TABLE OF CONTENTS

Detailed Table of Contents

Doth Thou Roth?

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

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Warning! Tax Law Changes Coming?

Two business days before the due date of this Outline, a proposed new tax law was introduced in Congress. See Appendix D for discussion of this proposed law and its effect (if enacted) on matters discussed in this Outline. Throughout this Outline, any statement or section whose content would be directly impacted by the proposed legislation contains the warning "See Appendix D."

Abbreviations, Symbols, and Defined Terms

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

¶ Paragraph references refer to sections of the author's book *Life and Death Planning for Retirement Benefits*. If (and only if) the referenced section begins with "¶ 5" the section can be found elsewhere in this Report. The book can be purchased in bound (paperback) form for $89.95 plus shipping through www.ataxplan.com, through Amazon.com, or by calling 800-247-6553; or in electronic online format, by subscription, at www.retirementbenefitsplanning.com.

AMT Alternative minimum tax. § 55.
Applicable Dollar Limit. The maximum permitted annual (regular) contribution to an IRA. ¶ 5.4.03.
Code Internal Revenue Code of 1986, as amended through October 31, 2017.
DRAC Designated Roth Account. See ¶ 5.7.01.
Five-Year Period. See ¶ 5.3.03.
IITC Investment in the contract. § 72(b)(2). See ¶ 5.3.04.
IRA Individual retirement account or individual retirement trust under § 408.
IRD Income in respect of a decedent. § 691.
IRS Internal Revenue Service.
MAGI Modified adjusted gross income. See ¶ 5.4.04(C).
Nonexclusion period. Same as "Five-Year Period"; see ¶ 5.3.03.
NUA Net unrealized appreciation. See ¶ 5.5.04(A).
QRP Qualified retirement plan under § 401(a).
Reg. Treasury Regulation.
RBD Required beginning date. See ¶ 5.2.01(A).
Regular contribution. See ¶ 5.4.02.
RMD Required minimum distribution under § 401(a)(9).
TAPRA The Taxpayer Relief Act of 1997 (Pub. L. 105-34).
Traditional IRA or plan. An IRA or retirement plan that is not a Roth IRA or Roth plan.

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Doth Thou Roth?

Explanation of references to "this Chapter" or "this book": This Heckerling seminar outline will comprise Chapter 5 of the forthcoming 8th edition of the author's book Life and Death Planning for Retirement Benefits (2018); it is already published in the electronic (ebook) edition of that book (www.retirementbenefitsplanning.com).

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

This Chapter covers everything the advisor needs to know about "Roth" retirement plans except the following matters that are covered in other Chapters: Roth conversions by the participant's surviving spouse (see ¶ 3.2.03(B), ¶ 3.2.04) or nonspouse (¶ 4.2.05) beneficiary; the executor's responsibilities with respect to a deceased participant's Roth conversion (¶ 4.1.02); the tax on "unrelated business taxable income" (¶ 8.2); and tax treatment of investment losses (¶ 8.1.02) and management fees (¶ 8.1.04).

5.1 Roth Plans: Various Matters

"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 tax structure: Contributions to the plan might or might not be tax deductible; and all distributions from the plan in excess of the participant's after-tax contributions would be includible in the recipient's gross income.

§ 408A established a new kind of IRA, called a Roth IRA, effective in 1998. Roth IRA contributions are never deductible, but distributions are normally tax-free. Thus, income tax on the plan's investment returns is not merely deferred, it is eliminated—at the cost of payment of income tax up front on the plan contributions. IRAs that operate the old-fashioned way are now called "traditional IRAs" when necessary to distinguish them from Roth IRAs. Reg. § 1.408A-8, A-1(a)(2).

In addition to tax-free distributions, the Roth IRA offers other advantages over traditional IRAs: no required minimum distributions during the participant's life (¶ 5.2.01); no maximum age for making contributions (¶ 5.4.04(A)); and the ability to withdraw the participant's own contributions, separately from any earnings thereon, income tax-free at any time (¶ 5.3.04).

Otherwise, Roth IRAs are just like traditional IRAs except where the Tax Code says they are different. § 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.

There are two primary paths to acquiring a Roth IRA. One is to make small annual contributions to a Roth instead of a traditional IRA; that path may be blocked by an income limitation. See ¶ 5.4.04(C). The other path is to "convert" a traditional plan or IRA to a Roth IRA, essentially by paying income tax on its current value. No income limit blocks that path, so the Roth conversion option is open to all owners of traditional retirement accounts. See ¶ 5.5.

Since 2006 we also have another type of Roth plan, the "designated Roth account" or "DRAC"; ¶ 5.7. DRACs have some, but not all, of the favorable features of Roth IRAs.

5.1.02 ***Income tax reporting: Roth distributions***

An individual who receives a tax-free "qualified distribution" (¶ 5.3.01) from her Roth IRA will receive a Form 1099-R reporting that distribution to her and to the IRS. Hopefully the IRA provider has correctly coded the distribution as "Q" (qualified distribution from a Roth IRA). The IRS's Instructions for Form 1040 (2016) are a little unclear, but it appears the most lucid way to report this would be to enter the gross amount of the distribution on line 15a and then enter "0" as the taxable amount on line 15b.

A trust has more difficult task. Suppose the trust's only asset is an inherited Roth IRA and the trust's only "income" for the year is a $30,000 qualified distribution from the Roth IRA. Again, hopefully, the IRA provider files Form 1099-R showing a gross distribution of $30,000, coded "Q." The taxable amount is zero, meaning the trust has no gross income for the year, and is not even required to file an income tax return. But if no return is filed the statute of limitations does not start to run. What if some day the IRS decides the Roth IRA is not qualified for some reason (see "Prohibited Transactions," Chapter 8)? It would be preferable to file a return to start the statute. Unlike the individual tax return form (1040), however, the fiduciary form (1041) does not have a handy set of lines for distinguishing gross IRA distributions from taxable IRA distributions. All "1099-R" income is to be reported on line 8, "Other income." See Instructions for IRS Form 1041 (2016), p. 20. One solution is to enter "see statement attached" on this line, then attach a copy of the 1099-R and a statement describing the Roth IRA, the distributions received, and why they are not taxable. The trustee will need to determine how to allocate expenses to such "tax-exempt" income and how to report distributions of it to any beneficiaries who receive distributions.

5.1.03 ***Abusive Roth transactions***

Although historically there has always been concern about people contributing to a tax-favored retirement plan more than is legally permitted, that concern was (pre-1998) tempered by the knowledge that eventually the retirement plan funds would have to be distributed and taxed. The retirement plan "abuser" was merely gaining tax deferral, not tax elimination.

The arrival of the Roth IRA changed the dynamics. The incentive to overfund a Roth IRA is much greater than the incentive to overfund a traditional retirement plan, because (if you get away with it) all the income and gains inside that illegally funded Roth IRA will be income tax-free. Thus abusive Roth transactions appeared on the scene very quickly after the birth of the Roth IRA.

The main approach to nonlegal shifting of income to a Roth is to have the Roth IRA own an entity to which the taxpayer's real business pays tax-deductible "business expenses" (or sells assets for below-market prices). In Notice 2004-8, 2004-4 IRB 333, the IRS attacked these devices as being: disguised IRA contributions designed to avoid the limits on annual IRA contributions (¶ 5.4.03); listed transactions for purposes of the anti-tax-shelter regulations (see Reg. § 54.6011-4); and possibly prohibited transactions (¶ 8.1.06). The IRS will dismantle the transactions through denial of deductions (for, *e.g.*, excessive payments from a business to the Roth IRA-owned entity), re-allocation of income, deductions, etc., among the persons and entities involved pursuant to § 482, or imposition of the excise tax for excess IRA contributions (§ 4973). See, *e.g.*, CCA 2009-17030. The 6% excess-contributions excise tax (¶ 2.1.08) is a particularly potent weapon because it is imposed annually as long as the excess contribution remains in the IRA, and there is no statute of limitations unless the taxpayer filed Form 5329 (¶ 1.9.02) for the applicable year.

Block Developers, LLC, et al. v. Commissioner, TC Memo 2017-142, is a typical example (and the opinion discusses several other similar cases). The taxpayer's "real" business sold some patents to a newly-formed LLC owned by Roth IRAs established by members of the taxpayer's family, then paid "royalties" on the patents to the LLC. The Tax Court made extensive findings regarding the LLC's lack of any business activity (it had no employees, advertising, office, etc.) or any purpose other than to shift income into the tax-exempt Roth IRAs, and upheld the IRS's treatment of the "royalties" as excess contributions to the Roth IRAs subject to excise tax under § 4973. Advisors should stay far away from such "planning ideas."

On the other hand: If Congress has explicitly created two "legal" tax-reducing devices, there is nothing wrong with combining them, according to *Summa Holdings, Inc. v. Commissioner*, 848 F.3rd 779 (6th Cir. 2017). § 991–§ 995 permit a company to create an income tax-exempt "Domestic International Sales Corporation," and pay tax-deductible commissions to that "DISC" on export sales. If DISC stock winds up inside a Roth IRA there is a triple tax-free bonanza: The DISC earns tax-exempt income and pays it to the tax-exempt Roth IRA which then distributes it tax-free to the Roth IRA owner. The IRS attacked such an arrangement, and won its case at the Tax Court level, but the Court of Appeals overruled the Tax Court, holding that, where Congress explicitly created both these devices *for the purpose of reducing taxes*, there is nothing wrong with combining them.

A taxpayer who had tried something similar using a (since repealed) § 927 "Foreign Sales Corporation" also lost at the Tax Court level. *Celia Mazzei, et al., v. Commissioner*, TC Memo 2014-55. Perhaps if the Mazzeis had appealed the verdict to a higher court they would have won.

Oddly, nothing was said of "prohibited transaction" issues in any of these cases; see ¶ 8.1.06.

The *Summa Holdings* case gives support to planners who advocate combining two tax rules to get a result they couldn't get directly. See, *e.g.*, "back-door" Roth IRA annual contributions (¶ 5.4.04(D)) and converting one IRA to multiple Roth IRAs to facilitate recharacterizing only losing investments (¶ 5.6.05). A court-created rule called the "step transaction doctrine" says that two related transactions will be collapsed and treated as one, and if the result is a single transaction that would not have been legal to do, you lose. Typically applied to corporate reorganization-type multi-step transactions, the step-transaction doctrine (or other attack based on "substance over form") has not to date been applied to these two Roth planning ideas.

For other Roth planning ideas that Congress or the IRS has considered potentially abusive or just plain too good to be allowed, and therefore has addressed with a change in the law or other loophole-closing action, see ¶ 5.5.03(D) (Roth conversion of annuity contracts), ¶ 5.5.04(A) (Roth conversion of NUA stock), ¶ 5.6.08 (immediate reconversion following a recharacterization), ¶ 5.7.10 (shifting value to a DRAC within a plan), ¶ 5.8.02(C) (Roth conversion followed by immediate distribution while under age 59½), and ¶ 5.9.06(C) (lifetime gift of a Roth IRA).

*5.1.04 **Roth options for surviving spouse-beneficiary***

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

1. **The minimum distribution rules.** There would be no further RMDs required until the spouse's death, because she now holds the account as owner rather than as beneficiary and the lifetime RMD rules do not apply to Roth IRAs (see ¶ 5.2.01).

2. **Income taxability of distributions.** This would mean that the decedent's basis in the account (his contributions) would be combined with the surviving spouse's own basis/contributions to her own Roth IRAs for purposes of applying the Ordering Rules (¶ 5.3.05) to any nonqualified distribution (¶ 5.3.04).

3. **Early distributions penalty.** Once the spouse elects to treat the inherited Roth IRA as her own, the account ceases to be a "death benefit" and accordingly distributions to her from the account will be subject to the additional tax on pre-age-59½ distributions unless an exception applies. See § 72(t).

There is one exception to this general rule that the elected Roth IRA becomes "indistinguishable" from any Roth IRA established by the spouse herself: She gets to "keep" the decedent's years of Roth IRA ownership, if longer than her own, for purposes of computing the Five-Year Period; see ¶ 5.3.03(B).

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

B. Roth conversion from nonIRA plan by surviving spouse. Since the surviving spouse has, with respect to QRP and 403(b) benefits left outright to her, every option the deceased participant would have had for those benefits (see ¶ 3.2.01 of *Life and Death Planning for Retirement Benefits*), the surviving spouse can roll over the benefits into a Roth IRA just as the deceased participant could have done (see ¶ 5.5.01(B)). The recipient Roth IRA could be either her own Roth IRA or an "inherited" Roth IRA in the name of the deceased participant payable to the surviving spouse as beneficiary. Having converted an inherited traditional plan or IRA to a Roth IRA, the surviving spouse would have the same option as other Roth-converters to recharacterize the conversion (¶ 5.6).

*5.1.05 **Deductibility of Roth IRA management expenses***

§ 212 allows individuals an income tax deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year...for the management, conservation, or maintenance of property held for the production or collection of income...." This is a miscellaneous itemized deduction, subject to the "two percent floor" of § 67, and to the reduction of itemized deductions applicable to high-income individuals under § 68 [see Appendix D].

The IRS acknowledges in Publication 590-A (2016, p. 10), that "Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA...may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040)."

However, § 265 denies a deduction for otherwise-deductible expenses "allocable" to income that is tax-exempt, or, as the regulations put it, "Wholly excluded from gross income under any provision of Subtitle A" or any other law. Reg. § 1.265-1(b)(1)(i). Though there is as yet no IRS pronouncement on the subject, it would appear that investment management fees allocable to a Roth IRA would be nondeductible under this provision once the account owner has fulfilled the Five-Year Period and triggering event requirements (¶ 5.3.02), since after that point all distributions from the Roth IRA would generally be tax-exempt qualified distributions.

The answer is less clear with respect to investment management fees incurred prior to the time the participant has met the tests necessary to have qualified distributions. Until the five-year and triggering event tests are met, income generated in the Roth IRA is not necessarily tax-exempt (because if the account were terminated at that stage the earnings would be taxable as nonqualified distributions; see ¶ 5.3.04). Also, even after the account meets the tests for qualified distributions, if the account is earning sufficient unrelated business taxable income (UBTI; ¶ 8.2) to generate a tax on that income, then its income is not "wholly" tax-exempt, so the no-deduction rule might not apply.

5.2 Roth IRAs: Minimum Distribution Aspects

See Chapter 1 regarding the minimum distribution rules applicable to traditional IRAs under § 401(a)(9).

The minimum distribution rules do not apply to a Roth IRA until after the participant dies. Thus, withdrawals beginning at age 70½ that are mandated for traditional IRAs (¶ 1.4) simply do not apply to Roth IRAs. However, the participant's RMDs from the traditional IRA must be taken into account when converting the IRA to a Roth; see ¶ 5.2.04. Also, a "Roth conversion" (¶ 5.5) followed by a "recharacterization" (¶ 5.6) can impact the computation of lifetime RMDs from the participant's traditional IRA; see ¶ 5.2.05.

After the participant's death, the minimum distribution rules *do* apply to the Roth IRA beneficiary, with distributions being computed as if the participant died "before his required beginning date." ¶ 5.2.02.

5.2.01 ***No distributions required during participant's life***

The lifetime required minimum distribution (RMD) rules generally require that a participant must take annual distributions from an IRA beginning at a certain age. The first year for which a distribution is required is the year the participant reaches age 70½. For that year only, the required distribution can be postponed until April 1 of the following year; otherwise for the rest of his life the participant must take a "required minimum distribution" in every calendar year. Distributions are computed using a schedule (theoretically) designed to assure that the projected death benefits to the participant's beneficiary will be no more than "incidental benefits" compared with the value of the projected distributions to the participant. See ¶ 1.3.

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

5.2.02 ***Post-death RMD rules do apply to Roth IRAs***

Once the participant dies, the minimum distribution rules *do* apply to Roth IRAs. The Roth IRA is not exempted from any minimum distribution rules other than § 401(a)(9)(A) and the incidental death benefits rule, both of which apply only during the participant's life, so distributions must begin coming out of the Roth IRA after his death.

Since there is no RBD for a Roth IRA, the post-death minimum distribution rules will always be applied "as though the Roth IRA owner died before his" RBD, regardless of when he dies. Reg. § 1.408A-6, A-14(b).

For how to compute RMDs from a Roth IRA after the participant's death, see ¶ 1.5.02–¶ 1.5.03. If the participant's surviving spouse inherits the Roth IRA, see ¶ 1.5.03(B) for how to compute RMDs to her so long as she holds the account as beneficiary. If she rolls the account over to her own Roth IRA (¶ 3.2.03(B)), it then becomes "her" Roth IRA; she is now the "participant" with respect to the account, and there are no further distributions required until after her death (¶ 5.2.01).

5.2.03 ***Roth IRA distributions do not count towards RMD***

Distributions from a Roth IRA cannot be used to fulfill a distribution requirement with respect to a traditional IRA. Traditional and Roth IRAs are not aggregated for RMD purposes. Reg. § 1.408A-6, A-15.

Carol Example: Carol is age 73. She has a Roth IRA and a traditional IRA. In Year 1, the RMD for her traditional IRA is $12,000. She takes $12,000 out of her Roth IRA. The Roth IRA distribution does not count towards fulfilling the distribution requirement for her traditional IRA.

5.2.04 ***Roth conversion in a year when RMD required***

Beginning in the first year that a minimum distribution is required (the year the participant reaches age 70½ in the case of lifetime RMDs from a traditional IRA; ¶ 1.4.02), the traditional plan or IRA may not be converted to a Roth IRA until after the RMD for the year of the conversion has been distributed out of the traditional plan or IRA. Reg. § 1.408A-4, A-6(a), (b). This regulation derives from two rules:

- An RMD may not be rolled over; it is not an "eligible rollover distribution." § 402(c)(4)(B), § 403(b)(8)(A)(i), § 408(d)(3)(E).

- The first distribution(s) coming out of a plan or IRA in any year is/are deemed to be the RMD for that year until the entire RMD has been distributed. Reg. § 1.402(c)-2, A-7(a), § 1.408-8, A-4.

These rules create "traps" in several situations; see ¶ 2.6.03.

That is why, if the participant wants never to have to take any RMD from his traditional IRA, he must convert it entirely to a Roth IRA no later than the year in which he reaches age 69½. After that year, the participant can still convert his IRA (or as much or as little of it as he desires) to a Roth IRA, but he will have to take the RMD for the conversion year *first* before he can convert any of the rest of the account. Since the first required distribution year is the year the participant turns age 70½, there can be no Roth conversion in that year until after the participant has taken the RMD—even though, if there were no Roth conversion, the participant could have postponed the RMD until April 1 of the following year.

What if the participant violates this rule? If funds are rolled or transferred from a traditional plan or IRA to a Roth IRA *before* the RMD for the year of the conversion has been distributed out of the traditional plan or IRA, the conversion is not a valid Roth conversion to the extent of the RMD. The IRS treats the RMD that was improperly "rolled" to the Roth IRA "as if" (1) the RMD had been distributed out of the traditional plan and (2) the recipient then contributed the same amount to the Roth IRA as a "regular contribution" (¶ 5.4.02). Reg. § 1.408A-4, A-6(c).

The good news with this IRS rule is that there will be no fifty percent penalty for failure to take the RMD (¶ 1.9.02), because the RMD is deemed to have been distributed. The bad news is that the "deemed" regular contribution to the Roth IRA will usually be an excess contribution, either because the deemed contribution is larger than the permitted maximum regular contribution (¶ 5.4.03) or because the person is not eligible to make a regular contribution to a Roth IRA. A person who is eligible to *convert* to a Roth (¶ 5.5.02) may be ineligible to make a *regular* contribution to a Roth IRA (¶ 5.4.04). An excess contribution to the Roth IRA will generate an excess-contribution penalty unless the excess contribution (and net income attributable to it) is withdrawn from the Roth IRA prior to the applicable deadline for corrective distributions; see ¶ 5.6.07.

