited Roth IRA, because of § 408(d)(3). If the plan simply distributes the money to the three beneficiaries, no beneficiary will be able to roll the distribution back into any kind of plan or IRA. So the distribution has to go into the Roth IRA *first*, then be recharacterized out (for Dick’s share) or distributed in cash from the Roth IRA (for Tom’s share).

Another conundrum, pointed out by Mike Jones, CPA, LISI contributor and chair of the retirement benefits editorial advisory board of *Trusts & Estates* magazine: What if the designated beneficiary is a see-through trust? It would be pretty easy to “pass” the \$100,000 income limit test (¶ 5.4.09) by leaving the plan, at the participant’s death, to a separate see-through trust that had no other income; the trust-named-as-beneficiary could then transfer the inherited plan to an inherited Roth IRA.

5.9.05 *Planning implications: Beneficiaries who will NOT roll to Roths*

For a nonspouse beneficiary who inherits a QRP, 403 plan, or governmental 457(b) plan, the nonspouse beneficiary plan-to-Roth-IRA rollover definitely offers an intriguing new planning possibility. A beneficiary may want to consider rolling all or part of the inherited plan to an inherited Roth IRA via direct rollover (remembering that the beneficiary's income must be under \$100,000 to do this prior to 2010).

How many beneficiaries will really want to do this? Not too many, because:

1. For a beneficiary whose income is over \$100,000, this type of Roth rollover isn't even an option until after 2009. Theoretically, the plan could hold onto the money and just pay the beneficiary MRDs until he/she became eligible, but that approach is not realistic in a plan that pays only the lump sum distribution form of death benefit.
2. Even if the beneficiary is eligible to do the Roth rollover, he/she may not be able to afford to pay the income tax cost of a Roth rollover.
3. If the beneficiary is eligible and can afford a Roth rollover, the beneficiary would usually be better off converting his/her *own* plan or IRA to a Roth IRA status rather than converting the inherited plan.

Daphne Example: Daphne's income in 2009 is under \$100,000. She has inherited a \$200,000 401(k) plan from her deceased mother (all pre-tax money) and 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 this year, 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 MRDs from it during her entire life; 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 MRDs, 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 "bang for the buck" in converting your own IRA or plan to a Roth IRA than in converting an inherited plan.

5.9.06 *Beneficiaries who WILL roll to Roths*

However, that being said, there will be some cases where the beneficiary definitely will want to roll an inherited plan to an inherited Roth IRA:

1. An eligible individual who is so in love with Roth IRAs that he/she wants to convert BOTH his/her own plans and IRAs AND the inherited plan to Roth IRA status.
2. If the inherited plan contains after-tax money, it would be "cheaper" to convert the inherited plan than to convert the beneficiary's own plan (if the beneficiary's own plan is 100% pretax money).

3. If the deceased 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, so this factor should enter into the consideration of the cost of the conversion. See § 691(c) and ¶ 2.3.04.
4. Any beneficiary who really wants a Roth IRA, and is eligible, but does not have a plan or IRA of his/her own that he/she can convert—especially if he/she expects his/her income to increase in the future.

Frank Example: Frank is age 40 and working. He has a 401(k) plan and income under \$100,000. He'd like to have a Roth IRA, 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 higher bracket. He inherits a 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 2009, leaving her 401(k) plan and other wealth to Sarah. Sarah's income is under \$100,000 and she 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.

5.9.07 Implications for clients retiring or leaving their jobs

George Example: George is retiring at age 65 from XYZ Corp. He has a \$500,000 401(k) plan balance, of which \$75,000 is after-tax money. He also owns a \$1 million IRA, all pre-tax money. He does not expect to be reemployed again ever. His income is over \$100,000. Should he roll over his 401(k) balance to an IRA? Or should he leave it where it is?

There are many factors to consider in making the decision whether to roll money out of a company plan, including creditors' rights, investment control, and fees, just to name a few. The new plan-to-Roth-IRA rollover option, and Notice 2008-30, have created two new reasons why George might want to leave the money right where it is instead of rolling it over to an IRA:

1. When 2010 arrives, and George becomes eligible to make a rollover contribution to a Roth IRA (because the \$100,000 income limitation will cease to exist), he can roll the 401(k) plan directly to a Roth IRA and pay tax only on the pretax money in the account. Thus, his Roth conversion will be "cheaper" because \$75,000 of the \$500,000 account is converted tax-free. If he rolls the money to a traditional IRA right now, the after-tax money will become "diluted" by the large amount of pretax money in his existing IRA.
2. When George dies, if the money is still in the 401(k) plan, his nonspouse beneficiaries will have the option to roll the inherited plan to an inherited Roth IRA (if the plan permits nonspouse beneficiary rollovers—which it will be required to do

after 2009, and is permitted to do in 2009—and the beneficiaries are eligible). If George rolls the money to an IRA now, his nonspouse beneficiaries will not be able to convert the inherited IRA to an inherited Roth IRA.

Do these two factors mean George should not roll over to an IRA? Not necessarily. For example, if George is leaving his retirement benefits to his spouse or to charity, then he can ignore factor #2. If George had no after-tax money in the plan, factor #1 wouldn't apply. But these are new factors that must enter in to the decision process; something new for your “rollover checklist”!

Table 1: IRA Contribution Limits

Year	Applicable Dollar Limit:	
	Under age 50	Age 50 or older
1998–2001	\$2,000	\$2,000
2002–2004	\$3,000	\$3,500
2005	\$4,000	\$4,500
2006–2007	\$4,000	\$5,000
2008–2010	\$5,000	\$6,000