



Roth Conversions: Pulling It All Together

Andrea Cohen, CFP®, is a senior financial adviser with Kovitz Investment Group, LLC in Chicago. She has more than 20 years experience working with corporate executives and high net worth individuals in the financial planning and executive compensation fields. Before joining Kovitz Investment Group in 2006, Cohen was a second vice president at Northern Trust in Chicago where she provided comprehensive financial planning services to high net worth families. Prior to Northern Trust, she was vice president of Personal Financial Planning, Inc., a fee-based financial planning firm also providing comprehensive financial planning services to high net worth families.

Since 1998, individuals have been able to convert IRAs to Roth IRAs as long as the individual's Modified Adjusted Gross Income (MAGI)¹ does not exceed \$100,000 in the year of conversion and the individual is not married and filing a separate income tax return for that year.² Beginning in 2010, the \$100,000 MAGI limit and the rule against conversions by married individuals filing separately no longer apply.³ This change opens the door to tax planning opportunities that were previously out of reach to millions of individuals.

While the Roth conversion offers many benefits, we cannot lose sight of the fact that it comes at a price. Not everyone stands to benefit from a Roth conversion, and those that do benefit, do so to varying degrees. Analysis is needed at the individual level to determine whether the benefits the individual is likely to receive, or that he or she may receive, from conversion justify the cost. Whether and to what degree an individual may benefit from conversion depends on a wide range of factors specific to his or her personal situation including age, financial resources, income tax position, applicability of estate tax, cash needs, retirement income sources, and personal and family goals. Roth conversion is not a "one-size-fits-all" strategy.

There have been many articles written about the Roth conversion since 2006 when the law that will effectively open the Roth conversion door to everyone was passed. The goal of this paper is to create a practical guide that can be used by individuals, planners and other professionals contemplating conversion. It is an attempt to merge the technical with the practical, to pull the various and fairly wide-ranging aspects of Roth conversion together in an organized and functional manner. This paper discusses the benefits of a Roth IRA and reasons to consider conversion, the potential downside or risk of conversion, factors that influence conversion results, general rules of thumb identifying when conversion is likely to make sense and when it is not, actions that can be taken at this time to prepare for the Roth conversion decision, and important actions to be taken at or following conversion.

The following discussion focuses on the strategy of conversion and assumes some familiarity with the general rules governing Roth IRAs and conversions. An overview of certain of these rules is provided in the sidebar.

Why Consider Conversion to a Roth IRA?

Roth IRAs can make it easier to grow, preserve, and spend retirement savings during one's lifetime due to special tax and distribution rules governing them. Consider the following:

- **Roth IRAs provide tax-free earnings versus tax-deferred earnings.** With traditional IRAs and retirement plan savings accounts, earnings are allowed to accumulate without taxation but are taxed upon withdrawal from the IRA or plan. With a Roth IRA, the earnings accumulate without taxation and will not be taxed upon withdrawal provided that the distribution is qualified (refer to the sidebar for an explanation of the requirements for a qualified distribution).
- **A Roth IRA is effectively "bigger" than a traditional IRA of the same asset size.** Contributions to a Roth IRA are made with after-tax dollars and earnings grow tax-free. This means 100 percent of the Roth IRA is available to the account owner and beneficiary, whereas with a traditional IRA a portion (equal to the taxes that will ultimately be paid) effectively belongs to the government. How much bigger the Roth IRA is depends on the rate at which the traditional IRA distributions will eventually be taxed.
- **Distributions from Roth IRAs are not required during the account owner's lifetime, thus preserving the benefit of tax-free compounding for a longer period of time.** With a traditional retirement account, the benefit of tax-deferral is lost when one is forced to take unneeded distributions due to the Required Minimum Distribution ("RMD") rules.
- **A Roth IRA provides tax diversification.** Qualified withdrawals from a Roth IRA are tax-free, whereas most other retirement income sources are fully or partially taxable (including distributions from traditional IRAs and retirement plan savings accounts, pension annuities, non-qualified annuities, and Social Security). Having a "bucket" from which funds can be withdrawn tax-free, and a choice of where to draw funds from, provides flexibility to manage taxes in retirement. This can be particularly beneficial for individuals who have most of their savings in tax deferred accounts and are heading toward a retirement that will be funded largely from taxable sources, as inevitably there will come a year when unexpected expenses are incurred. Withdrawal of additional amounts from taxable sources to cover the extra expenses will increase taxable income in that calendar year, which may push into, and be taxed at, a higher marginal rate than would otherwise apply. A Roth IRA "bucket" can help manage taxes by keeping taxable income from creeping into higher brackets.
- **Conversion to a Roth IRA reduces taxable income in future years and may result in future tax or Medicare premium savings.** Conversion will reduce or eliminate taxable IRA distributions in the future, thereby lowering taxable income and AGI, which is used as a threshold for limiting deductions, exemptions and credits. In addition, the amount of Social Security that is subject to taxation and the Medicare B premium rate are also based on a modified version of income that starts with AGI. Distributions from a Roth IRA are not added into the computation to determine how much Social Security is subject to tax.