Angie Example: Angie, age 75, has two traditional IRAs, one worth $100,000 and one worth $200,000. Her 2016 RMD is (assume) $4,367 for the smaller IRA and $8,734 for the larger one. Before taking any distributions in 2016 from either account, she transfers the entire smaller ($100,000) IRA to a Roth IRA. This is a mistake—she should have taken the 2016 RMD attributable to that account *before* doing a Roth conversion. She *could* have taken the RMD for both of her traditional IRAs (total $13,101) entirely from either one of them (see ¶ 1.3.04), but it does not appear that she can now correct her rollover/conversion mistake by taking $13,101 from the $200,000 traditional IRA. Instead, the conversion is treated as a taxable distribution of the $4,367 RMD from the smaller IRA; a regular contribution of $4,367 to the Roth IRA; and a conversion contribution of $95,633 to the Roth IRA (*i.e.*, the balance of the smaller IRA after taking out the RMD of $4,367). If Angie is not eligible, or does not want, to make a regular contribution of $4,367 to the Roth IRA, she should withdraw that amount (plus net income attributable to it) from the Roth IRA as soon as possible; see ¶ 2.1.08 for rules on such "corrective IRA distributions," ¶ 5.6.04 for how to compute the net income attributable.

If she is not eligible to make that regular contribution (¶ 5.4.04) and does NOT withdraw it by the applicable deadline then she will owe the six percent additional tax for an excess IRA contribution (¶ 5.4.05). However, she will not owe the 50 percent penalty for failure to take an RMD because she is deemed to have *taken* the RMD. She still needs to take the 2016 RMD ($8,734) attributable to her larger IRA from the larger IRA; and after doing that she can convert all or any part of the rest of the larger IRA to a Roth IRA in 2016. For example, she could convert $4,367 of the larger IRA to a Roth IRA if she wants to stick to her original goal of converting exactly $100,000.

*5.2.05 **RMD adjustment for recharacterized Roth conversions***

When computing the prior year-end account balance for the participant's traditional IRA (for purposes of determining his RMD for the current year), an adjustment is required to reflect any traditional-to-Roth-IRA conversion that occurred in the prior year that was "recharacterized" in the current year. Specifically:

If there is a Roth conversion (¶ 5.5) in a particular year ("Year 1"), and that conversion is recharacterized in the following year ("Year 2"; see ¶ 5.6.07 for deadline), the recharacterized conversion contribution, and the net income allocable to it (which must be transferred to the traditional IRA along with the contribution itself in order to have a valid recharacterization; ¶ 5.6.04) are added to the prior year-end account balance of the traditional IRA that received the recharacterized amount, for purposes of computing the RMD from such traditional IRA for *the year of the recharacterization* ("Year 2"). This rule applies to recharacterizations of both "failed" (¶ 5.5.05) and valid Roth conversions. Reg. § 1.408-8, A-8(b). The amount added to the prior year-end balance is the amount that is actually transferred into the traditional IRA, not the prior year-end balance of the Roth IRA itself.

5.3 Roth IRAs: Income Tax Aspects

This section explains the tax treatment of "qualified," "nonqualified," and "other" distributions from a Roth IRA, and how to tell which is which.

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

"Qualified distributions" from a Roth IRA are income tax-free. It is relatively easy to qualify for "qualified" distributions; see ¶ 5.3.02–¶ 5.3.03. *Non*qualified distributions from a Roth IRA may or may not be tax-free; see ¶ 5.3.04.

Note: The requirements for a qualified distribution from a "Designated Roth Account" (DRAC) in a qualified plan, and tax treatment of nonqualified DRAC distributions, are slightly different from the Roth IRA equivalents; see ¶ 5.7.04–¶ 5.7.05.

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

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

B. **Aggregation of Roth IRAs for income tax purposes.** See ¶ 2.2.08(F) for the rule (in § 408(d)(2)) that all of an individual's IRAs are generally aggregated (treated as one account) for purposes of determining how much of any particular distribution constitutes a return of the participant's after-tax contributions. § 408A(d)(4)(A) provides that "§ 408(d)(2) shall be applied separately with respect to Roth IRAs and other individual retirement plans." This means that the taxation of distributions from *traditional* IRAs is computed without regard to the existence of, or distributions from, *Roth* IRAs in the same year; and that all of the participant's Roth IRAs are treated as one single account for purposes of applying the Ordering Rules (¶ 5.3.05). Note, however, that:

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

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

- *Returned, recharacterized, contributions:* The aggregation rule does not apply for purposes of computing net income attributable to a returned or recharacterized IRA contribution. ¶ 5.6.04. That computation is done with respect only to the IRA that received the contribution being returned or recharacterized. Reg. § 1.408-11(c)(3), § 1.408A-5, A-2(c)(4). Also, the contribution being recharacterized (and its earnings) must be returned out of the actual IRA it was contributed to—distribution of the equivalent amount from a different IRA is not permitted. Reg. § 1.408A-5, A-2(c)(4).

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

§ 1.408A-6, A-19. For other events that may cause a “deemed” distribution from an IRA (including a Roth IRA) without an actual distribution, see ¶ 2.1.04.

D. **Basis in distributed property.** A Roth IRA may distribute cash and/or property. If property is distributed from a Roth IRA to the participant or beneficiary, the recipient’s basis in such property (for purposes of computing gain or loss when the recipient later sells the property) is its fair market value on the date of the distribution (regardless of whether the distribution is “qualified”). Reg. § 1.408A-6, A-16. If a Roth IRA is worth less than the participant’s basis in the account, see ¶ 5.5.03(C).

*5.3.02 **Qualified distributions: Definition***

In order for a distribution from a Roth IRA to be a “qualified distribution” (*i.e.*, tax-free) two tests must be met: a *holding period* test and a *triggering event* test. “Qualified distributions” are distributions that occur after (1) a five-year waiting period has elapsed and (2) a “triggering event” has occurred. However, certain distributions can *never* be “qualified,” even if these two tests have been met; see ¶ 5.3.06.

For how to compute the five-year waiting period, see ¶ 5.3.03. The most common “triggering events” are attaining age 59½ and death. For most people, therefore, getting tax-free qualified distributions from their Roth IRA will be a matter of waiting five years and being over age 59½, but to be absolutely precise, a qualified distribution is one that is made after the Five-Year Period (¶ 5.3.03) 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 regarding this standard); or

4. Is a “qualified special purpose distribution,” *i.e.*, a distribution of up to $10,000 for certain purchases of a “first home.” § 408A(d)(2)(A)(iv), (d)(5); § 72(t)(2)(F), (t)(8); see ¶ 9.4.09.

Presumably, “trigger” #4 will rarely be pulled. Remember, an individual can withdraw all of his own contributions to a Roth IRA income tax-free at any time; see ¶ 5.3.04. Therefore this trigger will be needed to shelter a distribution from income tax only if the nondisabled first-time homebuyer who is under age 59½ (or who has owned a Roth IRA for less than five years) has to withdraw all of his contributions to the account plus up to $10,000 of earnings to afford the “first home.”

The conditions for a qualified distribution from a Roth IRA resemble the requirements for avoiding the 10 percent “early distributions” extra tax of § 72(t) (¶ 5.8), but are not identical. For example, withdrawals from a Roth IRA to pay higher education expenses are not *per se* qualified distributions, even though they are exempt from the 10 percent extra tax (¶ 9.4.08).

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

Satisfying a five-year waiting period is one of the two tests a Roth IRA owner must pass in order to have tax-free “qualified distributions” (¶ 5.3.02) from his Roth IRA. The waiting period is called the **nonexclusion period** in the statute, the **Five-Year Period** in this book.

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

Fred Example: On May 3, 2009, Fred put $1,000 into his Roth IRA. Fred’s Five-Year Period starts January 1, 2009, and is completed on December 31, 2013. The first year in which he can possibly have a qualified distribution is 2014. 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 2016, Fred converts his $100,000 traditional IRA to a Roth IRA. This new Roth IRA automatically meets the Five-Year Period requirement, because Fred has already completed the Five-Year Period for every Roth IRA he will ever own.

If a Roth IRA contribution is entirely recharacterized (¶ 5.6.03), it is treated as if it had never been made. Reg. § 1.408A-6, A-2, last sentence. Thus, if Fred had recharacterized his 2009 Roth IRA contribution, that contribution would not start the Five-Year Period running. If he *closes* all his Roth IRAs, see "C."

For purpose of computing the Five-Year Period for a Roth IRA, a rollover into the Roth IRA from a Designated Roth Account (DRAC) is treated as a "regular contribution" to the Roth IRA. Reg. § 1.408A-10, A-3(a), third sentence. Thus, it would start the Five-Year Period running if this is the individual's first Roth IRA contribution. Note: Whatever holding period the DRAC had achieved does NOT carry over to the Roth IRA the DRAC is "rolled" into (see ¶ 5.7.09); and, the rules for computing the Five-Year Period for a DRAC are not the same as for a Roth IRA (¶ 5.7.04(B)).

B. Five-Year Period for beneficiaries. The five-year holding period requirement is not eliminated by the participant's death; the inheriting beneficiaries still must fulfill this requirement to have qualified distributions. However, the holding period does not start afresh just because the Roth IRA passed to a new owner (the beneficiary); the deceased participant's holding period carries over to the beneficiary. Reg. § 1.408A-6, A-7(a).

The Five-Year Period is determined separately with respect to the beneficiary's *own* Roth IRAs (on the one hand) and for the Roth IRAs he has *inherited* from each decedent (on the other hand). Reg. § 1.408A-6, A-7(b). See ¶ 4.2.05(C) regarding an "inherited" Roth IRA that is created by means of a Roth conversion by a Designated Beneficiary.

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

Scott Example: Scott contributes to his first Roth IRA in December 2008. His Five-Year Period therefore begins January 1, 2008, and will be completed December 31, 2012. He dies in 2010, leaving the Roth IRA in equal shares to his wife (age 45) and daughter (age 22). The wife and daughter divide the account into two separate equal inherited Roth IRAs, one payable to each of them (¶ 4.2.02(B)). The wife elects to treat the separate Roth IRA payable to her as her own Roth IRA.

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

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

C. Effect of closing out all Roth IRAs. What is the effect on the Five-Year Period calculation if a participant who has had a Roth IRA in existence beyond the end of all applicable periods for withdrawing a "corrective distribution" (¶ 2.1.08(A)) or recharacterizing (¶ 5.6.07) the contribution then closes out all his Roth IRAs, so he no longer has any Roth IRA? The regulation dealing with *DRACs* (see ¶ 5.7.04(B)) provides that the beginning of the Five-Year Period for a participant's DRACs under a particular retirement plan is *not* redetermined simply because he closes out all his DRACs at any point. The Roth *IRA* regulations do not address this point.

5.3.04 Tax treatment of nonqualified distributions

A **nonqualified distribution** is one made before the Five-Year Period (¶ 5.3.03) is up; or which is made before any of the triggering events (age 59½, disability, death, etc.; ¶ 5.3.02) has occurred. A nonqualified distribution is not *per se* excludible from gross income. However, even if a distribution is not "qualified" it receives favorable tax treatment compared with distributions from a traditional IRA. (Note: Certain distributions are not taxed as either qualified or non-qualified; see ¶ 5.3.06.)

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 "investment in the contract" (IITC; sometimes called "basis") in the Roth IRA. § 72(b)(2); see ¶ 2.2. If the account has grown to be worth more than this IITC, the rest of the account value (which represents the earnings and growth that have occurred since the original contribution; the IRS calls this portion the "**earnings**") has not yet been taxed (and may never be taxed if it is distributed in the form of a qualified distribution).

The general rule is that all distributions (for exceptions see ¶ 5.3.05) from a Roth IRA are deemed to come first out of the participant's contributions. ¶ 5.3.05, #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 2015, Jules converted his $400,000 traditional IRA to a Roth IRA. He died in 2017, leaving the account (now worth $500,000) to his son Jim. Jim must start taking RMDs in 2018, the year after the year of Jules's death. Jules's death is a "triggering event," but the Five-Year Period will not be up until December 31, 2019, so the distributions Jim is required to take in 2018 and 2019 are not qualified distributions. Nevertheless, these distributions are tax-free to Jim, because they are deemed to come out of the $400,000 contribution 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 "IITC" (nontaxable) portion and the post-contribution earnings (taxable) of all of the participant's aggregated IRAs (the "cream in the coffee rule"; see ¶ 2.2.08).

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

It might appear that once a client has met the requirements for a qualified distribution, he could stop keeping track of how many dollars in the account constituted "IITC" versus "earnings." Is there any possibility a nonqualified distribution could occur after that point? Yes there is. A disabled individual receives a qualified distribution from a DRAC, then later ceases to be disabled and takes another DRAC distribution before age 59½. Reg. § 1.402A-1, A-7. Another example: A participant who has met the requirements for a qualified distribution dies and leaves the Roth IRA to his spouse who rolls it over to her own Roth IRA while under age 59½ and not disabled.

5.3.05 ***The Ordering Rules***

Any distribution from a Roth IRA is deemed to come from certain sources within the individual's aggregated Roth IRAs (¶ 5.3.01(B)), in a certain order. § 408A(d)(4)(B); Reg. § 1.408A-6, A-8, A-9. The following "**Ordering Rules**" apply to all Roth IRA distributions *except* corrective distributions (¶ 2.1.08; Reg. § 1.408A-6, A-8, A-9) and Roth-IRA-to-Roth-IRA rollovers (Reg. § 1.408A-6, A-9(d)). For how they apply to recharacterized contributions (¶ 5.6), see Reg. § 1.408A-6, A-9(f)-(h).

1. "...[D]istributions from Roth IRAs are deemed to consist first of regular contributions, then of conversion contributions, and finally, of earnings." Reg. § 1.408A-10, A-3(a), first sentence.

2. A qualified distribution from a DRAC that is rolled into a Roth IRA is treated as a "regular contribution" to the Roth IRA for purposes of Rule #1. Reg. § 1.408A-10, A-3(a), third sentence.

3. If the Roth IRA received any rollover contribution that was a nonqualified distribution from a DRAC, then the participant's after-tax contributions to the DRAC are considered "regular" contributions to the Roth IRA. The portion of the rolled over distribution allocable to earnings in the DRAC is allocated to earnings in the Roth IRA (last category distributed—drops down to #5 on this list). Reg. § 1.408A-10, A-3(a), second sentence.

4. If the distribution exceeds the total of the participant's "regular" contributions, the distribution is deemed to come next from the participant's "conversion" contributions on a first-in first-out basis. Once it is determined pursuant to the preceding sentence that the distribution is deemed to come from a particular conversion contribution, the dollars that were includible in gross income by virtue of that conversion (¶ 5.5.03) are deemed distributed first. (All of the

conversion contribution would have been includible in income except the participant's own after-tax money that was included in the rollover; see ¶ 2.2.) The part that was not includible in income would still not be includible in income. NOTE: This Rule #4 matters *only* to someone who is under age 59½ at the time of the distribution, see ¶ 5.8.02; and

5. 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 dictate that the participant's already-taxed contributions to the Roth IRA come out first and accordingly distributions from the Roth IRA are not income-taxable until the total distributed exceeds those contributions.

- The Ordering Rules matter also for someone who converts a traditional plan to a Roth IRA before reaching age 59½, and then takes a distribution within five years of the conversion and while still under age 59½. The Ordering Rules will apply in determining whether the 10 percent extra tax applies to the distribution. See ¶ 5.8.02(C).

5.3.06 ***Distributions not taxed as either qualified or nonqualified***

If various requirements are met, an IRA (or Roth IRA) contribution that is returned (together with any earnings thereon) to the contributor by a certain deadline is deemed never to have been contributed; see ¶ 2.1.08. This type of distribution is usually called a "corrective distribution," regardless of whether it was made in order to correct a mistake (such as an excess contribution) or merely because the contributor changed his mind. Corrective distributions are not subject to the Ordering Rules (¶ 5.3.05). The "earnings" distributed as part of a corrective distribution cannot be a qualified distribution, and are not considered a nonqualified distribution. Instead, the earnings are taxable under § 72, and will be subject to the 10% extra tax if the individual is under age 59½ and no exception applies. Reg. § 1.408A-6, A-1(d), A-4, A-9(e).

One can speculate that the IRS might someday apply this rule to the earnings on *any* excess Roth IRA contribution, regardless of whether the excess contribution was returned to the contributor as part of a corrective distribution; see ¶ 5.1.03.

5.4 How to Fund a Roth IRA; Regular Contributions

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

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

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

- An individual who has compensation income (and whose adjusted gross income is under certain levels) can make a "**regular contribution**" to a Roth IRA. See ¶ 5.4.02–¶ 5.4.04.

- A participant who owns a traditional retirement plan or IRA can transfer funds (or "roll over" distributions) from the traditional plan or IRA to a Roth IRA. This is called a "Roth **conversion**." See ¶ 5.5.

- A participant can roll money from a **DRAC** into a Roth IRA. See ¶ 5.7.08–¶ 5.7.09.

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

- A **qualified reservist distribution** may be contributed, at any time within two years after the end of the reservist's active duty period, to any individual retirement plan (IRA or Roth IRA), without regard to the normal limits on IRA contributions. § 72(t)(2)(G)(ii). See ¶ 2.7.04(C) and ¶ 9.4.12.

- Certain **U.S. military death gratuities** can be contributed to a Roth IRA. See § 408A(e)(2) and IRS Publication 590-A ("Contributions to Individual Retirement Arrangements (IRAs)," 2016 ed., p. 46). This type of contribution is not further covered in this book.

- Certain individuals who received compensation in connection with the **Exxon Valdez** oil spill can contribute up to $100,000 of their settlement to a Roth IRA or other eligible retirement plan. Eligible individuals include both plaintiffs in the Exxon Valdez lawsuit and any individual who is (1) the spouse or immediate relative of a plaintiff and (2) a beneficiary of such plaintiff's estate. (Note that this is the only instance in which a nonspouse beneficiary can transfer inherited funds to the *beneficiary's own* retirement plan; compare ¶ 4.2.04.) This contribution must be made in the same year as the payment is received (or may be made "for" that year at any time up until the *unextended* due date of the tax return for that year). If made to a Roth IRA, the contribution is includible in the individual's income, just like other Roth plan contributions. If contributed to a traditional plan, the contribution is excluded from the individual's income. Either way, the contribution is treated as a rollover contribution. See IRS Publication 590-A (2016 ed., p. 47). This type of contribution is not further covered in this book.

- Certain **qualified airline employees** could contribute to a Roth IRA and/or a traditional IRA certain payments they received in connection with the bankruptcy of a "commercial passenger airline carrier." See IRS Announcement 2015-13, 2015-15 IRB 908. A pilot's widow was allowed to roll over (to her own Roth IRA) the payment made for the pilot. PLR 2012-43017. The IRS says it does not have the authority to extend the deadline for these contributions; see PLR 2010-51027. This type of contribution is not further covered in this book.

5.4.02 "Regular" contributions from compensation income

One way to fund a Roth IRA is by making what the IRS calls "regular" (as opposed to "rollover"; ¶ 5.5) contributions to it. This section discusses the requirements for making a regular contribution to a Roth IRA, as contrasted with the rules governing regular contributions to a traditional IRA. See ¶ 5.6.02 regarding how to change your mind about which type of IRA you contributed to.

As with traditional IRAs, **only cash** may be contributed. § 408A(a), § 408(a)(1). See ¶ 5.6.06(A) regarding the **deadline** for making a regular Roth IRA contribution.

"Regular" Roth IRA Contributions: Variable Meanings

The meaning of "regular" Roth IRA contribution fluctuates a bit. It is normally used to mean a permissible annual-type IRA contribution from compensation income. However, to the IRS, *any* contribution to a Roth IRA that is not a qualified rollover contribution is a "regular contribution." Reg. § 1.408A-3, A-1. So certain contributions that are *intended* to be rollovers or Roth conversions, but don't meet the rollover requirements, such as a "failed conversion," ¶ 5.5.05, or the rollover of an RMD, ¶ 5.2.04, would be categorized as "regular" Roth IRA contributions. Adding to the confusion, a perfectly legal tax-free rollover of a qualified distribution from a DRAC to a Roth IRA is treated as a "regular contribution" to the Roth IRA for purposes of applying the Ordering Rules. Reg. § 1.408A-10, A-3(a), third sentence; see ¶ 5.3.03, #2.

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 ¶ 5.4.03). An individual who does not have compensation income, or whose compensation income is not high enough to support the full maximum contribution to an IRA, but whose spouse does have sufficient compensation income, can make a regular contribution to an IRA or Roth IRA based on the "working" spouse's income. § 219(c)(1)(B)(ii).

