

# The Off-Ignored Tax Transaction Reinvigorated: Roth IRA Conversions – Now is the Time to Get Reacquainted

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## I. Roth IRAs - History

A. Enactment. Enacted with the Taxpayer Relief Act of 1997 (P.L. 105-34), the year after SBJPA. Roth IRA contributions became available beginning in 1998—Yes, this is its 13<sup>th</sup> year!!

B. Limitations. Compensation limitations for contributions, and small amount of contributions, generally caused most attorneys to ignore all Roth rules entirely (although contributions can be made after age 70-1/2). This became more pronounced with availability of Roth 401(k) accounts (not limited by compensation) as enacted by EGTRRA (applicable beginning in 2006, although most plans still do not allow them).

C. Conversion limitations. Likewise, conversions to a Roth were not available for married individuals filing separately and for anyone with a modified AGI exceeding \$100,000.

1. AGI changed. Conversions were made more available with the elimination of MRDs from AGI for conversion purposes beginning in 2005.

2. Required 2-step rollover eliminated. Another partial roadblock was that conversions could only occur from a traditional IRA, requiring a 2-step rollover for assets in a qualified plan (to an IRA, then to a Roth), until direct rollovers to a Roth IRA from a qualified plan were permitted beginning in 2008 (enacted by PPA '06).

D. Advantages of Roth IRA? But, few saw a significant advantage to Roth IRAs, especially in light of the single-year tax hit at the time of conversion (although the early distribution excise tax does not apply, all amounts converted are included in income in the year of the conversion).

1. MRD. But, MRDs are not required from a Roth IRA except at death, so conversion at the proper time can allow significant assets to continue to be sheltered for eventual tax-free (not tax-deferred) distributions. And, MRD changes can now allow spread over designated beneficiaries' individual life expectancies (rather than only over life expectancy of oldest beneficiary). In addition, spouse can treat Roth IRA as his/her own at Roth IRA owner's death, further delaying MRDs.

2. Income tax. And, of course, there is no income tax at all (even on earnings) if Roth is held until the appropriate distribution event: (i) 5 years (each conversion treated

separately), AND (ii) age 59-1/2, or death (even to estate), or disability, or qualified special purpose distribution (i.e., 1<sup>st</sup> home purchase). (Excise taxes may apply on the entire amount of the eventual distribution, even if not included in income, for early distributions of conversions.)

3. Contributions. Can be made after age 70-1/2, perhaps adding significant dollars to tax-free distributions to next generations. (Rather generous modified AGI limitations for 2010 are \$105,000 (reduced proportionately to \$120,000) for single filers, and \$167,000 (reduced proportionately to \$177,000) for married joint filers, again without considering MRDs in the calculation).
4. Distributions. Nontaxable portion comes out first on eventual distribution (while conversions are proportional as between traditional and after-tax IRAs, including SIMPLEs and SEPs).
5. Estate tax (obsoleted for 2010). Removes income tax on the eventual distributions (from the qualified plan or IRA) from the estate.
6. Recharacterizations. Available until October 15 of the year following the year of the conversion, permitting the new Roth to be recharacterized. reconversions then permitted in the taxable year following the recharacterization, or 30 days after the recharacterization.

## II. Why Now?

1. Limitations eliminated. Effective in 2010, AGI and married-filing-separately limitations were removed (enacted with TIPRA , a few months prior to PPA '06).
2. Favorable income tax treatment (except in WI). For a 2010 conversion, by default, half of amount will be included in income in 2011, and half in 2012. Election can be made to include all in income in 2010 (depending on what you figure will happen to taxes in the future).