Conversion to a Roth IRA can also be an effective estate planning tool when one's goal is to pass wealth to family members in a younger generation.

- **Roth conversions can reduce the size of the account owner's taxable estate, and thus estate taxes.** Converting to a Roth IRA requires prepayment of the income tax on the converted IRA amount. For account owners that will be subject to estate tax, that pre-paid income tax reduces the size of the taxable estate and thereby estate taxes at death. With a traditional IRA, the full value of the IRA including the portion that represents the government's interest will be included in the account owner's taxable estate and estate taxes will be paid on the deferred income tax. While the beneficiary is permitted a deduction for estate tax paid in the year(s) income is recognized from the IRA, the beneficiary may not get full use of the deduction and there is no deduction for state estate tax paid. It is generally more advantageous to incur income taxes before estate taxes, than estate taxes before income taxes.
- **Conversion to a Roth IRA allows for tax-free compounding over a longer period of time if funds are not needed during the account owner's lifetime.** Funds in a Roth IRA can compound undisturbed during an account owner's (and spouse's) lifetime, resulting in the transfer of a much larger account upon death assuming even modest appreciation. And it doesn't end there! Earnings in an inherited Roth IRA continue to grow tax-free following death. Although a non-spouse beneficiary must begin to take (tax-free) distributions following death, those distributions can be stretched over the lifetime of a child or grandchild beneficiary thus stretching out the length of time funds remain in the Roth IRA growing tax-free.
- **Potential income tax savings when the beneficiary is expected to be in a higher income tax bracket than the account owner.** In situations where it is anticipated that the IRA funds will not be fully spent by the account owner, it can make sense to compare the rate at which conversion taxes would be paid by the account owner with the rate at which beneficiary distributions would likely be taxed. Individual beneficiaries may be forced to take RMDs during their working years when their taxable income is highest, or may be successful in their own right already incurring (and subjecting RMDs from the inherited IRA to) taxes at the highest marginal rate. This differential between the account owner and beneficiary tax rates can also be meaningful when the beneficiary is a trust that permits IRA distributions to be retained in trust thereby subjecting retained distributions to taxation at the trust level.

What's the Downside?

While the Roth IRA has many appealing attributes as discussed above, conversion comes at a price. The price is the upfront taxes paid, and admittedly paying taxes before one would otherwise have to goes against conventional wisdom. This cost, which can be quite hefty depending on the applicable tax rate and the amount converted, must be justified by the benefits one is likely to receive, or that he or she may receive, from conversion. For some, there may also be incidental costs to conversion attributable to reporting higher income, such as a temporary increase in Medicare B premiums or reduced eligibility for college financial aid.

As a trade-off for incurring taxes up front, one would ideally like the results from conversion to be guaranteed. Unfortunately, this is not the case. It may turn out that one overpaid for conversion or that the anticipated benefits never materialize due to factors beyond one's control.

- **Taxes paid at conversion may turn out to be meaningfully higher than the taxes that would otherwise have been paid.** This could result from a change in tax structure or a change in any of a number of factors in one's personal situation.
- **Taxes paid at conversion may be based on value that is never received.** The value of assets converted may fall precipitously and never recover, meaning taxes were paid on value that will never be received. However, if asset values were to drop within the re-characterization window (see sidebar), the conversion could be undone.
- **There is no guarantee that the government won't change the rules or that the U.S. taxing system won't be restructured.** While it may seem unlikely now, the rules governing Roth IRAs could be changed to be less favorable and applied to all Roth IRAs without grandfathering provisions for existing accounts. It's difficult to handicap the odds of this happening, but not so hard to imagine a trimming back of the very favorable tax treatment currently afforded to Roth IRAs as new governmental revenue sources are sought. It is also possible that the laws governing distributions from traditional IRAs or retirement plan accounts could be changed to provide a more favorable tax result for distributions from those accounts, or that the U.S. income tax scheme could be replaced or supplemented by a flat tax, consumption tax or other tax system.