"**Compensation**" is partly defined in § 219(f)(1). It includes self-employment income, and does not include pension, annuity, or deferred compensation payments. It includes taxable alimony [see Appendix D] and separate maintenance payments (§ 71). It includes nontaxable combat pay; see IRS Publication 590-A (2016), p. 6. It includes "wages, commissions, professional fees, tips, and other amounts received for personal services...." Reg. § 1.408A-3, A-4. See Rev. Proc. 91-18, 1991-1 C.B. 522, for further detail.

5.4.03 Applicable Dollar Limit for regular contributions

This brief summary of the amount that may be contributed as a "regular" contribution to an IRA or Roth IRA is included for convenience. For more detail on the maximum IRA contribution see IRS Publication 590-A or § 219 and related regulations.

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

The maximum amount that may be contributed to all of a person's *traditional* IRAs for a particular year is the lesser of a particular dollar amount (called in this book the "**Applicable Dollar Limit**") or the individual's compensation income (¶ 5.4.02) for the year. See § 219(b)(1), § 408(a)(1), (o). The Applicable Dollar Limit is the sum of the *general dollar limit* and the permitted "*catch-up contribution*" if the individual is age 50 or older as of the end of the year.

The general dollar limit for 2017 is $5,500, to be increased by cost-of-living adjustments (COLA) if there is sufficient inflation in future years. § 219(b)(5)(A), (C). The catch-up contribution for the 50-and-older set is $1,000 for 2006 and later years (with no COLA). § 219(b)(5)(B).

Note: The maximum annual IRA contribution is arrived at indirectly under the Code. § 219 lays out elaborate requirements for the maximum *deductible* IRA contribution; in particular, § 219(g) says if you or your spouse is an active participant in an employer plan you cannot deduct an IRA contribution if your income exceeds certain levels. Then § 408(o) says, by the way, to the extent you're barred from making a *deductible* contribution to an IRA because of the limits in § 219(g), you can make a *nondeductible* contribution of that amount instead.

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).

An individual who has compensation income (¶ 5.4.02), and who meets the other eligibility requirements (see ¶ 5.4.04 for Roth IRAs, § 219 for traditional IRAs) may contribute to either a traditional IRA or a Roth IRA (whichever he is eligible to contribute to), or both if he is eligible to contribute to both, provided that the total contributed to both types of accounts for the year may not exceed the lesser of (1) the Applicable Dollar Limit or (2) the individual's compensation income for the year. Note that:

- Contributions made on the individual's behalf to a SEP-IRA or a SIMPLE plan (¶ 8.3.13) are ignored for this purpose; these are considered *employer* contributions, and as such have no effect on the maximum the *individual* may contribute to his own traditional or Roth IRA. § 408A(f).

- Lower contribution limits apply to an individual who also contributes to a "§ 501(c)(18) plan" (not covered in this book); see IRS Publication 590-A.

5.4.04 Who may make a "regular" Roth IRA contribution

Any individual who has compensation income (¶ 5.4.02), regardless of his age, and regardless of whether he participates in a workplace retirement plan, may make a "regular" contribution to a Roth IRA—provided that his income is below certain levels.

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

B. **Participation in employer plan irrelevant.** A person who meets the income test (see "C") and has compensation income (¶ 5.4.02) may contribute to a Roth IRA regardless of whether he also participates in a "workplace" retirement plan in the same year. Active participation in an employer plan has no impact on eligibility to contribute to either a traditional or a Roth IRA; it is relevant only for determining whether a contribution to a traditional IRA is deductible. See § 219(g)(3).

C. **Income must be below certain levels.** Only individuals with "modified adjusted gross income" (MAGI) below certain limits can contribute to a Roth IRA. The income test for making a regular contribution to a Roth IRA is not the same as the income test that applied (through 2009) to determine eligibility to convert a traditional plan to a Roth IRA (¶ 5.5.02(E))—and did not disappear at the end of 2009.

The definition of MAGI for purposes of the Roth IRA contribution income limits starts with the modified definition of AGI used under § 219(g)(3) (income limits for making a deductible contribution to a traditional IRA when the individual is also a participant in an employer plan). However, MAGI for purposes of Roth contribution eligibility does not include the deemed distribution amount (¶ 5.5.03–¶ 5.5.04) that results from converting a traditional retirement plan or IRA to a Roth IRA. § 408A(c)(3)(B)(i). The gross income resulting from a Roth conversion is disregarded for purposes of determining whether the taxpayer's MAGI is low enough to make him eligible to contribute to a Roth IRA.

Don Example: Don's MAGI in 2017, not counting the income from his Roth conversion, is $25,000. He does a Roth conversion in 2017 that adds $300,000 to his 2017 MAGI. The conversion income is includible in Don's "real" gross income for 2017, and he has to pay tax on it, but it is excluded from the "MAGI" figure for purposes of determining his eligibility to make a "regular" Roth IRA contribution for 2017.

In order for an individual to be eligible to contribute the full Applicable Dollar Limit (¶ 5.4.03) to a Roth IRA, his MAGI may not exceed a certain "**applicable dollar amount**." The applicable dollar amount depends on filing status, and is adjusted upwards, after 2006, for post-2005 inflation. The applicable dollar amount was originally $95,000 for a single taxpayer, $150,000 for a married taxpayer filing a joint return, or $zero for a married taxpayer filing a separate return. § 408A(c)(3). The 2017 applicable dollar amounts are $118,000 (single), $186,000 (married filing jointly), and $zero (married filing separately). Notice 2016-62, 2016-46 IRB 725.

If MAGI exceeds these levels, the Applicable Dollar Limit (ADL) amount the individual can contribute to a Roth IRA phases downward. It is reduced to zero once his income exceeds the applicable dollar amount by $15,000 (single taxpayer) or $10,000 (married taxpayer filing separately or jointly). § 408A(c)(3)(A), (B)(ii). For this purpose, "a married individual who has lived apart from his or her spouse for the entire taxable year and who files separately is treated as not married." Reg. § 1.408A-3, A-3(b).

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

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

There is no waiting period or minimum holding period following the making of a contribution to a traditional IRA before the individual is eligible to convert the account so funded to a Roth IRA, just as (before direct plan-to-Roth IRA conversions were permitted; see ¶ 5.5.01(B)) there was no waiting period that prevented an eligible individual who rolled money from a traditional nonIRA retirement plan to a traditional IRA from immediately converting the traditional IRA to a Roth IRA.

This so-called backdoor Roth contribution does not necessarily save taxes: The conversion of the new "little" traditional IRA created with the nondeductible contribution is taxed under the cream-in-the-coffee rule of § 72(e)(8), under which all of an individual's traditional IRAs are aggregated for purposes of determining how much of a particular distribution (or Roth conversion) is pretax or after-tax money. See ¶ 5.5.03(B).

Sandy Example: In 2014, Sandy, age 28, has compensation income of $300,000 and participates in a 401(k) plan at her job. Because of her high income, she is not eligible to make a regular contribution to a Roth IRA. So instead she makes a nondeductible contribution of $5,500 to a traditional IRA on June 1, 2014. Soon thereafter she converts the account to a Roth IRA. If she has no other IRAs at any time during 2014, her conversion will be "tax-free" to the extent the converted account contains nothing other than her own after-tax contribution. If she does have other IRAs in 2014, the conversion will be taxed under the "cream-in-the-coffee" rule; see ¶ 5.5.03(B).

5.4.05 ***Excise tax on excess Roth IRA contributions***

There is an excise tax of six percent imposed on "regular" contributions to Roth IRAs in excess of the applicable limits (¶ 5.4.03), just as there is for excess contributions to traditional IRAs. § 4973; Reg. § 1.408A-3, A-7. See ¶ 2.1.08. The extra tax for excess IRA contributions is applied separately to the individual's traditional and Roth IRAs. Reg. § 1.408A-3, A-7. Remedies for excess contributions include corrective distribution (¶ 2.1.08(A)–(E)), recharacterization (¶ 5.6), and "absorption" (¶ 2.1.08(I)).

5.5 Conversion of Traditional Plan or IRA to a Roth IRA

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

This Chapter describes the federal income tax treatment of Roth conversions. State income tax treatment is not covered in this book.

Since there is no limit on the amount that can be converted from a traditional plan or IRA to a Roth IRA, a conversion contribution can be a much more substantial amount than the few thousand dollars per year maximum regular Roth IRA contribution (¶ 5.4.03).

See ¶ 5.8.02 for how a Roth conversion interacts with the 10 percent extra tax on early distributions. See ¶ 5.6.06(B) regarding the deadline for completing a Roth conversion.

> This ¶ 5.5 deals with Roth IRA conversions by the *participant*. Regarding the ability or inability of a *beneficiary* to convert an inherited plan or IRA to a Roth IRA, see ¶ 3.2.04 (for the surviving spouse) or ¶ 4.2.05 (for other beneficiaries).

At one time, a Roth IRA was the only possible destination for "conversions." Now, Designated Roth Accounts (DRACs) can accept "in-plan" conversions of money that is in the "traditional side" of the plan that contains the DRAC. See ¶ 5.7.03. However, except for in-plan conversions as described in ¶ 5.7.03, funds from a traditional plan or IRA that are to be converted to Roth status can be rolled only into a Roth IRA and can NOT be rolled or converted directly to a DRAC.

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

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

A. **Individual retirement accounts.** An "individual retirement plan" may be converted to a Roth IRA. § 408A(d)(3)(B), (C); § 402(c)(8)(B)(i), (ii); Reg. § 1.408A-4, A-5. "Individual retirement plans" include <u>individual retirement accounts</u> (IRAs) and <u>individual retirement trusts</u> (IRTs) under § 408(a), (h). Traditional IRA-to-Roth IRA conversions have been permitted since 1998. See ¶ 5.5.03 for the *tax treatment* of converting an IRA. See ¶ 5.5.06 for *how* to convert an IRA.

The Code provides that a "simplified employee pension" ("SEP-IRA"; § 408(k)) or "simple retirement arrangement" ("SIMPLE"; § 408(p)) cannot be "redesignated" as a Roth IRA. § 408A(f)(1). That prohibition is almost meaningless because, in the real world, a traditional IRAs is not normally converted to a Roth IRA by being "redesignated" as a Roth IRA; it is converted by having assets or money transferred from the traditional IRA to an entirely different account (with a different account number and form of agreement) that is a Roth IRA. The IRS clarifies (in Reg. § 1.408A-4, A-4) that an amount in an individual's SEP or SIMPLE IRA can be converted to a Roth IRA on the same terms as an amount in any other traditional IRA, subject to two limitations:

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

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

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

B. NonIRA plans. Prior to 2008, the Code permitted rollovers into Roth IRAs only from IRAs and DRACs (¶ 5.7). Thus, someone who desired to "convert" money in a traditional nonIRA retirement plan had to first roll the money to an IRA, then convert the IRA. The expanded rollover provision effective in 2008 and later years now permits rollovers into Roth IRAs directly from several *additional* types of eligible retirement plans, eliminating the necessity of the two-step process in the conversion of nonIRA plans (though the two-step process continues to exist hypothetically in the tax treatment of these conversions; see ¶ 5.5.04(A)). See ¶ 5.5.04 for the *tax treatment* of nonIRA plan-to-Roth IRA conversions. See ¶ 5.5.07 for *how* to convert a nonIRA plan to a Roth IRA. Here are the types of nonIRA plans distributions from which may be rolled over (converted) to a Roth IRA:

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

2. 403(a) and (b) contracts and plans. § 408A(e)(1)(B), § 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)(1)(B), § 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 Pension Protection Act of 2006, § 824. This change rendered Reg. § 1.408A-4, A-5, obsolete.

In this book, references to conversion of a "traditional plan" mean only a traditional retirement plan of the type listed in 1–3 above.

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

This ¶ 5.5.02 explains who is eligible to convert a plan or IRA to a Roth IRA, including the effects (or noneffects) of age (A), participation in other plans (B), prior conversions (C), filing status (D), and income (E).

If a person converts a traditional IRA or plan to a Roth IRA but is not eligible to do so, the result is a "failed conversion." See ¶ 5.5.05. After 2009 the only ways a person can be "ineligible" to convert an IRA or a traditional plan of the permitted type (¶ 5.5.01(B)) are: If he reconverts a traditional IRA to a Roth too soon after recharacterizing (see "C"); or if he is a beneficiary and tries to convert an inherited IRA to a Roth IRA, or to convert an inherited plan to a Roth IRA without meeting the requirements described in ¶ 4.2.05. Prior to 2010, a person could also be ineligible to convert to a Roth based on his filing status ("D") or income ("E"); those requirements no longer apply.

A. Age: Under 59½, over 70½, or in between. Any IRA owner or plan participant can convert his traditional plan or IRA to a Roth IRA regardless of his age; you are never too young or too old to convert to a Roth IRA. However, if the participant is under age 59½, see ¶ 5.8 regarding how the 10 percent extra tax on early distributions applies to certain post-conversion distributions. Also, an individual who is turning (or past) age 70½ in the conversion year must take the RMD for that year *before* he can convert any money from the account to a Roth IRA; see ¶ 5.2.04.

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

C. Prior conversion. There is generally no limit on the number of times a participant can convert all or part of any traditional plan or IRA to a Roth IRA; see ¶ 5.5.06. The only exception applies in the case of someone who has *un*converted (recharacterized) and then wants to *re*convert the same amount; see ¶ 5.6.08.

D. Filing status. For years prior to 2010, a person who used the filing status "married filing separately" could not do a Roth conversion. For conversion of plan distributions made in 2010 and later years, there is no filing status test.

E. **Income limit.** For distributions occurring in years prior to 2010, an individual was not eligible to convert if his modified adjusted gross income exceeded $100,000. See § 408A(c)(3)(B) as in effect for years prior to 2010. For conversion of plan distributions made in 2010 and later years, there is no income test. For details on the income limit, including how MAGI was computed for purposes of this now-obsolete test, see the author's *Special Report: Ancient History* (www.ataxplan.com).

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

A rollover from a traditional IRA to a Roth IRA is generally treated, for income tax purposes, as a distribution from the traditional IRA. The term "conversion" is often used (including in § 408A(d)(3)(C)) for the rollover of funds from a traditional IRA to a Roth IRA, which is a taxable event, just as a handy way to distinguish that type of rollover from a "normal" rollover, which is nontaxable.

A. **A Roth conversion is a "taxable rollover.**" Under § 408(d)(3)(A), rollovers generally are nontaxable. However, § 408A(d)(3)(A) provides that "Notwithstanding" § 408(d)(3), "there shall be included in gross income any amount which would be includible were it not part of a qualified rollover contribution." Thus, Roth conversions *are* taxable despite § 408(d)(3). Whatever amount of a traditional IRA is converted or rolled over to a Roth IRA is taxed exactly as if it had been distributed from the traditional IRA and not rolled over, with the following exceptions: for conversions in 1998 and 2010, special "income spreading" treatment was allowed (¶ 5.5.03(A)); the 10% early distributions tax does not apply (¶ 5.8.02); and, if the converted property includes an annuity contract, see "D."

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

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

- The gross income resulting from a Roth conversion in 1998 could be spread equally over the four taxable years 1998–2001. The income resulting from a Roth conversion in 2010 could similarly be reported in two equal instalments in 2011 and 2012. For details on these now-expired tax deals, see the author's *Special Report: Ancient History* (www.ataxplan.com).

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

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

C. **Realizing a loss on a Roth conversion.** Suppose the individual's traditional IRA (at the time of conversion to a Roth) is worth less than his IITC:

Tucker Example: Tucker made nondeductible contributions totaling $20,000 to a traditional IRA in the years leading up to Year 1. This was and is his only IRA, and he made no contributions to any IRA in Year 1. As of the date in Year 1 when he does his conversion to a Roth the account is worth only $17,000. What becomes of his "missing" $3,000 of IITC?

A transfer from a traditional to a Roth IRA is 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 a Roth IRA, he would have been entitled to deduct the $3,000 loss as a miscellaneous itemized deduction, according to the IRS. See ¶ 8.1.02. Accordingly, it would appear that Tucker would report a miscellaneous itemized deduction of $3,000 on his Form 1040 for Year 1 as a result of the Roth conversion.

D. Conversion valuation rule for annuities. If one of the traditional IRA assets being converted to a Roth IRA is an annuity contract, a special valuation rule applies. The taxpayer must report the "fair market value" of the contract (not simply the "cash surrender value" or similar stated contract value) as the amount of income includible as a result of the conversion. Reg. § 1.408A-4, A-14, effective for conversions on or after August 19, 2005. The regulation prescribes alternative methods for determining such fair market value.

Until Roth IRA conversions came along, it made little difference how annuity contracts were valued upon distribution from a retirement plan, because distribution of an annuity contract is generally not a taxable event. Reg. § 1.402(a)-1(a)(2). The arrival of the Roth IRA conversion changed the landscape. The lower an IRA-owned annuity contract can be valued when the IRA is converted to a Roth IRA, the less income tax the participant must pay on the conversion. Subsequent distributions from the annuity contract will go into the Roth IRA, distributions from which will be tax-free. According to the IRS, "some advisers" sought to take advantage of this loophole, and marketed, to IRA owners, "a single premium annuity contract with significant artificial penalties that apply in the" early years, "causing the annuity to have a low cash surrender value...." The IRA owner would then convert his IRA to a Roth IRA, and report the contract's artificially low cash surrender value (CSV) as the gross income resulting from the conversion. T.D. 9220, 2005-2 C.B. 596, "Explanation of Provisions." To stop such abuses, the IRS issued Reg. § 1.408A-4, A-14.

5.5.04 ***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-to-Roth-IRA rollovers taxable (¶ 5.5.03(A)), just throwing a few more Code sections into the "notwithstanding" clause: "Notwithstanding sections *402(c)*, *403(b)(8)*, 408(d)(3), and *457(e)(16)*, there shall be included in gross income any amount which would be includible were it not part of a qualified rollover contribution." § 408A(d)(3)(A)(i), (B), and (C), as in effect after 2007; emphasis added.

Notice 2008-30, 2008-1 CB 638, Section II, questions 1–7, Notice 2009-75, 2009-39 IRB 436, and Notice 2014-54, 2014-41 IRB 670, provide guidance on plan-to-Roth-IRA conversions.

For conversions in 2010, special "income spreading" treatment was allowed; see ¶ 5.5.03(A). If the assets converted include an annuity contract, see ¶ 5.5.03(D).

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

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

For example, if an employee takes (from the employer's QRP) an LSD that includes appreciated employer stock, the "net unrealized appreciation" (NUA) inherent in the stock receives special income tax treatment if it is not rolled over to an IRA; see ¶ 2.5. But if the employee rolls (converts) the NUA stock to a Roth IRA, the conversion will be fully taxable as ordinary income (except to the extent of any after-tax money included in the distribution; see "B"), just as if the stock had been rolled to a traditional IRA that was then converted to a Roth IRA. The special tax deal that applies to an LSD of NUA stock can not be combined with a Roth conversion of the stock. This is true even if the Roth conversion is accomplished by an "in-plan conversion" (¶ 5.7.03) rather than by transfer to a Roth IRA. Notice 2010-84, 2010-5 IRB 872, A-7, fourth sentence.

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

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

Alternatively, Myron may decide to convert *only* the after-tax money to a Roth IRA (effecting a tax-free Roth conversion), while rolling the pretax money to a traditional IRA in a normal (nontaxable) rollover. He can accomplish this split rollover by requesting, as part of a single transaction (such as distribution of his account upon his retirement), that the after-tax money be transmitted via direct rollover to a Roth IRA he has established and that the pretax money be transmitted via direct rollover to a traditional IRA he has established. See IRS Notice 2014-54, 2014-41 IRB, Part V, Example 4. *Since this allows his after-tax contributions to grow tax-free after the rollover, every employee who has after-tax money in his employer plan should transfer at least his after-tax money to a Roth IRA using this procedure when taking a distribution from the plan.*

C. **Income tax withholding.** A direct rollover from a QRP to a Roth IRA (or any IRA) is not subject to the mandatory 20 percent income tax withholding that normally applies to the distribution of an eligible rollover distribution from a qualified plan (¶ 2.3.02(C)). Any distributee and plan administrator can arrange for voluntary withholding even for a direct rollover (Notice 2008-30, A-6), though such withholding would not normally be considered advisable in a Roth conversion.

D. **Beneficiary's conversion by direct rollover from inherited QRP.** A designated beneficiary is entitled to request a direct rollover of inherited QRP benefits into a traditional or Roth IRA. § 402(c)(11). See IRS Notices 2007-7, 2007-1 CB 395 (Section V), and 2008-30, 2008-12 IRB 638, A-4, and ¶ 4.2.04 of the author's book *Life and Death Planning for Retirement Benefits* for explanation of the requirements of such "beneficiary rollovers." A designated beneficiary has the same options as a living participant to request partial outright distribution combined with partial direct rollover to an (inherited) traditional IRA (see "B"), or to request partial direct rollover to an (inherited) Roth IRA combined with partial direct rollover to an (inherited) traditional IRA (see "C"). However, a designated beneficiary who is not the surviving spouse does not have the option to use a distribution followed by a rollover.

*5.5.05 **Failed conversions***

"The term **failed conversion** means a transaction in which an individual contributes to a Roth IRA an amount transferred or distributed from a traditional IRA or Simple IRA (including a transfer by redesignation) in a transaction that does not constitute a conversion under Sec. 1.408A-4 A-1." Reg. § 1.408A-8, A-1(b)(4). Although this definition has not been explicitly extended to include defective conversions from nonIRA plans, it may be that defective conversions from nonIRA plans are deemed included in this definition of "failed conversion" by virtue of the fact that a Roth conversion from a nonIRA plan is treated for tax purposes "as if" it passed through a traditional IRA on its way to the Roth; see ¶ 5.5.04(A).

A failed conversion should be "fixed" by recharacterization. ¶ 5.6. If the failed conversion is not so repaired, it will be treated as if the amount transferred to the Roth IRA had been (1) distributed from the original plan or IRA (with resulting income tax, and 10% additional tax (¶ 5.8.02(B)) if applicable) and then (2) contributed to the Roth IRA as a "regular contribution" (¶ 5.4.02). Reg. § 1.408A-4, A-3. Typically the deemed regular contribution to the Roth IRA resulting from a failed conversion will be an "excess contribution" (¶ 5.4.05).

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

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

1. A distribution from a traditional IRA may be contributed (rolled over) to a Roth IRA within 60 days after the distribution is made. See ¶ 2.7 and ¶ 5.6.06(B) regarding this deadline.

2. An amount may be transferred directly from the traditional IRA to the Roth IRA, with the same or a different trustee or custodian.

3. The traditional IRA can simply be "redesignated" as a Roth IRA maintained by the same trustee or custodian; this is treated as a transfer of the entire account balance. Reg. § 1.408A-4, A-1(b)(3). This method may be purely theoretical; it seems likely that few if any IRA providers could transform a traditional IRA into a Roth IRA by mere redesignation. The IRA provider probably would require that the assets be transferred to an entirely different account (with a different account number and form of agreement) that is a Roth IRA.

All three of these transactions are considered rollovers ("a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA"). Although a Roth conversion generally must meet the requirements applicable to other types of rollovers (see, *e.g.*, ¶ 5.2.04), a Roth conversion is *not* considered a rollover for purposes of the one-rollover-per-year limitation (§ 408(d)(3)(B); ¶ 2.6.05), so a Roth conversion may occur even if it is within 12 months of a tax-free traditional IRA-to-IRA rollover. Reg. § 1.408A-4, A-1(a), (c).

Prior to the arrival of Roth IRAs, "rollovers" were always tax-free, and many presumably still associate that word with tax-free transfers from one retirement plan to another. In contrast, the rollover of funds from a traditional IRA to a Roth IRA is taxable. ¶ 5.5.03(A).

Both partial and total conversions are allowed. An eligible individual (¶ 5.5.02) 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. Reg. § 1.408A-4, A-1.

Similarly, there is generally no limit on the number of times an individual may convert traditional IRA funds to Roth IRA status. A person who converts part of his traditional IRA to a Roth IRA is free at any later time (in the same or a later year) to convert more of the same or another IRA to a Roth IRA. The one exception applies to someone who did a Roth IRA conversion, then later undid the conversion via a "recharacterization"; see ¶ 5.6.08.

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

A participant entitled to a distribution from a traditional 401(a), 403, or governmental 457(b) plan can transfer that distribution to a Roth IRA either by direct rollover or by 60-day (indirect) rollover. ¶ 5.5.01(B). For definitions of direct, indirect, and 60-day rollover, see ¶ 2.6.01. The direct rollover is preferable because it avoids the mandatory 20 percent withholding for federal income taxes otherwise applicable to the taxable portion of the distribution. See ¶ 2.3.02.

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

The plan may allow employees to have direct rollovers of their distributions into multiple "destination" IRAs (*e.g.*, a traditional and a Roth); however, the plan is not required to offer that option. The most options the plan *must* offer the participant with respect to his distribution is to split it into two distributions, one transferred directly to one eligible retirement plan and one paid directly to the participant. Since the direct payment to the participant may trigger mandatory income tax withholding the plan could be "forced" to write up to three checks (one to an eligible plan as a direct rollover, one to the participant, and one to the IRS). Reg. § 1.401(a)(31)-1, A-9, A-10.

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

A major difference between converting a traditional IRA to a Roth, and converting money from a nonIRA plan, has to do with the participant's ability to obtain a distribution that he can convert. An IRA owner, regardless of age or employment status, is generally free (at least under the Tax Code) at any time to withdraw money from his account. He will be taxable on the distribution, and may owe an extra 10% tax if he is under age 59½, but nobody can stop him from taking the distribution if he wants to do so and is willing to pay the taxes.

Not so with a qualified plan. Most qualified plans prohibit *any* distributions prior to attaining retirement age or severance of employment. 401(k) plans are generally forbidden to distribute the employee's elective deferral account prior to age 59½ or termination of service. § 401(k)(2)(B)(i). There is a hardship exception to that rule, but hardship distributions cannot be rolled over. § 402(c)(4)(c). Plans that do permit "in-service distributions" often restrict such distributions to employees over age 62. § 401(a)(36). *See "Tax Law Changes?," p.* Thus, the advisor is likely to encounter the opportunity for plan-to-Roth-IRA conversions only when the participant is leaving the service of the employer that sponsors the plan. For the employee who would like to do a Roth conversion but cannot take money out of his traditional account in the employer plan, consider an "in-plan conversion" (¶ 5.7.03) if available.

5.6 Recharacterizing an IRA or Roth IRA Contribution

WARNING! The "Tax Cuts and Jobs Act" introduced in Congress November 2, 2017, would, if enacted as written, repeal § 408A(d)(6)(A) effective for 2018 and later years. See Appendix D. If enacted, this tax law change would make this entire ¶ 5.6 obsolete for 2018 and later years.

The Code allows a taxpayer who has made "any contribution to an individual retirement plan" during a particular taxable year to move that contribution to "any other individual retirement plan." If the transfer meets certain requirements, the contribution is treated, for all purposes of the income tax code, as if it had been originally made to the second (transferee) IRA—"Except as provided by the Secretary." § 408A(d)(6)(A). The IRS has issued Reg. § 1.408A-5 governing (and limiting) such transfers.

The Code calls these transfers "adjustments." The IRS and this book call them "**recharacterizations**." § 408A(d)(6) both (1) allows taxpayers to change their minds about their IRA contribution or conversion and (2) enables them to fix mistakes.

5.6.01 ***Recharacterization: Introduction and overview***

The most common use of recharacterization is to undo a Roth IRA conversion: A taxpayer who has converted a traditional IRA or plan distribution to a Roth IRA can reverse that conversion using § 408A(d)(6), thereby avoiding the income tax that otherwise would have been due on the Roth conversion. (Note: "In-plan" conversions can NOT be recharacterized; see ¶ 5.7.03.)

Though much less common, a taxpayer who has made a "regular" IRA or Roth IRA contribution can also use § 408A(d)(6), if he changes his mind about what type of IRA he wants (or is eligible for), to switch the contribution from a traditional to a Roth IRA, or vice versa. Reg. § 1.408A-5, A-10, Examples 2, 3.

Finally, recharacterization can be used to fix mistakes. See ¶ 5.6.09.

Treatment of a transfer as a recharacterization is elective. Reg. § 1.408A-5, A-1(a), (b).

Here are the requirements that must be met to achieve the desired treatment of having the contribution that was originally made to "IRA #1" treated as if it had originally been made to "IRA #2," under § 408A(d)(6) and Reg. § 1.408A-5:

- Not all IRA contributions may be recharacterized. For which may and which may not, see ¶ 5.6.02.
- The movement from the first to the second IRA must be accomplished by "trustee-to-trustee transfer" (§ 408A(d)(6)(A)) and meet certain other "mechanical" requirements; see ¶ 5.6.03.
- Not only the contribution itself but also the "net income attributable to" the contribution must be transferred to the second IRA. ¶ 5.6.04.
- Partial recharacterizations are allowed. ¶ 5.6.05.
- The deadlines for IRA contributions, and recharacterizations, are confusing. See ¶ 5.6.06, ¶ 5.6.07.
- See ¶ 5.2.05 regarding the effect of a recharacterization on calculation of the required minimum distribution.
- Recharacterization applies only to *IRA contributions*; it is not available for in-plan conversions. See ¶ 5.7.03.

5.6.02 ***IRA contributions that may be recharacterized (or not)***

Here are the types of IRA contributions that can be recharacterized:

- The contribution (conversion) to a Roth IRA of a distribution from a traditional plan or IRA may be recharacterized as a contribution to a traditional IRA. Both valid Roth conversions and "failed" conversions (¶ 5.5.05) may be recharacterized. Regs. § 1.408A-4, A-3(a), § 1.408-8, A-8(b).

- A "regular" contribution (¶ 5.4.02) made to either type of IRA (traditional or Roth) for a particular year may be recharacterized as a contribution to the other type. Reg. § 1.408A-5, A-10, Examples 2, 3.

Though the IRS's example of recharacterizing a "regular" contribution deals with a small annual-type regular contribution, remember that the IRS considers every IRA contribution that does not qualify as a valid "rollover contribution" to be a "regular contribution"—even if the contribution exceeds the annual IRA contribution limit. See, *e.g.*, Reg. § 1.408A-4, A-6(c). Thus, recharacterization should be considered whenever a botched IRA rollover occurs as it may provide a way to fix the problem. See ¶ 5.6.09.

However, not every IRA contribution can be recharacterized. Here are IRA contributions that can NOT be recharacterized:

1. If money has been rolled over from a *traditional* retirement plan into a *traditional* IRA via a <u>tax-free rollover</u> (whether by direct rollover or 60-day rollover), the taxpayer cannot later change his mind and "recharacterize" that as a Roth conversion by moving the rolled amount to a Roth IRA. "[A]n amount contributed to an IRA in a tax-free transfer cannot be recharacterized." Reg. § 1.408A-5, A-4. A participant (but not a beneficiary) can convert, to a Roth IRA, the traditional IRA he has created via this tax-free rollover; he just cannot make such conversion "retroactive" to the original tax-free rollover from the plan to IRA #1.

2. Similarly, a <u>tax-free transfer or rollover</u> from one traditional IRA into another cannot be recharacterized as a Roth conversion. Reg. § 1.408A-5, A-10, Example 4.

3. <u>Employer contributions to a SEP or SIMPLE IRA</u> may not be recharacterized as contributions to a Roth IRA, because the employer could not have made direct contributions to a Roth IRA in the first place. Reg. § 1.408A-5, A-5. But the employee may be able to convert the SEP or SIMPLE account to a Roth IRA; see ¶ 5.5.01(A).

4. A recharacterized contribution apparently cannot be recharacterized *again*, because the decision to recharacterize cannot be revoked once the transfer to "IRA #2" has occurred. Reg. § 1.408A-5, A-6(b).

5.6.03 ***How to recharacterize an IRA contribution***

A recharacterization requires four steps:

<u>Step 1</u>: Identify the traditional or Roth IRA account into which the recharacterized contribution is to be moved. Open a new account if necessary. This transferee account ("SECOND IRA") must be one into which the original contribution could legally have been made. Note: Even a Roth conversion that comes from a *nonIRA* plan (¶ 5.5.01(B)) is recharacterized by being moved into *a traditional IRA*, NOT back into the traditional nonIRA plan it was in prior to the Roth conversion. Notice 2008-30, 2008-1 CB 638, A-5, A-7. See PLR 2014-49012.

<u>Step 2</u>: Provide notice of the election, and directions, to the two IRA sponsors involved (or to the single sponsor, if the both the transferor and transferee IRAs are with the same IRA provider), *on or before the date of the transfer*. The notice must state "that the individual has elected to treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, for Federal tax purposes" and "must include the following information: the type and amount of the contribution to the FIRST IRA that is to be recharacterized; the date on which the contribution was made to the FIRST IRA and the year for which it was made; a direction to the trustee of the FIRST IRA to transfer, in a trustee-to-trustee transfer, the amount of the contribution and net income allocable to the contribution to the trustee of the SECOND IRA; and the name of the trustee of the FIRST IRA and the trustee of the SECOND IRA and any additional information needed to make the transfer." Reg. § 1.408A-5, A-6(a), (b).
<u>Step 3</u>: Transfer the contribution that is to be recharacterized, plus (or minus) earnings attributable thereto (¶ 5.6.04) from the IRA it was actually contributed to (FIRST IRA) to the second (transferee) IRA (SECOND IRA) by the applicable deadline (¶ 5.6.07). § 408A(d)(7); Reg. § 1.408A-5, A-1(a). The transfer must be by means of a trustee-to-trustee (plan-to-plan) transfer—it can NOT be accomplished by a "60-day rollover." Reg. § 1.408A-5, A-1(a). See ¶ 2.6.01 for the difference.

<u>Step 4</u>: "An individual who makes this election must report the recharacterization, and must treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, on the individual's Federal income tax return for the [applicable]

taxable year...in accordance with the applicable Federal tax forms and instructions." Reg. § 1.408A-5, A-6(b). See Instructions to IRS Form 1040, lines 15a and 15b (2016), p. 25, and Form 8606 (2016), "Recharacterizations," p. 4.

5.6.04 ***Income allocable to the contribution***

To recharacterize an IRA contribution, not only the original contribution but also "any net income allocable to such contribution" must be transferred out of the IRA it was actually contributed to and into the other IRA. § 408A(d)(6)(B); Reg. § 1.408A-5, A-2(a), (c)(4).

This ¶ 5.6.04 explains how to compute the net income allocable to an IRA or Roth IRA contribution for purposes of either a corrective distribution (¶ 2.1.08) or a recharacterization. Note that the "net income" may be a negative amount―a loss, in other words. Reg. § 1.408A-5, A-2(b); A-2(c)(6), Example 1.

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

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

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

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

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

Because Method 1 is much simpler to apply than Method 2 (below), there is an advantage to keeping each year's Roth IRA conversion contributions in a separate Roth IRA account (not commingled with any pre-existing Roth IRA), until the period has expired for recharacterizing such contributions (¶ 5.6.07).

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

$$\text{Net Income} = \text{Contribution} \times \frac{(\text{ACB} - \text{AOB})}{\text{AOB}}$$

In the above formula, "ACB" means adjusted closing balance and "AOB" means adjusted opening balance.

The "adjusted opening balance" means the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions made to or transfers into (including the contribution that is being recharacterized) during the computation period. Reg. § 1.408-11(b)(1).

The "adjusted closing balance" means the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including contributions returned pursuant to § 408(d)(4)―"corrective distributions"; see ¶ 2.1.08) and recharacterizations of contributions made from the IRA during the computation period. Reg. § 1.408-11(b)(2).

The "computation period" means the period beginning immediately prior to the time the particular contribution being recharacterized (or the first of such contributions, if multiple contributions are being recharacterized) was made to the IRA and ending immediately prior to the removal of the contribution(s) being recharacterized. Reg. § 1.408-11(b)(3), § 1.408A-5, A-2(c). See the regulations for examples.

For purposes of applying this formula, IRAs are not aggregated; earnings are computed only with respect to the actual account to which the contribution was made, even if the individual owns multiple IRAs. Reg. § 1.408-11(c)(3), § 1.408A-5, A-2(c)(4). Compare ¶ 5.3.01(B).

Fouad Example: Fouad converted $200,000 from his 401(k) plan to a new separate Roth IRA account in January 2016. By November 2016, the account had declined in value to $160,000, and he decided to recharacterize. He closed the Roth IRA and transferred its entire value ($160,000) to a traditional IRA ("Method 1" above). He has successfully recharacterized his entire conversion, because he transferred to the traditional IRA the $200,000 contribution plus the "earnings thereon"; the "earnings" were a loss of $40,000. He can then "reconvert" this IRA to a Roth in 2017 if he wishes (see ¶ 5.6.08).

*5.6.05 **Partial recharacterizations***

Recharacterizations are not an all-or-nothing thing; partial recharacterizations are permitted. Reg. § 1.408A-5, A-1(a). However, you cannot "cherry pick" the assets you recharacterize so as to recharacterize only the "losers."

If a participant converted his IRA to a Roth IRA at a time when the account contained 100 shares of Acme and 100 shares of Omega, and then a few months later the Acme had appreciated but the Omega had declined in value, the participant might like to recharacterize just the Omega stock. But the regulation's definition of the "income" on the account (the income that must be transferred to a traditional IRA along with the contribution being recharacterized; see ¶ 5.6.04) 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)(6), Example 2.

If an individual converts his IRA to *multiple* Roth IRAs, the regulations appear to permit him to "unconvert" one or more of the multiple Roths without undoing all of them. See Reg. § 1.408A-5, A-1. Thus, a client might consider converting his IRA into several Roth IRAs, with portfolio assets whose values are less likely to move in tandem placed into separate Roth IRAs. That way, if one asset class declines in value prior to the deadline for recharacterizing the account, he can recharacterize just the Roth IRA that holds that asset class, and leave the other Roth IRAs alone. If using this strategy, the assets can be moved from a single traditional IRA directly into the multiple destination Roth IRAs; it is not necessary to first divide the assets into multiple traditional IRAs then convert those.

*5.6.06 **Deadlines for Roth IRA contributions, conversions***

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

A. **Deadline for "regular" contribution.** Starting with the easiest one: The deadline for making a <u>regular contribution</u> to a Roth IRA (¶ 5.4.02) 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. § 219(f)(3), Reg. § 1.408A-3, A-2(b).

For example, a contribution "for" the year 2016 may be made at any time after December 31, 2015, and before April 16, 2017. When a participant makes a regular IRA contribution between January 1 and April 15, the IRA provider must ask which year it is for, since between those dates it could be a contribution "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 15^{th} day of the fourth month following the end of the individual's taxable year. § 6072(a). That means April 15^{th} for most people. However, the actual deadline will be a bit later if April 15^{th} falls on a weekend or holiday. § 7503. Also, the deadline may be extended for individuals in an area affected by a disaster; and of course the deadline is different for an individual whose taxable year is not the calendar year. In this book, "April 15" is used as shorthand for "the unextended due date of the individual's income tax return for the year in question, whatever that may be."

B. **Deadline for "conversion" contribution.** Conversions are slightly more complicated. Because the conversion is technically a "rollover" (see ¶ 5.5.03(A)), a conversion contribution is tied to the traditional plan distribution that is being "rolled over." Therefore a Roth IRA conversion that is supposed to be "for" the year 2016 must be tied to a *distribution that occurs in the calendar year 2016*. The due date of the 2016 return is *irrelevant*. A distribution made from a traditional plan in the calendar year 2016, if it is to be contributed to a Roth IRA, must be so contributed within 60 days after the date of the distribution. Reg. § 1.408A-4, A-1(b)(1). See § 402(c)(3)(A), § 408(d)(3)(A)(i), and ¶ 2.7.

Note that the ability to recharacterize a "Year 1" IRA contribution until October 15 of "Year 2" (see ¶ 5.6.07) does *not* create a new extended right to do Roth conversions between January 1 and October 15 of "Year 2" that will count as "Year 1" conversions. If, in Year 1, there was no traditional plan or IRA distribution that was contributed to a Roth IRA, there is nothing to "recharacterize."

January 1, 2017, would be the first date in 2017 on which an amount could be distributed out of a traditional IRA; therefore the earliest possible date for a "2017 Roth conversion" would be January 1, 2017 (same-day conversion of a January 1 distribution). The last possible date in calendar 2017 on which an amount could be distributed out of a traditional plan would be December 31, 2017. Therefore the last possible date for a "2017 conversion" would be 60 days after December 31, 2017 (the deadline for rolling over a distribution made on December 31, 2017). § 408(d)(3)(A)(i); see ¶ 2.7. Note that:

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

- The 60-day rollover deadline can be extended in cases of hardship. See ¶ 2.7.05. In PLR 2011-05046 this provision was used to allow a late Roth IRA conversion (hardship based on taxpayer's medical problems).