It is impossible to know with certainty the economic results of conversion. Even the most well thought out analysis involves assumptions about the future, which are unknowable today. The inherent uncertainty is not by itself a reason to forego conversion, but something that should be acknowledged, and the range of possible outcomes considered when determining if the benefits from conversion outweigh the cost.

Factors That Influence Conversion Results

So now that we know the potential benefits, cost, and risks of conversion, how can we assess whether conversion makes sense for a specific individual or situation? The key is knowing what factors influence conversion results and understanding how such factors apply in a given situation. Five factors that have the greatest economic impact on conversion results are:

Current Versus Future Tax Rates. How does the tax rate applicable on conversion compare to the tax rate expected to be paid on IRA distributions in the future? All things being equal, it is always better to pay taxes at a lower rate and keep a bigger piece of the pie. With Roth conversions, however, all things are not equal, and in some situations the benefits from other aspects of the Roth conversion can overcome paying taxes at a higher rate. In general, if the conversion tax rate is:

- lower than the expected future tax rate, conversion will almost always make sense;
- the same as the expected future tax rate, conversion will likely make sense if taxes can be paid from non-retirement accounts; or
- higher than the expected future tax rate, conversion will only make sense if other benefits received from the Roth conversion outweigh the incremental cost and acceleration of payment.

In some situations it may be easy to predict with a reasonable level of confidence whether income would be subject to taxation at a higher or lower rate

today than in the future. In other situations, however, projecting forward will require thought beyond the marginal tax bracket structure. Biases of where one believes tax rates are headed will also factor in, although caution should be exercised if the decision turns solely on predictions made about the taxing structure out 10, 20, 30 or more years into the future.

Availability of Funds to Pay the Conversion Taxes. Whenever possible, it is always best to pay the income tax due on conversion from non-IRA funds. Using non-IRA funds has the effect of making the retirement account "bigger" thus sheltering earnings on a larger asset base from future taxation. This point cannot be over emphasized-the ability to effectively shelter more of one's assets from taxation is a key driver behind the Roth conversion strategy and what gives the Roth conversion a leg up in the analysis.

To illustrate, assume conversion of a \$100,000 IRA at an effective tax rate of 25 percent. Assume further that a rate of 25 percent is expected to apply to future IRA distributions. Essentially \$75,000 of the pre-converted IRA will be available for use by the account owner, and \$25,000 will be paid to the government in the form of taxes. If the IRA is converted and funds from the IRA are needed to pay taxes on the conversion, the account owner will still have just \$75,000 sheltered from future taxes. If instead, non-IRA funds are used to pay the taxes, the account owner will have \$100,000 sheltered from future taxes and \$25,000 less in his or her non-retirement account. It is as if \$25,000 was moved from a taxable environment to a non-taxable environment.

Need to Access Conversion Funds. The longer conversion funds can remain in the Roth IRA and grow tax-free, the better the economic result. Funds are more likely to remain in the Roth IRA longer when the account owner is younger or will not need the converted amount to fund living or other expenses.

Estate Tax/Intergenerational Transfers. Everything else being equal, conversion for an account owner who expects to be subject to the estate tax will make more sense than for a person without an estate tax problem as one potential benefit of a Roth conversion is estate tax savings. Conversion will also make more sense when an account owner does not need to access retirement assets to live on and wants to leave assets to children or grandchildren, as the funds are more likely to remain in the Roth IRA over a longer period of time.

Investment Performance. In general, the greater the return on converted funds, the greater the amount of earnings that escape taxation, and the better the economic result. Opportunities may appear from time to time that increase the possibility of enhanced returns following conversion. For example, many account owners saw the value of their retirement accounts plummet in 2008 and into 2009, creating an opportunity (for those eligible) to effect a Roth conversion at a much lower tax cost than what would have been the case previously. Another example is when one believes an asset held in his or her IRA is likely to appreciate rapidly in the near future. While a favorable result is not guaranteed as future performance always remains uncertain, an opportunistic conversion taking advantage of perceived low values can tilt the deck in one's favor.