- If a "Year 1" distribution is contributed to a Roth IRA in "Year 2" (within the applicable deadline for completing an indirect rollover) that is still considered a *Year 1* conversion for purposes of the eligibility tests (¶ 5.5.02(D), (E)). Reg. § 1.408A-4, A-2(b), first sentence.

5.6.07 ***Recharacterization deadline: Due date "including extensions"***

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

1. A <u>regular contribution</u> (¶ 5.4.02) to either a Roth IRA or a traditional IRA for a particular year, that was made by the *unextended* due date of the return for that year, can be recharacterized by the *extended* due date of the return for that year.

2. A <u>conversion contribution</u> to a Roth IRA may be recharacterized by the extended due date of the return for the taxable year in which the *distribution* that was converted to a Roth was distributed (which may not be the calendar year in which the distribution was contributed to a Roth IRA).

"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" takes necessary corrective actions (such as filing an amended return if necessary). Emphasis added.

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

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

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

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

B. **April 15 if return is filed late.** If the individual does not file his income tax return for Year 1 on or before the date it is due (whether that due date is April 15 or some later date he qualified for under an extension), he must complete the recharacterization by April 15 of Year 2. See PLR 2014-31038 for an example of a taxpayer who attempted to recharacterize on Oct. 12-13 of "Year 2" but was too late because his tax return had not been timely filed. (He was allowed a late recharacterization, because he was the victim of fraud by his tax preparer; see "C.")

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

First, blanket extensions of time are sometimes granted to 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. To find applicable disaster tax relief, search www.irs.gov for the name of the event (*e.g.*, Hurricane Irma).

Second, there are procedures for applying to the IRS for relief in cases of good faith errors. See Reg. § 301.9100-1 *et seq*.. This procedure is nicknamed "9100 relief." If seeking such relief, you need to study the regulations and carry out all the steps required thereby.

9100 relief has been sought and granted extensively in connection with Roth IRA conversions and occasionally in connection with other IRA rollovers or contributions:

In connection with post-death recharacterizations of Roth conversions, see PLRs 2002-19040 and 2002-34074 and ¶ 4.1.02.

In the years 1998–2009, a taxpayer was eligible to convert traditional IRA money to a Roth IRA only if his adjusted gross income (AGI) did not exceed $100,000. See ¶ 5.5.02(E). In numerous PLRs granting late recharacterization, the taxpayer carried out a Roth conversion that he was actually not eligible to make because of this income limit. In most cases the taxpayer's error about the income limit was due to either: erroneous advice from a financial advisor (FA), financial institution (FI), or tax preparer; or subsequent income adjustments the taxpayer did not know of at the time of the conversion; or other understandable source of confusion (which factors also caused the taxpayer to miss the recharacterization deadline). In some rulings, however, the error seems to have entirely the taxpayer's own. Nevertheless, when the original conversion was invalid (failed conversion), the IRS has not denied late recharacterization in any ruling the author has seen to date. See PLRs 2001-16053, 2001-16058, 2001-19059, 2001-20040, 2001-22050, 2001-26040, 2001-28058, 2001-29040, 2001-30058, 2009-09073, 2009-28044, 2009-48065, 2010-04037, 2010-16095, 2014-04016, 2014-04018, 2014-39006, and 2014-42071.

Also, if the taxpayer timely initiated a recharacterization, but it was not completed on time solely due to financial institution error, the IRS (to date) permits late recharacterization. See PLRs 2001-16057, 2008-26040, 2008-50052, 2009-21036, 2014-31038, 2014-49012, and 2014-49013.

If the initial Roth conversion was valid, and the taxpayer did not timely initiate recharacterization, the taxpayer will need to convince the IRS that factors beyond his control caused him to miss the recharacterization deadline—factors such as mental disability (2014-23044) or fraudulent concealment of investment losses (2015-06015). Receiving incorrect professional advice or financial institution information about the tax consequences of the conversion (along with a suitable reason for not knowing of the need to recharacterize by a certain date) can be grounds for late recharacterization; see PLRs 2013-01020, 2013-20022, 2014-48034, 2015-06017, 2016-03047. Similarly, 9100 relief can be granted if the need for late recharacterization is caused by any other mistake or omission by a financial advisor, financial institution, or tax professional; see PLRs 2014-27025, 2014-39006, 2016-17019, 2016-27008.

However, if the IRS believes the late recharacterization is sought due to "hindsight" (Roth investments declined in value), and the taxpayer can not pin most of the blame for lateness on someone other than himself (even if there are other parties who contributed to it), the IRS will not grant 9100 relief. See PLRs 2010-24071, 2016-35013.

For late recharacterization allowed in connection with regular Roth IRA contributions (as opposed to conversions) see PLRs 2015-11022, 2016-03048; in connection with improper rollover from traditional IRA to SIMPLE, see 2014-46036.

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

Once a recharacterization of an amount converted from a traditional IRA to a Roth IRA occurs, the individual "may not reconvert that amount" to a Roth IRA until the taxable year following the taxable year of the original conversion, or until at least 30 days have elapsed since the recharacterization, *whichever is later*. Thus, recharacterization cannot be used to flip the same dollars back and forth quickly between traditional and Roth IRA status. Reg. § 1.408A-5, A-9.

If the individual defies this rule and attempts to reconvert before the prescribed time period ends, the result is a *failed conversion*. See ¶ 5.5.05.

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

Brittany Example: Brittany's IRA (traditional IRA #1) in Year 1 holds 30,000 shares of Acme stock worth $10 a share ($300,000). In January Year 1 she moves 10,000 shares from her traditional IRA #1 to Roth IRA #1, thus effecting a $100,000 Roth conversion. A month later the Acme stock has declined to $7 per share, so her Roth IRA is worth only $70,000 and her traditional IRA only $140,000. Brittany wants to undo her Roth conversion that occurred at a higher price, but she wants to stick with her goal of converting about $100,000 worth of Acme stock in Year 1. She recharacterizes the first conversion by moving the Acme stock out of Roth IRA #1 back to a new traditional IRA (IRA #2). She then immediately transfers another $100,002 worth of Acme stock (14,286 shares at $7) from traditional IRA #1 to Roth IRA #2. It appears that this new conversion is permitted because it is not a conversion of the same "amount." If Brittany is concerned that the second conversion might not be permitted, she could do the second conversion just BEFORE she recharacterizes the first conversion, thereby presumably avoiding any question about whether the second conversion is a "reconversion" of the recharacterized amount.

A Roth conversion effected by transfer from a nonIRA plan to a Roth IRA can be recharacterized under § 408A(d)(6). Notice 2008-30, 2008-1 CB 638, A-5, A-7. The rule banning same-year reconversions, by its explicit terms, applies only with respect to recharacterized conversions from *an IRA* to a Roth IRA, not to conversions from a nonIRA plan. However, the IRS may intend that this ban also applies to plan-to-Roth-IRA conversions, under the rule that plan-to-Roth-IRA conversions are taxed "as if" the money went through a traditional IRA first on its way to the Roth IRA; see ¶ 5.5.04(A).

5.6.09 ***Using § 408A(d)(6) to fix mistakes*** [see Appendix D!]

It is clear that (in addition to providing a mechanism for changing your mind about a Roth conversion) a § 408A(d)(6) transfer (recharacterization) can be used to cure certain mistakes. Perhaps it can be used to fix some other mistakes as well.

Here are mistakes known to be "fixable" by recharacterization:

- Recharacterizing a Roth conversion that the would-be converter was not eligible to make is the most common example. Prior to 2010, an income ceiling test applied to Roth conversions. Many individuals who did Roth conversions prior to 2010 actually were not eligible because of this income ceiling, but either did not know about the ceiling, or thought it was higher than it was, or "passed" the test at the time of the conversion but later "flunked" it due to later-discovered income or adjustments on their tax return due to IRS audit. These individuals had to use § 408A(d)(6) to recharacterize their unlawful Roth conversions. See Reg. § 1.408A-5, A-10, Example 1. In many cases the IRS allowed them to do this even after the deadline; see ¶ 5.6.07(C).

- An employer contribution to a SEP or SIMPLE plan cannot, itself, be converted to Roth IRA status by means of a recharacterization. ¶ 5.6.02. If such a "conversion" is mistakenly done, it can be corrected by recharacterizing the wrongly-transferred amount back into the SEP or SIMPLE. Reg. § 1.408A-5, A-5.

- Any "failed" Roth conversion (*e.g.*, if someone converted an "amount" to a Roth IRA too soon after recharacterizing a conversion of the same "amount"; see ¶ 5.6.08) can be recharacterized. Reg. § 1.408A-4, A-3(a).

- A recharacterization is "never treated as a rollover for purposes of the one-rollover-per-year limitation..., even if the contribution would have been treated as a rollover contribution by the...[transferee] IRA if it had been made directly to the" transferee IRA in the first place. Accordingly, a person who wants to roll over an IRA distribution to an IRA, but who is barred from doing so by the one-IRA-to-IRA-rollover-per-12-months rule (¶ 2.6.05), can achieve his desired result by instead rolling his distribution into a Roth IRA (Roth conversion), then recharacterizing that contribution into a traditional IRA. Reg. § 1.408A-5, A-8.

- SIMPLE IRAs cannot legally receive rollovers or transfers from other IRAs. "...[I]f an amount is erroneously rolled over or transferred from a traditional IRA to a SIMPLE IRA, the contribution can subsequently be recharacterized as a contribution to another traditional IRA." Reg. § 1.408A-5, A-4; PLR 2014-46036. Note that recharacterization in this case does not involve moving money between Roth and traditional IRAs—the transfer is between two traditional retirement accounts.

An intriguing possibility is the use of § 408A(d)(6) when an eligible rollover distribution is mistakenly deposited into the wrong IRA. For example, husband retires and requests a direct rollover to his IRA; by mistake the money is deposited in wife's IRA. Or a Designated Beneficiary requests a direct rollover of an inherited 401(k) plan death benefit (see ¶ 4.2.04); by mistake the rollover lands in the beneficiary's own IRA rather than an inherited IRA. It appears this type of mistake could be "fixable" with a § 408A(d)(6) transfer into the correct IRA, provided the transfer includes the applicable net earnings and is completed by the deadline, so that the contribution is deemed originally made to the transferee (second) IRA. In PLR 2012-46044, an IRA customer had multiple IRAs, one of which was an inherited IRA that was not correctly titled as an inherited IRA. Because of that mistake, money was inadvertently rolled from two of his noninherited IRAs into the inherited IRA (failed rollover). The mistake was discovered later and the IRS granted a waiver of the 60-day rollover deadline to allow the taxpayer to roll the original IRA distributions into another IRA (one correctly titled as a noninherited IRA). If the taxpayer had used § 408A(d)(6), to recharacterize the erroneous contribution to the inherited IRA as a contribution to a noninherited IRA, he would have been able to move the post-contribution earnings as well as the contribution itself into the proper type of IRA.

But this application of § 408A(d)(6) has not been reported in any published source. The argument in favor of it is, § 408A(d)(6) says that *any* transfer from one IRA to another (if made within the required time frame and accompanied by its "net earnings") is deemed to have been contributed to the second (transferee) IRA, *except to the extent otherwise provided by the Secretary of the Treasury*. The IRS has not issued any pronouncement prohibiting § 408A(d)(6) post-death transfers from the beneficiary's own IRA to an inherited IRA. On the contrary, the IRS's regulation says that "an individual" who makes an IRA contribution, and transfers the contribution to a second IRA (within the required time frame and accompanied by earnings) can elect to have the contribution treated as contributed to the second IRA "except as otherwise provided in this section"—and the "section" does not prohibit this type of transfer. Reg. § 1.408A-5, A-1(a).

The IRS's only pronouncement touching near the subject is (in connection with nonspouse beneficiary direct rollovers from a nonIRA plan; ¶ 4.2.04) that "If an amount distributed from a plan is *received by a nonspouse beneficiary*, the distribution is not eligible for rollover." IRS Notice 2007-7, 2007-1 CB 395, A-15; emphasis added. So if the inherited QRP amount is actually sent to the beneficiary's taxable account, the distribution cannot be rolled over. This wording in Notice 2007-7 seems to leave the door open for a § 408A(d)(6) recharacterization/corrective transfer, if the plan distribution *was not* "received by" the nonspouse beneficiary, it was always inside some kind of retirement account—just, temporarily, the wrong type of account.

The argument against this interpretation is that, in another context (purported Roth conversion of a distribution *that was not eligible for rollover*), the IRS treats the improper rollover as a distribution followed by a "regular" contribution of the rollover-ineligible amount to the recipient's own IRA. Reg. § 1.408A-4, A-6(c); see ¶ 5.2.04. If the IRS were to apply the "deemed distribution" rule in the context of the transfer of an inherited plan or IRA benefit to the incorrect type of account, § 408A(d)(6) would not work because the contribution that would need to be recharacterized is the *beneficiary's* "deemed" contribution, not the direct rollover that went from the inherited qualified plan or IRA into the wrong account...and since the beneficiary could not properly have contributed to an inherited IRA, "deeming" his contribution to have gone into that account doesn't help.

However, the IRS has not to date stated that a direct rollover or transfer, into the wrong account, *of an amount that is eligible to be rolled or transferred* is automatically treated as a distribution. On the contrary, the regulation says that a failed Roth conversion is treated as a distribution *only if the improper contribution is not recharacterized*. Reg. § 1.408A-4, A-3(b).

Unlike the situation where the rollover or transfer is proper except for landing in the wrong account, treating the improper conversion *of the RMD amount* as a deemed distribution *helps* the taxpayer (by avoiding imposition of excise tax for failure to take the RMD; ¶ 1.9). Since the taxpayer would have to pay income tax on this "deemed" distribution in any event, he is not harmed by losing out on the rollover he wasn't eligible to make in the first place. But applying that automatic-deemed-non-fixable-distribution rule to a misdirected rollover/transfer *that never leaves the retirement plan* *environment* would produce harshly unfavorable results for the individual whose legal rollover or transfer merely went to the wrong account.

5.7 Designated Roth Accounts

In 2006, a new type of "Roth" plan joined the roster, the "designated Roth account" ("DRAC") inside a 401(k) or 403(b) "cash or deferred arrangement" (CODA) plan. Originally allowing only annual-type contributions (where an employee could elect to have his "salary reduction" contribution go into either a traditional or a Roth-type account in a 401(k) or 403(b) plan), DRAC rules rapidly evolved to allow (as of 2017), "in-plan" Roth conversions and annual CODA Roth contributions for just about any CODA plan that wants to allow them. This Section states today's rules; for different rules that applied in 2006–2016, see the author's "*Special Report: Ancient History*" (www.ataxplan.com).

*5.7.01 **Meet the DRAC; Contrast with Roth IRAs***

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

Needless to say, elective deferrals are subject to many complicated tax rules. Through 2005, the reward for successfully complying with these rules was that the amount of the elective deferral would be excluded from the participant's income (except for FICA tax purposes; see ¶ 5.7.02(D)). 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).

Now participants have an additional option for elective deferrals under any 401(k), 403(b), or governmental 457 plan, provided the employer has added such option to the plan: Instead of deferring income tax on the deferred compensation, he can pay tax on it currently and have it contributed to a **designated Roth account** (**DRAC**) within the plan; later qualified distributions from the DRAC will be tax-free. § 402A(d)(1). The portion of the elective deferral that the participant elects to have contributed to a DRAC is called a "**designated Roth contribution**." § 402A(a)(1).

Only "applicable retirement plans" are permitted to have DRACs. § 402A(a). Applicable retirement plans are defined as qualified (§ 401(a)) plans that have elective deferral (§ 401(k)) provisions, 403(b) plans (so DRACs are sometimes called "Roth 401(k)" or "Roth 403(b)" accounts), and governmental 457(b) plans. § 402A(e)(1); see Reg. § 1.401(k)-1(f), § 1.403(b)-3(c), Prop. Reg. § 1.457-4. *This chapter addresses DRACs in 401(k) plans only.*

The attractiveness of DRACs has been enhanced by the addition of the option of in-plan Roth conversions, allowing employees to convert existing traditional plan accounts, and even after-tax contributions, to Roth status, even if not permitted to withdraw the funds from the plan. See ¶ 5.7.03

Though they have similar tax treatment, there are several significant differences between DRACs and Roth IRAs. These mainly stem from the fact that the DRAC (unlike a Roth IRA) is part of an employer plan. As such it is subject to all the same rules that apply to traditional 401(k), 403(b), or 457(b) plan accounts, except to the extent § 402A provides otherwise. Here are the resulting primary points of contrast between DRACs and Roth IRAs:

- DRACs are subject to the same lifetime and post-death **minimum distribution rules** as other 401(k) plan benefits. Roth IRAs are exempt from the lifetime RMD rules; see ¶ 5.2.01.
- DRAC contributions are irrevocable (¶ 5.7.02(C)), unlike Roth IRA contributions, which can be recharacterized (¶ 5.6).
- DRAC distributions are subject to the **income tax withholding rules** applicable to other distributions from qualified plans; see ¶ 2.3. Roth IRAs are subject to the less stringent IRA withholding rules.
- DRACs are subject to any federally granted spousal rights the employer plan is subject to (see ¶ 3.4). These do not apply to Roth IRAs.
- DRACs are subject to the rules restricting distributions from elective deferral accounts (not covered in this book; see, instead, Chapter 27 of *The Pension Answer Book*). Roth IRAs are subject to none of these.
- Other differences include the definition of qualified distributions (¶ 5.7.04), the treatment of nonqualified distributions (¶ 5.7.05), and the rollover rules (¶ 5.7.06–¶ 5.7.09).

There are three ways money can get into a DRAC: Regular "salary reduction" contributions by the employee (¶ 5.7.02), "in-plan conversions" (¶ 5.7.03), and by rollover from another DRAC (¶ 5.7.07).

*5.7.02 **Regular (annual-type) DRAC contributions***

The employer cannot make matching (or any other) contributions to a DRAC. The employer's matching contribution (if any), and any other employer contributions to the plan on behalf of the participant, must be made to the participant's "traditional" account, regardless of whether the participant's contribution that is being "matched" was made to a traditional account or to a DRAC. Reg. § 1.401(k)-1(f)(3), third sentence. "Regular" (annual-type) contributions to a DRAC may be made only by means of the employee's elective deferrals.

A. **Who may contribute.** Any participant in a 401(k) plan can elect to have all or part of his elective deferral ("salary reduction") go into a DRAC, *if* his employer's plan permits designated Roth contributions (plans are not required to offer this option). A self-employed individual who has a self-employed (Keogh) 401(k) plan can have all or part of his elective deferral contributed to a DRAC. Reg. § 1.401(k)-1(f)(2), second sentence.

In contrast to Roth IRAs (¶ 5.4.04(C)), there is <u>no income ceiling</u> above which the participant is not allowed to make designated Roth contributions. § 402A. The DRAC was the first Roth retirement plan not to limit contributions to individuals with income below certain levels.

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

B. **How much may be contributed.** The maximum amount that may be contributed to a DRAC is whatever maximum amount of elective deferral contribution the participant may make to his 401(k) plan for the year in question. § 402A(c)(2), § 402(g)(1).

The dollar limit for elective deferrals was set at $15,000 plus a "catch-up" contribution of $5,000 if the participant is 50 or older by the end of the year. § 402(g)(1)(B), (C). Cost-of-living adjustments (COLAs) increase both the base amount (§ 402(g)(4)) and the catch-up contribution (§ 414(v)(2)(C)) after 2006. For 2017 the adjusted maximum is $18,000 and the catchup is $6,000. IRS News Release 2016-141. Note the contrast with IRAs, where the catchup contribution for individuals over age 49 is not subject to a COLA. ¶ 5.4.03.

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

As a reminder, as is true for a traditional 401(k) plan, the elective deferral limits apply to an individual based on *all* elective deferral plans he participates in (with this or any other employer; § 402(g)(1)(A)); and § 415 also limits the amount that may be contributed. These limits are beyond the scope of this book; see instead Chapter 27 of *The Pension Answer Book* by Stephen Krass.

C. **Election is prospective and irrevocable.** Elective deferrals may be contributed *prospectively only* to a DRAC. Once the participant has elected to have his deferral contribution sent to a traditional 401(k) account, he cannot change his mind and withdraw the contribution or "recharacterize" the contribution into the DRAC (or vice versa). Reg. § 1.401(k)-1(f)(1)(i). This is unlike a traditional or Roth IRA, contributions to which can be withdrawn or recharacterized for a certain period of time, if the contributor changes his mind; see ¶ 5.6.02. The irrevocability of the DRAC decision makes 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. If in doubt, he should contribute to the traditional account, since he can always later move that to a DRAC (if "in-plan conversion" are permitted by the plan; see ¶ 5.7.03), whereas there is no way to undo a DRAC contribution.

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

*5.7.03 **DRAC contributions via in-plan conversion***

A plan that has a DRAC program (*i.e.*, it allows employees to make their cash-or-deferred contributions to either a "Roth" account or a "traditional" CODA account; see ¶ 5.7.02) can also allow the employee to transfer any vested amount from his traditional plan account(s) to a DRAC in the same plan. § 402A(c)(4), "Taxable rollovers to designated Roth accounts"; Notice 2010-84, A-1. The IRS calls this type of transfer an "**in-plan Roth rollover**." It is also called an **in-plan Roth conversion**.

The plan is not required to offer in-plan conversions, even if it offers DRACs. Notice 2010-84, A-4.

Unlike an IRA-to-Roth-IRA conversion (¶ 5.5.03), or a plan-to-Roth IRA conversion (¶ 5.5.04) an in-plan conversion is irrevocable—there is no Code provision or mechanism for "recharacterizing" an in-plan conversion. Notice 2010-84, A-6.

When first allowed (after 9/27/2010), in-plan conversions were permitted only for amounts that the employee was (as of the time of the conversion) entitled to take out of the plan altogether—for example, funds that a retired employee had optionally chosen to leave in the plan, or (in the case of a still-employed individual) funds that qualified for an "in-service distribution" (¶ 5.5.07). For 2013 and later years, the plan can allow in-plan conversion for any amount the employee has in the plan, even amounts that could not legally be distributed to the employee at the time of such transfer. § 402A(c)(4)(E).

At this writing, IRS regulations have not been updated to reflect in-plan Roth conversions. See, *e.g.*, now-obsolete Reg. § 1.401(k)-1(f)(3), third sentence, providing that a DRAC can only accept rollovers described in § 402A(c)(3)(B) (*i.e.*, rollovers from other DRACs). Instead, IRS guidance is found in Notice 2010-84, 2010-51 IRB 872, and Notice 2013-74, 2013-52 IRB 819.

A. **Who can or might want to do an in-plan Roth conversion.** Any participant can do an in-plan Roth rollover as far as the Tax Code is concerned. In-plan conversions are also allowed for the surviving spouse as beneficiary. Other Designated Beneficiaries cannot do in-plan conversions. Notice 2010-84, A-14.

If someone has a choice of rolling (converting) money from a traditional plan account to either a DRAC or a Roth IRA, the Roth IRA has many advantages—such as the ability to later undo the conversion by recharacterization (¶ 5.6), and no RMDs during life (¶ 5.2.01), neither of which advantages is available for a DRAC.

However, many 401(k) plan participants do not have the option to transfer their traditional 401(k) accounts to a Roth IRA, because that type of conversion would require them to take the money out of the employer plan. Generally a 401(k) plan cannot distribute funds to the employee until she is either over age 59½ or has terminated employment. § 401(k)(2)(B)(i). There is an exception for hardship distributions, but hardship distributions cannot be rolled over. § 402(c)(4)(C). For employees under 59½, therefore, it's often either do an in-plan Roth conversion or do NO Roth conversion.

If an employee has the option of both types of conversions, the employee would choose the in-plan conversion over the Roth IRA conversion only if he has some particular reason to want to keep his funds in that plan, such as creditor protection concerns or availability of investment expertise that would be lost by rolling to an IRA.

B. **In-plan conversion before age 59½.** In-plan conversions are subject to the same waiver and recapture provisions regarding the 10 percent early-distributions penalty as Roth IRA conversions: The 10 percent tax does not apply to the conversion itself, but does apply to any portion of the converted amount that is withdrawn within five years after the conversion. § 402A(c)(4)(A)(ii), (D); § 408A(d)(3)(F); Notice 2010-84, A-12. A-13. See ¶ 5.8.02(C) for explanation of this rule.

C. **How to do an in-plan conversion.** An in-plan conversion can be done either by direct transfer or by 60-day rollover. Of course, the 60-day rollover option applies only to an amount actually distributed from the plan.

D. **In-plan conversions and NUA stock.** See ¶ 2.5 for the favorable tax treatment available for a "lump sum distribution" that includes "net unrealized appreciation" (NUA) of employer stock. An employee who holds appreciated employer stock in his retirement plan should be extremely careful regarding in-plan conversions for two reasons. First, an in-plan conversion is considered a "distribution" from the plan and thus may destroy lump-sum status for later distributions. IRS Notice 2013-74, 2013-52 IRB 819, A-9. Second, an in-plan conversion of the stock does not qualify for the favorable NUA tax treatment under any circumstances.

"An in-plan Roth rollover is treated as a distribution for purposes of determining eligibility for the special tax rules on NUA, whether the rollover is made by an in-plan Roth direct rollover or by an in-plan Roth 60-day rollover"—even though an in-plan conversion is *not* treated as a distribution for other purposes such as the requirement of spousal consent (IRS Notice 2010-84, A-3). This means that an employee who retired (separated from service), then did an in-plan Roth conversion of some money in his 401(k) plan, would lose his eligibility for the special "NUA" deal for any later distributions (unless there is a new "triggering event").

The in-plan conversion is taxed as if it were a rollover to a Roth IRA of the same amount, meaning the entire fair market value of the property transferred (including "NUA"), minus the participant's investment in the contract, is includible in gross income. Notice 2010-84, A-7; see ¶ 5.5.04.

E. Additional after-tax contributions to expand Roth account. The in-plan conversion option is available for any funds the employee legally has in the plan, not just the elective deferral (CODA) account. It applies to any distribution from the plan (other than from the DRAC itself) which is transferred to the DRAC. § 402A(c)(4)(B).

A 401(k) plan can hold various accounts for plan participants, including rollover accounts (holding rollovers from IRAs or other plans) and after-tax employee contribution accounts (see Reg. § 1.401(k)-1(a)(2)(ii)). The potential for increased Roth conversions is spurring some companies to allow employees to make additional after-tax contributions to their 401(k) plans.

Once the employee reaches her RBD, RMDs must be taken from the plan; the RMD for any of the employee's accounts can be satisfied by a distribution from any of such accounts. ¶ 1.3.05.

How much can an employee contribute this way? Tax Code rules and plan- and employer-imposed limitations will dictate the maximum that can be contributed. These subjects are beyond the scope of this book; consult the plan administrator.

Teresa Example: Teresa is age 45. Her 2017 salary is $250,000. The company she works for has a 401(k) plan that permits all DRAC options. She made the maximum 2017 401(k) "salary reduction" contribution of $18,000, and her employer contributed another $25,000, for a total of $43,000. So far she has two "accounts" in this plan, her Employee Elective Deferral Account, and the Employer Contribution Account (both 100% pretax money). The plan administrator verifies that she can make an additional voluntary nondeductible contribution of up to $11,000 to a third plan account, her "Employee Contribution Account" and that (following the contribution) she can convert that account to a DRAC. The conversion is taxable only to the extent of earnings (if any) that have accrued between the date of the contribution and the date of the conversion. All future growth on that account will be tax-free, assuming it comes out as a qualified distribution.

Not all plans offer the option of employee after-tax contributions, and even when it is offered, a particular employee may not be allowed to contribute due to tax code or plan-imposed limits. But plans increasingly are allowing this option for employees who want to save more. The drawback is that the account will be out of the employee's reach until separation from service or other events permitting a plan distribution.

*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 qualified 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. § 402A(d)(2)(A); § 408A(d)(2)(A). Compare ¶ 5.3.02, #4.

B. **How the Five-Year Period is computed for a DRAC.** As with Roth IRAs, DRACs have a five-year waiting period (called the "**nonexclusion period**" in the statute, the "**Five-Year Period**" in this book) before a qualified distribution can occur. § 402A(d)(2)(B). However, there is a difference in the way the Five-Year Period is calculated. With a Roth IRA, the Five-Year Period begins with the first year there is a contribution to *any* Roth IRA; see ¶ 5.3.03.

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*. That first contribution could have been an elective deferral contribution to the DRAC, or an in-plan Roth conversion, or a rollover from another DRAC...and if there was a direct rollover from another DRAC it's possible the other DRAC's holding period could be tacked on to the holding period for this DRAC; see ¶ 5.7.07(D). § 402A(d)(2)(B)(i); Notice 2013-74, A-8.

The start of the Five-Year Period is not "redetermined." It still begins with the *first* contribution, even if the employee takes distribution of the entire account during the Five-Year Period then later makes more contributions. Reg. § 1.402A-1, A-4(c).

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

However, certain DRAC contributions do NOT start the Five-Year Period tolling. "...[A] contribution that is returned as an excess deferral or excess contribution does not begin the 5 taxable-year period of participation. Similarly, a contribution returned as a permissible withdrawal under section 414(w) ["automatic contribution arrangements"] does not begin the 5 taxable-year period of participation." Reg. § 1.402A-1, A-4(a). 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, most subsequent distributions are qualified (for exceptions, see "C"). Qualified status is determined based on *the year in which the distribution actually occurs*, not on some prior year to which it may relate. For example, a required minimum distribution (RMD) that is taken in the year the required beginning date (RBD) occurs (after completion of the Five-Year Period) but which actually is the RMD for the prior year (which was within the Five-Year Period), is a qualified distribution. A distribution received after completion of the Five-Year Period (and after a triggering event) is a qualified distribution, even if it is part of a series of substantially equal periodic payments that started prior to the completion of the Five-Year Period. T.D. 9324, *Explanation of Provisions*, "Determination of 5-Taxable-Year Period for Qualified Distributions."

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

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

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

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

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

- <u>Dividends paid on employer securities</u> 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 DRAC. 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 <u>life insurance</u>. A-4(f). See ¶ 8.2.01.

- Returned contributions under a § 414(w) automatic contribution arrangement. A-4(h).

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

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

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

D. **Payments to beneficiaries.** In the case of a distribution from a DRAC to a beneficiary, it is generally the death, age, or disability of the participant that determines whether the distribution is qualified; however, if the beneficiary is the surviving spouse, and the surviving spouse rolls the distribution over to a DRAC sponsored by the surviving spouse's own employer, the surviving spouse's death, age, disability, etc. will determine qualified status. Reg. § 1.402A-1, A-4(d).

E. **QDROs.** See Reg. § 1.402A-1, A-4(d), regarding QDRO payments from designated Roth accounts.

5.7.05 ***Nonqualified DRAC distributions***

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

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

But if there is a nonqualified distribution, the earnings cannot come out tax-free. Accordingly, we need to determine how much of any nonqualified distribution represents a return of the participant's IITC (tax-free) and how much is considered earnings (taxable), and here's where we find the difference between Roth IRAs and DRACs. With a Roth IRA, the participant's own contributions (*i.e.*, the after-tax money) come out first. ¶ 5.3.04, ¶ 5.3.05. Accordingly, even nonqualified Roth IRA distributions are income tax-free until the entire IITC has been distributed.

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

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

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

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

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

Any DRAC distribution can have potentially up to three "destinations": Outright to the participant (or beneficiary), directly to another DRAC, or directly to a Roth IRA. Note that:

- If a DRAC contains both "investment in the contract" (IITC) and "earnings," the participant can direct that those two portions be sent to different "destinations." See ¶ 2.2.05.

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

These rules for tracking the participant's "income" and "investment in the contract" in the distributing DRAC must be observed, in the case of a partial distribution from a DRAC, even if the distribution is a qualified distribution (so it is tax-free; ¶ 5.3.01(A)), because of the possibility that the participant might later receive a *non*qualified distribution from that DRAC; see ¶ 5.3.04.

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

*5.7.07 **Rollovers into a DRAC***

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

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

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

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

C. **Total direct rollover preserves IITC 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 IITC in the distributing DRAC exceeds the fair market value of the distribution, the employee's IITC in the distributing DRAC becomes part of his IITC in the recipient DRAC, despite the fact that his IITC exceeds the account's value. This rule helps an employee whose DRAC is "under water" preserve his high IITC 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 (if it's longer) becomes the holding period in the transferee plan for purposes of computing the Five-Year Period (¶ 5.7.04(B)). With an "indirect" (60-day) rollover, the years in the prior plan *will not count* in computing the Five-Year Period for the transferee plan. § 402A(d)(2)(B); Reg. § 1.402A-1, A-4(b).

E. **60-day ("indirect") rollover.** If the participant actually receives the DRAC distribution (*i.e.*, he did not arrange for a direct rollover), then he has 60 days to roll all or part of the *pretax* portion (only) of the distribution into another DRAC; see ¶ 2.7. Here are additional rules regarding such indirect DRAC-to-DRAC rollovers:

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

2. The nontaxable portion of a DRAC distribution (*i.e.*, the IITC—or the entire distribution in the case of a qualified distribution) may NOT be rolled to another DRAC by means of a 60-day rollover. § 402(c)(2); Reg. § 1.402A-1, A-5(a), second sentence. The only way to preserve Roth status of this portion would be to roll it to a Roth IRA (¶ 5.7.08) (or use a direct rollover to a DRAC instead of a 60-day rollover; see "B").

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

4. Finally, since a 60-day rollover involves the distribution of an eligible rollover distribution to the participant, it is subject to mandatory 20 percent withholding of federal income tax from the taxable portion of the distribution. § 3405(c). To roll over the withheld amount, the participant must use substituted funds. Reg. § 1.402(c)-2, A-11, third sentence.

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

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

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

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

B. **Minimum distribution effects.** Rolling over from a DRAC to a Roth IRA will end the requirement of lifetime RMDs with respect to the rolled funds (¶ 5.2.01) and (depending on the participant's age at the time of the rollover) may change the method of computing the Applicable Distribution Period (ADP) that will apply to the participant's beneficiaries from the "death post-RBD rules" to the "death pre-RBD rules"; see ¶ 1.5.02. For the meaning of RBD and ADP with respect to any particular participant or plan, and the minimum distribution rules applicable in case of death pre- or post-RBD, see Chapter 1.

C. **Favorable effect on IITC recovery.** Rolling from a DRAC to a Roth IRA enables the participant (once the rollover is completed) to withdraw his own contributions tax-free from the Roth IRA while leaving any "earnings" inside the account, something he could NOT do with the DRAC, because the Roth IRA has more favorable rules for recovery of IITC than a DRAC. Compare ¶ 5.3.04 with ¶ 5.7.05.

D. **Rollover when IITC is higher than market value.** There is a special rule for determining IITC in the Roth IRA when there is a rollover into the Roth IRA from a DRAC, *if* the employee's IITC 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 IITC in the DRAC exceeded the market value of the DRAC, the excess IITC is treated as a regular contribution to the Roth

IRA (*i.e.*, it is added to the employee's IITC in the Roth IRA). Reg. § 1.408A-10, A-3(b). "Excess IITC" here would mean the IITC to the extent it was not used to shelter the nonrolled portion of the distribution from tax.

Debbie Example: Debbie's DRAC at Acme Widget is worth $40,000. Her IITC is $50,000. She takes a distribution of $40,000 (*i.e.* the entire account) and within 60 days rolls $30,000 into a Roth IRA. The $10,000 she does not roll over is sheltered by her IITC, leaving an additional $40,000 of IITC that is carried over into the Roth IRA. So the Roth IRA has a value of $30,000 and an IITC of $40,000.

Does this ability to preserve "excess IITC" also apply to *direct* DRAC-to-Roth-IRA rollovers (not just 60-day rollovers), and to a rollover of the *entire* distribution (not just to partial rollovers)? The regulation specifically mentions only partial 60-day rollovers.

Preserving the "excess IITC" could be important in two situations. One is if the participant or beneficiary later takes a *nonqualified* distribution from the Roth IRA. Such a distribution would be includible in income only to the extent the distribution exceeded the participant's IITC. ¶ 5.3.04. For that purpose, having the benefit of a larger IITC means that less (or none) of the distribution will be income-taxable. The other advantage of preserving IITC would occur if the individual cashed out all of his Roth IRAs, and the total sum received was less than the individual's IITC in the account, so the individual would be entitled to a loss deduction. See ¶ 8.1.02.

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

The Five-Year Period for a Roth IRA begins January 1 of the first year the participant has any Roth IRA (¶ 5.3.03), *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." So if the participant never had a Roth IRA prior to this rollover, the Five-Year Period for his Roth IRA will begin January 1 of the year the rollover distribution is contributed to the Roth IRA. Reg. § 1.408A-10, A-4. If the contribution is in a later taxable year than the distribution (*e.g.*, December DRAC distribution deposited in Roth IRA the following January) it would appear the deposit-year is the first year, not the distribution-year.

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

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

A. **Rollover of a qualified distribution.** If the DRAC distribution that is rolled over to the Roth IRA is *itself* a qualified distribution (¶ 5.7.04), then the entire rollover amount is treated as a "regular contribution" to the Roth IRA. Reg. § 1.408A-10, A-3(a), third sentence. A regular contribution can be withdrawn from a Roth IRA at any time, tax-free. ¶ 5.3.04. Thus, only the post-rollover earnings on the rollover amount may be subject to a "fresh start" Five-Year Period in order to become tax-free qualified distributions. Reg. § 1.408A-10, A-4(b), Example 3.

Denny Example: Denny, age 60, receives a qualified distribution of $40,000 from his DRAC in 2010 and rolls it over to a Roth IRA. This is the first Roth IRA Denny has ever had. He cannot have a qualified distribution from the Roth IRA until 2015. Any distributions he takes from the Roth IRA before 2015 will be nonqualified. However, he can take out up to $40,000 of nonqualified distributions income tax-free as recovery of IITC, 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. ¶ 5.3.05. Only post-rollover appreciation ("earnings") will be income-taxable if withdrawn prior to 2015.

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

Amanda Example: Amanda, age 60, started a Roth IRA in 1998 with $1,000. In 2009 she makes a $20,000 DRAC contribution to her proprietorship's "self-employed 401(k) plan." In 2010 she retires and rolls the DRAC over to a Roth IRA (either the existing one or a new one—it doesn't matter). Even though her holding period for the DRAC was less than five years, so the DRAC distribution is a nonqualified distribution, it "instantly" becomes qualified once she rolls it to a Roth IRA, because she has already completed the Five-Year Period for any Roth IRAs she may ever own. Since she is over 59½, she has also met the "triggering event test" (¶ 5.3.02) so she can withdraw as much as she likes tax-free at any time from any Roth IRA she owns.

C. **Danger: Rolling to a new Roth IRA.** The person who may be hurt by this rule is someone who had no prior Roth IRA, and had completed one or more years in his DRAC at the time he rolls a *non*qualified distribution from the DRAC to a Roth IRA. He loses the years he had completed, and starts the 5-year clock over again. Because his rollover was NOT of a qualified distribution, only his IITC in the DRAC (*i.e.*, the amount of his 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 years anyway before he can have a qualified distribution from the Roth IRA). However, it could be tough for a person who has accumulated many years in the DRAC and then rolls to a Roth IRA *shortly before reaching age 59½*. If the first year for which he has ever owned a Roth IRA is the year he establishes a Roth IRA with his DRAC rollover, then he will have to wait five *more* years to have a qualified distribution from that Roth IRA.

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

5.7.10 ***Employer obligations; DRAC accounting***

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

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

5.8 Roths and Pre-Age 59½ Distributions (10% Tax)

Generally, there is a 10 percent "additional tax" on distributions from a retirement plan that occur while the participant is younger than age 59½. § 72(t). For details on this "early distributions" additional tax, and its more than one dozen exceptions, see Chapter 9. This ¶ 5.8 discusses the 10 percent extra tax as it applies to Roth IRAs, designated Roth accounts (DRACs; ¶ 5.7), and Roth conversions.

5.8.01 ***10% premature distributions tax applies to Roth distributions***

§ 72(t) imposes a 10 percent "additional tax" on certain retirement plan distributions received prior to age 59½. See Chapter 9.