Rules of Thumb

Once the factors that influence conversion results are understood, we can draw some conclusions about when conversion is likely to be, or may be, a good strategy, and when it is not. The rules of thumb provided below generally hold true, however, they may not be the right answer for everyone and specifics of each individual's circumstances should be considered. Also, conversion is not necessarily an all or nothing decision, as partial conversion or conversion spread over a number of years may be the preferred solution. In all cases, it is best to pay conversion taxes with non-retirement funds.

Situations where conversion *is likely* to be a good strategy:

When conversion can be done at a tax rate that is lower than the rate expected to be paid on future IRA distributions. Potential situations include:

- retirees between working years and collecting Social Security and/ or RMDs;
- married individuals prior to death of the first spouse (due to expectation of change in filing status from married filing jointly to single);
- individuals in the upper tax brackets who expect to remain in the upper tax bracket and expect tax rates to increase; and
- young people with low incomes and some accumulated IRA funds.

By converting only a portion of the IRA or spreading conversion over multiple years, one can manage the taxes paid on conversion and capture conversion at the desired rate.

When conversion would enable one to take advantage of favorable tax attributes, particularly if they may be lost or the Roth conversion allows them to be used more effectively. Examples include situations where there is a net operating loss carry-forward, a current year flow-through business loss, passive losses that are to be recognized, charitable deduction carry-forwards, and unusually high itemized deductions (though AMT may be an issue).

Additional situations where conversion is likely to be a good strategy include:

- When the percentage of non-deductible contributions (tax basis) in the IRA(s) is meaningful.
- When the future tax savings likely to be realized as a result of reduced taxable income outweighs the current cost of conversion.
- When an account owner is nearing death and conversion would result in lower combined income and estate tax than the combined amount expected to be paid if pre-tax retirement assets are passed at death. When the account owner is in a lower tax bracket than the beneficiary(ies), does not need the IRA funds to live on, and can pay the income tax (and estate tax if applicable) from non-IRA assets thereby maximizing the size and duration of the Roth IRA.

Situations where conversion *may be* a good strategy:

- To hedge against a *projected* increase in future tax rates.
- To take advantage of unique investment opportunities or economic conditions when it appears the chances of achieving higher investment returns are greater.
- When taxes paid at conversion are not higher, or are only marginally higher, than the rate expected to be paid on future IRA distributions and income tax resulting from conversion can be paid with non-IRA assets. In addition to effectively creating a larger tax sheltered account, one may also benefit from hedging against an increase in future tax rates or adding tax diversity to his or her portfolio.

The marginally higher rate that one is willing to pay at conversion is not be the same for everyone. What may be an acceptable marginally higher rate (and worthy of analysis) is probably less than 10 percent if no estate tax savings are expected, and within this 1 to 10 percent range will be: > lower, when the expected future tax rate is lower, the account owner is older and will need to spend converted funds, the converted funds will be spent down during the account owner's lifetime, and/or a modest return on investment is expected; and > higher, when the expected future tax rate is higher, the account owner is young or won't otherwise need to access the funds for many years, the converted funds won't be spent and will pass to a younger beneficiary, and/or a higher return on investment is expected. If estate tax savings are expected, one should be willing to pay tax at a higher incremental rate than if no estate tax savings are expected.

When the account owner will be subject to estate taxes and will not need to draw from the Roth IRA. This will be more advantageous when income tax paid on conversion is not more than marginally higher than the rate expected to be paid by the beneficiary on future IRA distributions, the beneficiary is younger and likely to take distributions over an extended period of time, and/or the account owner lives in a state where state estate taxes are also assessed at death.

Situations where conversion would *likely not* be a good strategy:

- When retirement account assets must be used to pay the resulting income tax. This is especially true if the account owner is under age 59½ at the time of conversion and the amount of distribution used to pay the taxes would be subject to the 10 percent early withdrawal penalty. It may be possible to overcome this if the account owner is able to convert at a lower tax rate than would apply at the time of future distributions or if estate tax savings are expected.
- When the tax rate that would apply on conversion is more than marginally higher than the rate expected to be paid on future IRA distributions. The higher the incremental tax paid, the greater the risk of overpaying for conversion and the less palatable conversion is to the account owner. Again, this marginally higher rate is not the same for everyone.
- When the IRA beneficiary is a charitable organization. No income tax is assessed on IRA assets that pass to a charitable beneficiary at death. Thus, any tax paid to convert IRA assets that ultimately pass to a charitable organization is too much. Additionally, a charity receives no additional benefit from the tax-free status of the Roth IRA since it is already exempt from taxes.