The 10 percent tax under § 72(t) applies to pre-age 59½ distributions from Roth IRAs the same as it applies to such distributions from traditional IRAs, under the rule that Roth IRAs are treated the same as traditional IRAs unless § 408A provides otherwise. Reg. § 1.408A-6, A-5. Similarly, there is nothing in the Code that exempts distributions from DRACs (¶ 5.7) from the 10 percent tax. If the distribution qualifies for any exception from the tax, the tax does not apply. See ¶ 9.2–¶ 9.4 for the exceptions to the 10 percent tax. If no exception applies, then:

A. **Qualified distribution.** A qualified distribution (from either a DRAC or Roth IRA) is excluded from gross income. See ¶ 5.3.01(A), ¶ 5.7.04. Since the 10 percent tax generally applies only to amounts includible in gross income (*for the one exception; see ¶ 5.8.02(C)*), it does not apply to any qualified distribution. See § 72(t)(1); Notice 87-16, 1987-1 C.B. 446, Question D9.

B. **Conversion followed by distribution within five years.** Notwithstanding the general rule that the participant's own contributions are returned to him tax-free, see ¶ 5.8.02(C) for a special rule that may result in the 10 percent tax being imposed on the return of the participant's own contribution.

C. **Nonqualified distributions.** Any "earnings" distributed as part of a nonqualified distribution prior to age 59½ will be subject to the 10 percent tax unless an exception applies; see ¶ 5.8.03.

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

Roth conversions before age 59½ are confusing. There are two taxes to worry about (the income tax and the 10 percent tax on early distributions); there are two separate parts of the Roth account (the participant's contribution(s) and the earnings); and there are two different five-year holding periods. .

First the good news: The 10 percent tax does not apply to the deemed distribution that results from converting a traditional retirement plan or IRA to a Roth IRA. § 408A(d)(3)(A)(ii); Reg. § 1.408A-4, A-7(b); Notice 2008-30, A-3. Similarly, it does not apply to the deemed distribution resulting from an in-plan Roth conversion; see ¶ 5.7.03(B). Thus a young person may convert his traditional plan or IRA to a Roth IRA, or do an in-plan conversion, without incurring the 10 percent tax.

However, this does not mean the individual can forget about the tax; it can still come into the picture in several ways:

A. **10 percent tax applies to withheld income tax.** The 10 percent tax would apply to any *income taxes withheld* from the conversion amount (¶ 2.3); such a tax payment would not qualify for the "conversion exception" since it is sent to the IRS and *not* converted to a Roth IRA. Also:

B. **10 percent tax applies to failed conversion.** A person who recharacterizes a Roth IRA conversion (¶ 5.6), then attempts to "reconvert" the same amount to a Roth IRA prior to expiration of the waiting period (¶ 5.6.08), has a "failed conversion." His attempted *re*conversion does not qualify for the 10%-tax exception applicable to successful Roth conversions. Reg. § 1.408A-4, A-3(b) (last sentence).

C. **10 percent tax applies to certain distributions within five years after a conversion.** Though a person who is under age 59½ can convert to a Roth IRA, or do an in-plan Roth conversion, without incurring the 10 percent tax, he has to come up with the money to pay the income tax on the conversion from some source *other* than the newly-converted Roth account money, because he will owe the 10 percent tax to the extent he taps that money, under the following special rule:

If a participant who is under the age of 59½ receives a distribution from a Roth IRA; and "any portion" of that distribution is allocable under the Ordering Rules (¶ 5.3.05) to funds that were rolled over to the Roth from a traditional plan or IRA and were includible in gross income; and "the distribution is made within the 5-taxable-year period beginning with the first day of the individual's taxable year in which the conversion contribution was made"; then the 10 percent tax will apply to "such portion" of the distribution (unless an exception applies). § 408A(d)(3)(F); Reg. § 1.408A-6, A-5(b); Notice 2008-30, A-3. See ¶ 9.2–¶ 9.4 for the exceptions to the 10 percent tax.

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 10 percent tax was held to be constitutional in *Kitt v. U.S.*, 277 F. 3d 1330 (Fed. Cir., 2002).

A similar rule applies to in-plan Roth conversions done before age 59½; see ¶ 5.7.03(B).

Note that this five-year period is not the same as the Five-Year Period for determining "qualified distributions":

✓ The Five-Year Period for determining qualified distributions from a Roth IRA begins with the first year *any* contribution is made to *any* Roth IRA of that individual. ¶ 5.3.03. In contrast, the "5 taxable-year period" for imposing the § 72(t) recapture tax begins, as to any conversion of a traditional plan or IRA to a Roth IRA, with the year of that *particular* conversion. Reg. § 1.408A-6, A-5(c).

✓ The Five-Year Period ("nonexclusion period") for determining qualified distributions from a DRAC (¶ 5.7.04(B)) begins in the first year any contribution is made to any DRAC in that particular plan. In contrast, the "5 taxable-year period" for imposing the § 72(t) recapture tax begins, as to any particular in-plan conversion, with the year of that conversion. Notice 2010-84, A-12.

Note also that this 10 percent "recapture" tax applies *even though* the distribution of the participant's conversion contribution amount 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 2009. He had no IITC in the traditional IRA, so the entire $100,000 was includible in his gross income in 2009. He has no other Roth IRAs, and makes no other contributions to this one. In 2012, at age 35 (*i.e.*, within five years after the conversion, and while he is still under age 59½) he withdraws $20,000 from the Roth IRA in order to buy a rare *Spiderman* comic book. Under the Ordering Rules, this distribution is deemed to come out of the portion of the 2009 conversion-contribution that was includible in his gross income in 2009, and therefore it is subject to the 10 percent tax *in 2012*.

Ayn Example: Ayn, age 32, converted $10,000 from her traditional 401(k) account to a designated Roth account in the same plan in 2014. She had no IITC in the traditional account, so the entire $10,000 was includible in her gross income in 2014. She has no other DRACs in this plan, and makes no other contributions to this one. In 2017, at age 35 (*i.e.*, within five years after the conversion, and while she is still under age 59½) she changes jobs and cashes out her entire DRAC, which is then worth $12,000. This is not a qualified distribution, so the $2,000 of earnings is subject to income tax in 2017 and also subject to the 10% tax because Ayn is still under age 59½. The $10,000 she contributed via in-plan conversion in 2014 is not subject to income tax because it was included in her gross income, and taxed, in 2014; but it is subject to the 10% tax ($1,000) because it was withdrawn less than five years after she converted it penalty-free in 2014, and she is still under age 59½. This example assumes she does not qualify for any other exception from the 10% tax.

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

Leslie Example: In 2004, Leslie (age 40) converted a $100,000 traditional IRA to a Roth IRA. In 2009, when that Roth IRA had grown to $140,000, Leslie made a regular contribution (¶ 5.4.02) of $5,000 to the same account. In 2010, he does another conversion, transferring $50,000 more from his traditional IRA to the same Roth IRA that holds all his prior contributions and earnings. In 2011, the Roth IRA has grown to $210,000, and Leslie, now age 47, withdraws $15,000 from the account to pay the income tax on his 2010 conversion. Assume he does not qualify for any of the exceptions to the 10 percent tax. Under the Ordering Rules (¶ 5.3.05), this distribution is deemed to come first from his 2009 regular contribution ($5,000), and the balance ($10,000) is deemed to come from his 2004 conversion contribution of $100,000. There is *no income tax* on this distribution, since it is deemed (under the Ordering Rules) to be coming entirely from his own already-taxed contributions; see ¶ 5.3.05. There is also *no 10 percent tax* applicable to withdrawal of his 2009 $5,000 "regular" contribution, because the recapture tax applies only to *conversion* contributions. Since the rest of his 2010 distribution is deemed to come from his 2004 conversion, which happened more than five years earlier, there also is no 10 percent tax on the distribution of this "old and cold" conversion money.

In the case of in-plan Roth conversions (¶ 5.7.03), the same rule would apply to withdrawals from the plan the DRAC is part of; to the extent the distribution comes out of the funds other than the converted-less-than-five-years-earlier portion of the DRAC, the recapture penalty does not apply.

5.8.03 ***10% tax applies to earnings distributed before age 59½***

Regardless of whether the individual's Roth IRA or DRAC was created by conversion or some other method, and regardless of how many years it has been since the Roth IRA or DRAC was created, an individual cannot withdraw the *earnings* from his Roth IRA or DRAC free of the 10 percent tax until he is over age 59½, unless either the distribution is income tax-free (see ¶ 5.8.01(A)) or a penalty exception applies. Thus a nonqualified Roth IRA or DRAC distribution prior to age 59½ will be subject to the 10% tax to the extent it is deemed to consist of "earnings," unless a penalty exception applies. Reg. § 1.408A-6, A-5(a), § 1.402A-1, A-3.

To figure out whether a nonqualified Roth IRA distribution is coming out of the participant's own contribution or out of "earnings," see ¶ 5.3.04 and ¶ 5.3.05. To make that determination for a DRAC distribution, see ¶ 5.7.05. To figure out whether an exception to the 10 percent tax applies see ¶ 9.2–¶ 9.4.

Because of the different ordering rules applicable to Roth IRA and DRAC distributions, it is often easier to get penalty-free distributions from a Roth IRA than from a DRAC:

Arthur Example: Arthur, age 40, converts a $10,000 traditional IRA to a Roth IRA in 2012. That same year, he does an in-plan conversion of $10,000 from his "traditional" 401(k) account to a DRAC in the same plan. Both converted accounts were 100% pretax money, so he owes income tax (but no 10% penalty) on $20,000 in 2012. In 2017 he finds he urgently needs $5,000. Both his Roth IRA and the DRAC have grown to $12,000. The five-year recapture period for his Roth conversions ended 12/31/16, but he still cannot get a "qualified distribution" from either plan because he is under age 59½, not disabled, etc.. The DRAC permits in-service distributions, but if he takes the $5,000 from the DRAC it will be deemed to come partly from the earnings in the account (see ¶ 5.7.05). The earnings portion would be income-taxable and subject to the 10% penalty. In contrast, he can withdraw $5,000 from the Roth IRA with no income tax and no penalty, because the distribution would be deemed to be a partial return of his already-taxed conversion contribution (¶ 5.3.05).

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

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

If a participant who is receiving a SOSEPP from a traditional IRA converts the traditional IRA to a Roth IRA, the conversion is "not treated as a distribution for purposes of determining whether a modification" of the series has occurred, so the conversion itself does not trigger the loss of the 10 percent tax-exempt status of the series. Reg. § 1.408A-4, A-12.

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

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

There is a SOSEPP exception also for distributions from a QRP, but it is available only if the participant has separated from the service of the employer that sponsors the plan. § 72(t)(3)(B). There is no IRS guidance on converting a former employee's qualified plan account to a Roth IRA (or doing an in-plan conversion) while the former employee is receiving a SOSEPP from the plan.

5.9 Roth Planning Ideas and Principles

This ¶ 5.9 looks at planning decisions and ideas connected with Roth retirement plans. It covers the decision of whether to go into a Roth plan in the first place (¶ 5.9.01–¶ 5.9.05); and the estate planner's concerns in connection with Roth plans and conversions (¶ 5.9.06).

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

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

The only significant widely-applicable drawback of a Roth plan is the cost. Generally, the price is payment of income taxes on the amount going in to the Roth retirement plan—taxes that could have been deferred (via a traditional retirement plan) until the money was taken out of the retirement plan. The debate is not whether a Roth IRA is a good type of retirement plan to own. It IS a good plan to own. The debate is all about the price tag: How much do you have to pay to get a Roth plan, and is it worth it, and can you afford it?

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

A. **Analyzing the cost and benefits of a Roth conversion.** Professionals who have crunched the numbers for many clients generally conclude that if the following factors apply the Roth conversion will be profitable for the converting participant and/or his beneficiaries:

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

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

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

4. The Roth investments do not decline in value.

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

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

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

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

You can not know for sure what the client's future tax rates, spending needs, or investment results will be. If the client's tax rate and investments go up, and his spending needs stay level or decline, the Roth conversion could be very profitable. If the client's tax rate and investments decline and/or spending needs accelerate, a Roth conversion could be a costly mistake—unless the conversion is free (¶ 5.9.02(A)).

C. **Beyond the spreadsheet.** One might conclude that financial projections regarding the profitability of a Roth contribution are too speculative to be useful, or the projections may indicate that the Roth choice is financially neutral. There can be factors that incline a client towards or away from a Roth plan without regard to what the spreadsheet says; see ¶ 5.9.02, ¶ 5.9.03.

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

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

5.9.02 ***Factors that incline towards doing a Roth conversion***

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

A. **If conversion is "cheap" or "free."** Whether a Roth conversion will "make a profit" involves a cost-benefit analysis. If the cost is zero the decision is easy—there are only benefits. Similarly, if the cost is very low, the benefits do not have to clear a very high hurdle for the Roth conversion to win the contest. This factor makes the Roth conversion decision easy for an individual who is in a zero tax bracket temporarily (due, for example, to a net operating loss from a business). This factor also makes a Roth conversion favorable if the distribution to be converted consists entirely of "after-tax money" (see ¶ 2.2.05, ¶ 5.7.03(E)).

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

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

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

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

This factor is also at work in setting up Roth IRAs for young family members (¶ 5.9.06(C)) and when a low-income parent converts to a Roth for the benefit of high-income heirs (¶ 5.9.04(B)).

C. **Participant does not want or need RMDs.** Money can stay in a Roth IRA much longer than in a traditional IRA, because of the different minimum distribution rules that apply (¶ 5.2.01)). This factor makes Roth IRAs attractive to individuals who would prefer to preserve their IRAs intact for heirs, or who do not want to deal with the annual hassle and penalty risk of RMDs.

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

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

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

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

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

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

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

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

B. **Future tax rate lower.** The Roth deal is unfavorable if the benefits would be subject to income taxes at a lower rate when they come out than the rate the participant paid to convert the plan to a Roth. For people who will be in a lower bracket after retirement than they are during their working years, the Roth conversion seems unlikely to be profitable.

C. **Legislative risk.** Prepaying the income tax would also presumably turn out to be a bad deal if the income tax is replaced by a value-added tax. 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.

A perhaps more realistic worry is that Congress, in a search for revenue, will diminish the benefits of the Roth account. Presumably Congress would not simply declare that Roth distributions are taxable after all, but it could: make Roth IRAs subject to lifetime minimum distribution rules, or faster post-death minimum distribution rules (both of these have been included in recent Washington tax proposals); mandate that all of a Roth's earnings accrued after a certain date would be taxable; subject Roth distributions to income tax, with a credit being given for taxes previously paid; and/or count Roth IRA distributions as income for purposes of Medicare premiums, the taxability of Social Security benefits, the alternative minimum tax, or the "threshold" for the 3.8% additional tax on net investment income (¶ 2.1.02).

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

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

If a participant converts his traditional plan or IRA to a Roth IRA prior to death, that conversion can benefit his beneficiaries.

A. **Reduce estate taxes.** Converting to a Roth IRA can reduce the participant's estate taxes by removing the income taxes due on the Roth conversion from the estate. [see Appendix D] The participant's gross estate will be that much smaller if the participant has paid the income tax prior to his death; or, if he converted shortly before death and the income taxes are owed by his estate as a debt, the deductible debt reduces his taxable estate.

Unlike gift taxes payable on gifts made within three years of death (§ 2035(b)), income tax paid (or due) on a Roth conversion that occurs within three years of death is not brought back into the estate for purposes of computing estate taxes.

If the participant dies owning a traditional plan or IRA, and has a taxable estate, there may be a "double tax" on the asset: First the estate pays estate tax on the value of the benefits, then the beneficiaries pay income tax on the benefits as they withdraw them. Theoretically, the double tax is averted by the income tax deduction the beneficiary gets for estate taxes paid on the benefits he inherits (the "IRD deduction"; see § 691(c) and ¶ 4.6.04). However the IRD deduction often does not fully eliminate the "double tax" effect, because (1) the beneficiary gets no income tax deduction for *state* estate taxes and (2) as an itemized deduction, the IRD deduction is reduced if the individual beneficiary has a high income (§ 68) [see Appendix D].

This advantage will not be important to someone whose benefits are not subject to estate taxes—whether because his estate is under the federal exemption amount ($5.49 million as of 2017) (but see next paragraph), or because the benefits will be left to charity (no estate tax or income tax).

The pre-death Roth conversion may also reduce state estate taxes if applicable. Retirement benefits are subject to "double tax" with respect to state estate taxes, because the beneficiary pays the estate tax on the benefits then pays income taxes on the same benefits when he withdraws them; and there is no federal "IRD deduction" for state 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 70, living happily on her Social Security payments plus $50,000 a year withdrawn from a substantial traditional IRA. Her children are all in the highest income tax bracket, and some day those high brackets will apply to distributions the children take from the traditional IRA they inherit at her death. She can convert some of the traditional IRA to a Roth IRA each year to use up her lower income tax brackets. Then her high-bracket children will pay no income tax on distributions from the inherited Roth IRA. (They might want to help her out with the income tax due on the conversion.)

C. **Beneficiaries may prefer a Roth IRA.** Even if the pure mathematics indicate no advantage to having the participant pay the income tax on the retirement benefits now by converting to a Roth (rather than having the beneficiaries pay it later when they inherit a traditional plan), it would be a convenience to the beneficiaries to inherit a Roth IRA (distributions from which are tax-free) rather than a traditional IRA, so they do not have to wrestle with the valuable but complicated IRD deduction every year (see "A"). If beneficiaries inherit a traditional IRA they do not have the option to convert it to a Roth, so if a Roth IRA would be a superior or preferred type of account to inherit the participant should do the conversion during life. ¶ 4.2.05(A).

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

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

A. **Traditional vs. Roth IRA.** An individual who has compensation income, and whose AGI is under the limits described at ¶ 5.4.04(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 (¶ 5.4.03) to each type of IRA. Assuming he wants to contribute to an IRA, and is eligible to contribute to either type, which type should he contribute to?

The decision is easy if the choice is between a Roth contribution and a *nondeductible* contribution to a traditional IRA. If there is no tax deduction for the IRA contribution, then the Roth option is "free." A Roth IRA is always better than a traditional IRA if it's free. See ¶ 5.9.01. A traditional IRA contribution is either totally or partially nondeductible if the individual and/or his spouse participates in a workplace retirement plan and has AGI in excess of certain amounts. § 219(g). Similarly, the decision is easy if the individual's taxable income is so low he is not subject to income tax, since, again, he gives up nothing by opting to contribute to the Roth IRA.

If neither the individual (nor his spouse) is an active participant in an employer plan; or, if he (or his spouse) is an active participant in an employer plan, but his (or their) AGI is low enough that he can get a tax deduction for a contribution to a traditional IRA; *and* his (or their) tax bracket is higher than zero; then his choice is between a *deductible* traditional IRA contribution (which could save current income taxes) and the nondeductible Roth IRA contribution. He should consider the factors discussed at ¶ 5.9.01–¶ 5.9.04 in making this choice.

B. **Traditional 401(k) vs. DRAC.** Which 401(k) participants should choose the DRAC (¶ 5.7) over a traditional 401(k) account for their annual "CODA" contribution? By choosing the DRAC, the individual gives up the immediate tax savings of having the contribution excluded from his income. The savings could be as high as 39.6%/43.4% of the contribution amount (maximum federal income tax rates as of 2017). The choice could be made considering whichever of the factors listed in ¶ 5.9.01–¶ 5.9.04 are applicable.

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

Bunny is a partner in large firm. The only tax-deferred retirement savings plan she has is the firm's 401(k) plan, where her account is now worth $600,000. Her only "tax shelter" is her annual 401(k) salary deferral contribution. She does not want to give up the immediate tax deduction. She does not bother to get a projection of her present vs. future tax rates; she opts for a traditional 401(k) contribution.

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

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

5.9.06 ***Roth plans and the estate plan***

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

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

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

By leaving Roth plan death benefits (rather than traditional plan death benefits) to his grandchildren (or to a "see-through trust" for their benefit), the participant gives his beneficiaries the advantage of long-term tax-free investment accumulations and does not "waste" any of the GST exemption (see ¶ 6.4.07) paying income taxes. For the economic advantages of a "stretch" payout of a retirement plan to young beneficiaries, see ¶ 1.1.03; for how to achieve a stretch payout for a trust named as beneficiary, see ¶ 6.2–¶ 6.3.