Getting Started

In most cases, some analysis will be needed to determine whether to proceed with the Roth conversion. Some actions you can take now are noted below. There is no reason to delay getting started.

Identify the aspects of the Roth conversion that will likely benefit the account owner. Not everyone stands to benefit from each and every aspect of the Roth conversion. Identifying which are relevant in a particular situation will focus the analysis.

Gather information on all of the account owner's IRAs, including market value and tax basis.

Determine at what rate conversion income would be taxed. Understand marginal rates and where break points are as a partial conversion may be optimum. Consider whether it makes sense to accelerate any tax deductions (such as charitable contributions). Determine if there are any incidental costs that may apply (such as a temporary increase in Medicare B premiums). For 2010 conversions, consider whether conversion income should be recognized fully in 2010 or equally over 2011 and 2012 (and subject to tax laws then in effect).⁴

Project future income amounts and estimate what the account owner's marginal tax rate(s) are likely to be in the future. Use this information to help assess whether the cost of conversion is reasonable.

Determine amount of non-IRA funds available to pay tax on conversion. If there is cost associated with accessing these funds (such as large capital gains tax upon liquidation), estimate this cost.

Analyze whether conversion makes sense, whether the benefits likely to be received outweigh the cost. Consider current and future tax rates, projected future cash needs, sources of funds, and estate planning aspects.

Decide whether to roll IRA assets on conversion to a new or existing Roth IRA, and whether to roll these assets to just one Roth IRA or to multiple Roth IRAs. The reason for converting into a new Roth IRA is administrative, whereas the reason for converting to multiple Roth IRAs is more strategic. Rational for using a new Roth IRA rather than an existing account is that it eliminates the need to compute the income or loss on the converted funds if the conversion is later undone since the income or loss would already be reflected in the account balance. Converting into multiple Roth IRAs can be beneficial if the IRA holds different types of assets. For example, if an IRA holding stocks and bonds is converted into two Roth IRAs, one receiving only stocks and the other only bonds, one could choose to recharacterize only the Roth IRA that holds the stocks (or bonds) if those investments were to perform poorly. While it is possible to selectively choose which Roth IRA to recharacterize, one cannot cherry-pick specific assets within a single Roth IRA to recharacterize (in the earlier example, if the stocks and bonds were converted into a single IRA, it would be impossible to separate and undo only the stock portion of the conversion).

Consider whether to make non-deductible IRA contributions for 2009 and 2010 prior to effecting a 2010 conversion. Making non-deductible contributions to an IRA is a means of funneling additional dollars to a Roth IRA. This will generally make sense if one has a relatively high basis in his or her IRAs, but will make very little difference if one's IRA basis is relatively low.

After Conversion

So far, so good ... but don't stop here unless the decision reached was to maintain the tax-deferred IRA and forego conversion. With the benefits and risks of conversion understood, the specific situation analyzed, the conversion decision made, and the conversion executed, there is still some work to be done.

Make sure the named beneficiary (or beneficiaries) of the Roth IRA qualifies for "stretch" distributions under the RMD rules. If the Roth IRA beneficiary fails to qualify for stretch distributions, the Roth IRA will have to be fully distributed by the end of the fifth year following the year of

the account owner's death. Failure to qualify for the stretch distributions greatly diminishes the value of a Roth IRA inheritance.⁵

Review whether estimated payments are necessary to meet minimum withholding requirements in year(s) conversion income will be recognized.

Monitor the conversion during the period in which such conversion can be recharacterized. A Roth conversion can generally be recharacterized up to the extended tax filing date for the year in which conversion occurs (i.e., October 15 of the following year). If investments plummet or the economics no longer look favorable due to changes in the individual's situation or tax laws, re-characterization should be considered.

For 2010 conversions, reconfirm whether to recognize conversion income fully in 2010 or equally in 2011 and 2012 in light of any new information that may become available. The decision must be made with filing of the 2010 income tax return which can be as late as the extended filing due date of October 17, 2011. By the tax filing deadline, there may be more clarity about near term tax law changes and the impact of those changes on the account owner's personal tax situation.

Conclusion

A Roth IRA conversion offers many benefits and is worthy of consideration by anyone in a position to take advantage of its benefits. For those first eligible for conversion in 2010, it may be an opportune time given that tax rates are currently low and many account values are still depressed as compared to a couple of years ago. A decision to convert will rarely come without some element of uncertainty as to the ultimate result, but this is true of any decision that involves assumptions about the future which are unknowable at the time of decision. In the case of a Roth conversion, however, the price of conversion is paid up front and understandably this can stop some would-be converters in their tracks. As with other decisions, one must accept that uncertainty exists and move forward with confidence knowing the decision to convert (or not) was based on weighing the cost against the benefits likely (or of some probability) to be received given the specifics of his or her situation and a reasonable perspective of how things may unfold in the future.

Footnotes

1. Modified Adjusted Gross Income (MAGI) for Roth conversion purposes is regular Adjusted Gross Income (AGI) *plus* certain income deductions or exclusions and *minus* any income from the Roth conversion itself and Required Minimum Distributions withdrawn from IRAs only. Amounts deducted or excluded from AGI that need to be added back for MAGI include: foreign earned income exclusion, foreign housing, domestic production activities, qualified bond interest as shown on Form 8815, student loan interest or qualified tuition, employer paid adoption benefits, and traditional IRA contributions.
2. An exception is made for married individuals filing separately who lived apart the entire year.
3. The Tax Increase Prevention and Reconciliation Act of 2005, which was signed into law on May 17, 2006, eliminates the \$100,000 income limitation and requirement for married individuals to file jointly effective for tax years after 2009.
4. In all likelihood, the federal tax rates and computation details applicable in 2011 and 2012 will differ from those applicable in 2010. Absent any new tax law changes, tax rates are scheduled to increase in 2011 upon sunset of a number of tax laws enacted in previous years. The sunset provisions will impact the marginal tax rates, tax rates applicable to capital gains and dividends, and deductibility of itemized deductions and exemptions—all of which have the effect of increasing the taxes due. There are also tax law changes being discussed which include raising taxes on high income earners through tax rate increases, limits on itemized deductions, and a surcharge. At the low-to-mid-income level, the lower tax rates implemented in previous years may be preserved and possibly new tax savings measures introduced in coming years. It is uncertain what measures may ultimately pass and where the lines will be drawn between those subject to higher taxation and those not.
5. "Stretch" payouts from a Roth IRA are only available for benefits that pass to a "Designated Beneficiary" as defined in the Internal Revenue Code and further explained in regulations. In general, benefits must pass to an individual (or to an individual through a properly drafted trust, which must comply with specific requirements). If multiple beneficiaries are named, all such beneficiaries must be individuals (whether passing directly or through a trust) in order for any to qualify for "stretch" distributions. An estate, family partnership, or corporation will not qualify as a Designated Beneficiary.

Converting IRA to Roth IRA-Overview

IRA Conversions

- The types of IRAs that can be converted include traditional and rollover IRAs, SEP IRAs and SIMPLE IRAs (provided SIMPLE IRA has been maintained for minimum two year period).
- Required Minimum Distributions cannot be converted.
- Partial IRA conversions are permitted.
- Conversions from an IRA to Roth IRA are disregarded for purposes of the "one rollover per 12 month period" rule that otherwise applies to IRAs and Roth IRAs.
- Conversion involves transfer or rollover of funds from an IRA to Roth IRA and is treated as a taxable distribution from the IRA followed by a contribution to the Roth IRA. Funds must leave the IRA by December 31 to be a conversion for that year.
- The taxable amount distributed from the IRA (determined by the pro-rata rules) must be included in the account owner's taxable income in the year of conversion (except for 2010 conversions as next noted). The early withdrawal penalty does not apply to converted amounts.
- For 2010 conversions only, recognition of taxable income will be deferred 50 percent to 2011 and 50 percent to 2012 unless the account owner opts out of the deferral choosing instead to recognize all taxable income from conversion in 2010. Election is made on the 2010 tax return. The same election must apply to all amounts converted by an individual in 2010. Spouses may make separate elections.

Computing the Taxable Income on IRA Conversion

- The amount of conversion is the fair market value of the property distributed or transferred from the IRA to the Roth IRA on the date the assets were taken from the IRA.
- If non-deductible contributions were made to an IRA, or after-tax contributions were otherwise rolled over into an IRA, a portion of the converted amount will be non-taxable. Once after-tax money has been combined with pre-tax money in an IRA, there is generally no way to separate them. In almost all cases, distributions from an IRA will be considered to come proportionally from each the pre-tax and after-tax portions.
- The IRS views all IRAs (including SEP IRAs and SIMPLE IRAs) as one pot, and thus takes all IRAs into account when determining the taxable income from conversion.
- The pro-rata allocation rule does *not* apply to rollovers from an IRA to an employer plan. Instead, an IRA distribution that is rolled to an employer plan is deemed to come entirely from the taxable portion of the IRA.

Re-characterization: The Conversion "Un-Do" Option

- A conversion can be "undone" at any time up to the extended due date of the tax return (generally October 15 of the year following the year of conversion) by "re-characterizing" the converted Roth IRA contribution back to the IRA (along with any net income (or loss) allocable to such contribution).
- If a Roth conversion is re-characterized, it is treated as if the funds never left the IRA for tax purposes, although there are certain reporting requirements.
- Only those funds that went into the Roth IRA can be re-characterized.
- A conversion can be undone in whole or in part, and can be undone for any reason.
- Once re-characterization of a Roth IRA conversion occurs, the amount cannot be reconverted to a Roth IRA until the later of i) the taxable year following the year of the original conversion; or ii) at least 30 days have elapsed since the re-characterization.
- Any re-characterization must be effected by a trustee-to-trustee transfer.

Tax-Free Earnings / Qualified Distributions

- Earnings while in a Roth IRA are not taxed, and will be tax-free when withdrawn provided that the distribution is "qualified." A distribution is "qualified" if it meets two tests: the "five-year" test and "type of distribution" test.
- The five-year test is satisfied beginning on January 1 of the fifth year after the year in which the taxpayer first establishes a Roth IRA. The five-year period is the same for all Roth IRAs-when the five-year test is met for one Roth IRA it is met for all Roth IRAs (regardless of when any separate Roth IRA may have been established).
- Even after meeting the five-year test, only certain types of distributions are qualified. Qualified distributions include distributions made i) after account owner attains age 59½; ii) on account of death; iii) following disability; and iv) for first time homebuyers up to \$10,000 lifetime limit.
- Qualified distributions that meet these tests will not be subject to federal income taxes or the 10 percent penalty for early withdrawals. State and local taxes may apply depending on specific state and local laws.

Non-Qualified Distributions, Ordering Rule and Taxable Earnings

- Only the "earnings" portion of a non-qualified distribution will be subject to income tax and potentially the 10 percent early withdrawal penalty. If taxable, ordinary income rates apply.

- Specific ordering rules govern withdrawals from Roth IRAs. Annual contributions are withdrawn first (tax-free), conversion contributions are withdrawn next (tax free, but potentially subject to the early withdrawal penalty), and then earnings (taxable, and subject to the early withdrawal penalty unless an exception applies).
- Conversion contributions will be subject to the early withdrawal penalty if converted prior to age 59½ and the converted funds are withdrawn (subject to above ordering rules) prior to the earlier of reaching age 59½ or five years from the conversion date unless another exception applies. This second "five-year period" applies only to conversion amounts and is determined and applied separately to each conversion.
- In applying these ordering rules, all Roth IRAs are treated as one Roth IRA.

RMDs/Death of an Account Owner

- RMDs do *not* apply to a Roth IRA until after the account owner's death.
- A spouse beneficiary can take the inherited Roth IRA as his/her own, thereby avoiding lifetime RMDs.
- RMDs apply to non-spouse beneficiaries.
- Non-spouse beneficiaries cannot convert an inherited IRA to an inherited Roth IRA.

Converting Employer Plan Balances to Roth IRA

Beginning in 2008, distributions from employer plans (including profit sharing, 401(k), 403(b) and 457 type plans) are eligible for conversion directly to a Roth IRA. Normal conversion eligibility rules apply. While conceptually similar to converting a traditional IRA, the conversion rules applicable to employer plans differ in certain respects from those applicable to IRAs. Certain of these differences are noted below.

- Non-spouse beneficiaries of employer plans can convert their inherited plan benefits into inherited Roth IRAs (plans must allow for this beginning in 2010). The transfer must be effected via direct trustee-to-trustee transfer.
- Conversions can be re-characterized, but the converted funds (along with allocable net income) must go back to an IRA and not back to the employer plan.
- Determination of the taxable income is based only on the employer plan from which distribution is being made-there is no requirement that all such employer plans be aggregated for purposes of determining the taxable portion. It is not clear at this time whether after-tax contributions in an employer plan that also contains pre-tax money can be isolated and converted to a Roth IRA in a tax-free transfer.