Whenever a client is leaving retirement benefits to a trust that is likely to accumulate plan distributions, be aware that a trust goes into the highest income tax bracket (and will become subject to the 3.8% additional tax on net investment income; ¶ 2.1.02) at a very low level of taxable income. If the client can prepay the income tax at a lower rate by converting the plan to a Roth that option should be considered.

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

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

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

Since the client's executor will have the power to recharacterize a Roth IRA conversion made by the client (if the client dies during the time window for recharacterizations) [but see Appendix D], the client's estate plan should anticipate this possibility. See ¶ 4.1.02. The estate planner could recommend such steps as:

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

- Including in the beneficiary designation form language preventing the Roth IRA beneficiary from blocking the executor's recharacterization of a Roth conversion.

- Giving the executor instructions, guidance, and/or protection regarding the recharacterization decision, such as requiring recharacterization if the account value drops by more than certain percentage (and forbidding it otherwise), or requiring recharacterization if requested by certain beneficiaries.

C. **Gifts with Roth IRAs.** Consider depositing money in a Roth IRA for a young child, grandchild, etc., who has a summer or after-school job that generates compensation income on which an IRA contribution can be based. The projections of what a humble $5,500 contribution will grow to by the time the 16-year-old reaches age 65 can be staggering. What gives pause is that there is no way to prevent the donee from taking the money out of the account once he reaches the age of majority.

For this idea to work, the donee must have compensation income. ¶ 5.4.02. 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 excise tax (¶ 5.4.05).

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

5.9.07 ***Roth conversion tips from all over***

Here are matters and ideas to consider for clients contemplating or proceeding with a Roth conversion, including ideas from various advisers on how to make the conversion process easier and/or more profitable. Those with a ★ are strongly recommended for most if not all clients. The rest are presented for the planner's consideration; they may be valid for some clients. For ideas specifically NOT recommended (☹) see ¶ 5.9.08 and ¶ 5.1.03.

A. **★Everyone should open a small Roth IRA.** Regardless of what gut instinct or the spreadsheet says, everyone who does not already have a Roth IRA, and who has a traditional plan or IRA that could be converted to a Roth, should open a Roth IRA as soon as possible, by converting at least a small amount from a traditional plan or IRA. This step is recommended even for someone who is not ready to commit to a larger conversion.... even for those who are sure they never want to do any conversion! This will get the client's five-year clock started (see ¶ 5.3.03), which will be beneficial if the client ever later decides to do a larger Roth conversion, or a tax-free Roth conversion, or later needs to roll funds from a DRAC to a Roth IRA (see ¶ 5.7.09(C)). This will also make future conversions easier because the client will already have a Roth IRA open; the future conversion will involve nothing more than transferring more money from the traditional plan into the already-opened Roth IRA (but see "P").

B. **Convert everything now, analyze later.** [see Appendix D!] Usually we think the process is, analyze the Roth conversion strategy and if it looks like it might make sense, convert. An alternative approach is for the client to convert every traditional plan and IRA he owns to a Roth IRA as early as possible, and wait until September of the following year (just before the client has to decide whether to "unconvert") to analyze whether the conversion is beneficial. If it is, keep it. If it appears not beneficial at that time, recharacterize it. The pitch to the client is, "Don't analyze now! There's no point! The success or failure of your Roth conversion depends on future tax rates, spending needs, and investment results, which are unknowable now. You get to 'undo' (recharacterize; see ¶ 5.6) the conversion as late as October 15 of the year after the conversion, and by then we'll know a lot more." See *The Gospel of Roth* by John D. Bledsoe, http://www.johnbledsoe.com/books.html.

C. **★Upon retirement roll after-tax money directly to a Roth** for a tax-free Roth conversion**.** See ¶ 5.5.04(B).

D. **★Tax-free conversion of after-tax money in an IRA.** See ¶ 5.5.03(B).

E. **★Consider whether to increase basis.** Some retirement plans permit employee after-tax contributions, including catch-up contributions, that can occasionally be substantial. Making such contributions, then rolling the plan (or the after-tax portion of it) directly to a Roth IRA, would be a good cheap way to get a Roth IRA. See PLR 2009-09074, in which an employee was allowed to make various contributions to the employer plan then roll over his account to a Roth IRA. Another alternative is to convert the employee contribution account to a designated Roth account inside the plan; see ¶ 5.7.03(E).

F. ★**Consider state tax impact.** Do not overlook the state tax impact of a conversion, especially if the client is considering changing domicile to a state with higher or lower income taxes, or to a state that would not give him "credit" for plan contributions that were not eligible for a state income tax deduction; or if the client is planning to leave the retirement plan at his death to beneficiaries who are in a state that has higher or lower income taxes than would apply to the client's conversion. If the conversion generates a substantial state income tax, choose carefully the year in which the state tax is paid. The alternative minimum tax (AMT; § 55) or reduction of itemized deduction (§ 68) [see Appendix D] may eliminate the benefit of the deduction for the state tax. This book does not cover state taxes.

G. ★**Keep a Roth and traditional IRA open at same firm.** Open the client's Roth IRA at the same firm that already holds the client's traditional IRA. Then the conversion will be easy and instantaneous. Moving money from one firm to another takes much longer than moving money between two accounts at the same firm. Also leave a small traditional IRA open at this firm even if the client is converting "everything" (else) to a Roth IRA; doing so will make it much easier to recharacterize (by moving money out of the Roth IRA into the already-open traditional IRA) should that be necessary. The drawback of having both traditional and Roth IRAs at the same firm is the occasional tendency of IRA provider firms to put deposits into (or take withdrawals from) the wrong account.

H. ★**Take RMD before converting.** An IRA owner who is attaining age 70½ in the year of the proposed Roth conversion, or who attained that age in an earlier year, must take his RMD for the conversion year out of his traditional IRA BEFORE he converts all or part of the rest of the account to a Roth IRA. ¶ 5.2.04.

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

J. ★**Opt out of tax withholding on the conversion.** The client must check a box on the request form to avoid having the transferring plan withhold income tax on the conversion. If income tax is withheld, the withheld portion of the distribution will be subject to income tax (and 10% penalty, if the participant is under age 59½, unless an exception applies), but will not end up inside the Roth IRA (unless the converter manages to complete the rollover of the withheld funds within 60 days using substituted funds; Reg. § 1.402(c)-2, A-11).

K. ★**Name a beneficiary for the Roth IRA.** Don't forget this vital step! See ¶ 5.9.06(A).

L. ★**Provide guidance in case of client's death, disability.** See ¶ ¶ 5.9.06(B).

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

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

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

N. ★**Extend the return (but pay tax by April 15th).** It is recommended that the client get an extension of time to file the income tax return for the conversion year to October 15 (instead of April 15) of the year following the conversion year, to make recharacterization easier. The client does not have to actually get an extension of time to file the tax return in order to be entitled to recharacterize as late as October 15 (see ¶ 5.6.07); but recharacterizing after the return has already been filed necessitates filing an amended return. Even if an extension of time to file the return for the conversion year is obtained, the *tax* is still due on April 15th of the following year.

O. ★**File the tax return on time.** Everyone says "the client has until October 15 of the year after the year of the conversion to decide whether to recharacterize a Roth conversion." That is not strictly speaking true. The recharacterization deadline is October 15 of the year after the year of the conversion *if and only if the tax return for the year of the conversion is filed on time*. See ¶ 5.6.07.

P. **Put each year's conversions into a separate Roth IRA.** [see Appendix D] This choice faces someone who, at the time he is converting a traditional plan or IRA to a Roth IRA, already has one or more Roth IRAs in existence. The question is whether the current year's Roth conversion should be made into a new separate Roth IRA, or whether it should be rolled into one of the individual's existing Roth IRAs.

The advantage of rolling into an existing Roth IRA is simplicity of administration of the account—it's easier to have just one Roth IRA rather than multiple Roth IRAs. The advantage of creating a brand new separate Roth IRA for the current year's conversion is that having a separate Roth IRA makes it much easier to recharacterize the amount converted, if that is later desired. If the "new" conversion is made into its own separate Roth IRA, recharacterization involves simply closing that account and transferring the entire amount to a traditional IRA. If the new conversion money is commingled with a pre-existing account, then later recharacterizing would involve apportioning post-conversion (pre-recharacterization) earnings between the new and the old money, which is more complicated. See ¶ 5.6.04.

Q. **Convert different asset classes to different Roth IRAs.** See ¶ 5.6.05.

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

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

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

1. ☹"Since I have to take an RMD from my traditional IRA anyway, and pay tax on it, I might as well convert the RMD to a Roth IRA so I at least get some benefit." Sorry, you cannot convert an RMD to a Roth IRA. See ¶ 5.2.04.

2. ☹"I'll convert everything in my traditional IRA except the RMD; I'll take that near the end of the year, to maximize deferral." This doesn't work because the first dollars out of the IRA in any year ARE the RMD, so you can't leave the RMD in and convert the rest.

3. ☹"I'll convert everything to a Roth IRA right now, then I'll 'recharacterize' in September next year [see Appendix D!] by transferring the contribution back to a traditional IRA just before the recharacterization deadline. In the meantime, I will have invested for a profit and I'll leave those profits inside the tax-free Roth IRA, but will have no tax on the conversion because I've returned the contribution to the traditional IRA." This doesn't work: To recharacterize, you must transfer both the contribution AND the earnings thereon back to the traditional IRA. See ¶ 5.6.04.

4. ☹"I'll transfer my NUA stock in a lump sum to a Roth IRA, pay tax on only the plan's basis, and the NUA will later be distributed tax free from the Roth IRA." Forget it. The IRS treats this as if you transferred the stock to a traditional IRA FIRST, meaning you pay ordinary income tax on the entire conversion. Furthermore you lose your NUA deal permanently (even if you later recharacterize [see Appendix D!] the Roth conversion). See ¶ 5.5.04(A).

5. ☹"I'll just convert my contributory IRA. It is mostly after-tax money, so the conversion will be almost tax-free. I'll leave my rollover IRA as is, because it's all pretax money." Out of the question. Both accounts are aggregated for purposes of applying the cream-in-the-coffee rule. See ¶ 5.5.03(B).

6. ☹"I'll convert my entire IRA to a Roth this year, so my traditional IRA balance is zero on December 31, then recharacterize the conversion next year [see Appendix D!]. That way I will owe no income tax on the conversion (because I recharacterized it) but also will have no RMD for next year (because the prior year-end balance of the traditional IRA was zero)." Guess what: They thought of that. If a conversion is recharacterized after the end of the conversion year, the recharacterized amount is added back to the traditional IRA's year-end balance (for the year of the conversion) for purposes of computing the following year's RMD. See ¶ 5.2.04.

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

Appendix A: Thoughts from Expert Planners

Estate planning lawyers, accountants, financial planners, and other tax experts who advise individual clients regularly confront the "Roth conversion" question: Should I or shouldn't I convert to a Roth? I asked several of America's top planners for their Roth conversion ideas and tips. Their answers are presented here, followed by more Roth ideas and tips gleaned from various publications.

My expert panel (in alphabetical order): Guerdon Ely, CFP; Michael Jones, CPA; Robert Keebler, CPA; and Bruce Steiner, Esq. Their tips/ideas are presented in reverse order of length:

Robert Keebler, CPA, Keebler and Associates, Green Bay, WI. Bob and his firm focus their practice on advising individuals and fiduciaries about the tax treatment of retirement benefits, including planning, reporting, compliance, and "cleanup" matters. They are often called upon to advise an individual whether or not to "Roth." Bob's tax expertise is backed up by financial modeling skills of his son, lawyer and civil engineer Grant Keebler, and his colleague Steve Bigge. Among them they have "modeled" Roth conversions for dozens of clients. Here are some of Bob's comments (see also ¶ 5.9.01(A)):

"We are watching the potential tax changes under discussion in Washington. If the estate tax stays in effect but the 691(c) [Income in Respect of a Decedent or IRD] deduction is eliminated, the lifetime Roth conversion becomes much more favorable for the high net worth individuals who are subject to estate tax. Similarly, if Congress replaces the 'life expectancy payout' with the '5-year rule,' the participant's Roth conversion will become relatively more attractive as a way of saving money for heirs."

Michael Jones, CPA, Thompson Jones LLP, Monterey, California. Mike and his firm advise clients on all tax aspects of retirement benefits including Roth conversions. Mike points out that the opportunity for the "designated beneficiary" of a decedent's qualified retirement plan to do a Roth conversion of the inherited plan is under utilized—partly, he thinks, because the administrators of qualified plans fail to mention that option to plan beneficiaries. This omission may be the IRS's fault because (Mike points out) the IRS's "model notice" plan administrators are supposed to provide to employees and beneficiaries when making distributions from the plan gives "notice" of the Roth conversion option only in connecting with a retiring employee. It doesn't mention beneficiaries.

A story from Mike: "A client came to us who had just become trustee of a trust for young grandchildren of a deceased 401(k) plan participant. The trust (which, as a "see-through trust," qualified as a "designated beneficiary") was named as beneficiary of the 401(k) plan. The client wanted to know the trust's best options for taking distribution of those benefits. Using projections (as well as statistical models prepared by the client's investment advisor), Mike and the client determined that a Roth conversion of the inherited plan would produce the most money over the long term for the grandchildren-trust beneficiaries. They then had to persuade, convince, and educate the plan administrator (who was unfamiliar with this option) in order to carry out the Roth conversion by transferring the funds from the inherited 401(k) account directly into an inherited Roth IRA opened by the trustee.

Bruce Steiner, Esq., Kleinberg, Kaplan, Wolff & Cohen PC, New York, NY. Bruce is an estate planning lawyer with a special interest in retirement benefits issues including Roth conversions. In his article "Roth Conversions are More Attractive under ATRA", *Trusts & Estates* April 2013 (p. 13), Bruce pointed out that the tax rate shifts made under that law increased the income tax costs of leaving traditional retirement to a trust while decreasing (for some taxpayers) the individual rates and therefore the cost of a Roth conversion. Here are some other situations he has seen where people had an opportunity to do a Roth conversion at a favorable tax rate:

- An individual with a substantial IRA was able to convert it to a Roth IRA at zero tax cost due to a large business loss.

- An individual who convert portions of an IRA to a Roth at an effective tax rate of 28% (the alternative minimum tax rate) rather than his "normal" 39.6% bracket rate.

- For many individuals (especially those taking early retirement), the years between retirement and the commencement of required minimum distributions (and/or Social Security benefits) offer a temporary period of lower-than-normal tax brackets, making Roth conversion favorable.

- "Deathbed" Roth conversions for individuals in states with high estate taxes—such conversions were done to eliminate the state estate tax that otherwise would be payable on the money used to pay the income tax on the Roth conversion.

- A beneficiary who is "always" in the highest income tax bracket anyway converted an inherited qualified plan benefit to an inherited Roth IRA (see ¶ 5.5.04(D)).

- A Roth conversion can increase the level of "asset protection" for a client concerned about potential creditors' claims, by increasing the value of more-protected IRA assets (a Roth IRA is worth more than a traditional IRA of the same nominal dollar value) compared to more-vulnerable non-retirement-plan assets (the conversion depletes cash in the "taxable accounts").

- Leaving the Roth IRA to a trust for descendants to use the federal estate tax credit shelter or generations skipping tax exemption is more tax-efficient than leaving a traditional retirement plan (which would cause part of the exemption to be "wasted" on income taxes).

Guerdon T. Ely, MBA, CFP, AIFA®, ChFC®, Ely Prudent Portfolios, LLC, Chico, California. As an investment advisor and financial planner, Guerdon is often called upon to advise clients whether a Roth conversion would be favorable for them. Here is his in-depth summary of his thoughts on this planning process:

"My basic rule has always been to convert as little as possible of your IRA to a Roth that gives you the biggest bang for your buck. My quick rule of thumb has been to not convert any amount that you might need in the next 15 or 20 years. (If estate tax is your biggest issue, then you would not use this rule of thumb. But not all my clients are rich and famous.) For young people that is usually all of it. For someone who is retiring and has a few years of low income before RMDs start and they say they need $100,000 from their IRAs annually, then you would not convert (20 X 100,000) $2 million (maybe $2.5 million for inflation). So, if they had a $3 million IRA you might convert $500,000. I like to use my rule of thumb to compare with my more detailed spreadsheet analysis to see if it makes sense.

"If going forward Roths have RMDs [as a result of legislative change] it is important what you do with that RMD. That change also might change how you invest your Roth. Asset location optimization would suggest that bonds are held in IRAs to defer tax on the income. Also, the generally lower returns would keep RMDs down. However, there might be reasons to hold tax-free municipal bonds on the outside of the IRA as well. The taxable account should hold tax efficient appreciating assets for their low turnover, capital gains treatment, the possibility of tax loss harvesting, and the stepped-up basis at death. Roths have been recommended to hold assets with the highest expected return (especially ones that are tax inefficient) because of their long-term time horizon and the fact that they will never be taxed. With a shorter time horizon, you might want to not be so aggressive with your Roth.

"Getting back to what you do with the Roth RMD, if you spend it, you lose a lot of the value of the Roth. If you invest it, since in my case it is money you do not need, you could use it to keep your overall portfolio in balance, using tax-free or tax efficient investments. So if your stocks are appreciated and your desired balance is 50% stocks and 50% bonds, you could invest the Roth RMD in tax free bonds (being careful for AMT issues). If your stocks tank, you could invest in stocks or funds that have low turnover to keep your portfolio in balance.

"There are a lot of moving parts. I have always used spread sheets I created to analyze the alternatives, but recently I have found eMoney to be an excellent source for doing this. I just did an analysis with a client using eMoney and we were both happy with the results. You can put in very detailed information about the clients and then run various scenarios. It helps you spot the things that make a difference. It also keeps you humble by reminding you that changes in assumptions can really affect results. Like I said, I am trying to convert the least possible and still get as much benefit as possible. That is especially true with the uncertainty of RMDs and being paranoid I worry about things like the [since-repealed] 15% excess distribution excise tax in the mid 90s."

Here are other Roth planning ideas gathered from various tax publications:

Carol Schmidlin, RFC, President of Franklin Planning, Sewell, NJ, has a special focus on planning for benefits of civilian employees of the federal government (there are 2.7 million of them!). Writing in *Ed Slott's IRA Advisor* (April 2014), she points out that about 15% of active (not retired) federal employees (mainly those who have over 30 years of service) can contribute up to 10% of their lifetime federal earnings via an after-tax contribution through the "Voluntary Contribution Program" (VCP), then convert the account tax-free to a Roth IRA.

Marty James, CPA, of Martin James Investment & Tax Management, Mooresville, IN, writing in *Ed Slott's IRA Advisor* (June 2014), discussed practical considerations in Roth conversion planning for a married couple planning to do some Roth converting, where both spouses own IRAs and the question is which spouse's IRA should be converted? Marty lists numerous factors that could tip the answer to that question one way or the other. If one spouse has only a small IRA consider converting that IRA first, so that spouse never has to bother with RMDs. Is one spouse older, and therefore will be hitting 70½ sooner? Is one spouse in poor health and likely to die sooner? Is one spouse eliminating RMDs from his traditional IRA by using qualified charitable contributions? Do the spouses have different domiciles for state income tax purposes? Do their IRAs have different destinations on death (e.g. trust vs. individual beneficiary)?

Alan S. Gassman, Esq., of Gassman, Bates & Associates, PA, Clearwater, FL, writing in *Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter* (Archive Message #549, November 2010), points out that a Roth conversion can produce negative results for a client or a couple who, in their later years, incur substantial deductible medical expenses such as nursing home fees. If they had spent their cash to pay the tax on the conversion, they would not have enough money to pay the nursing home—and withdrawing benefits tax-free from the Roth IRA doesn't benefit them if they are in a zero tax bracket. If they had not converted, they would have more money to pay these burdensome expenses, and could withdraw money from a traditional IRA as needed tax-free due to their high medical expenses [see Appendix D—a proposed tax law change would eliminated the medical expense deduction].

Appendix B: Articles of Interest

Choate, N., "Retirement Benefits: Unexpected Drama," 143 *Trusts & Estates* 1 (Jan. 2004), p. 40.

James, Marty, CPA, "Solving Practical Roth IRA Conversion Problems." June 2014 *Ed Slott's IRA Advisor*, p. 5. Useful and interesting observations about such questions as, *e.g.*, which spouse's IRA should be converted to a Roth if both spouses have IRAs.

Keebler, Robert S., CPA, and Bigge, Stephen J., "To Convert or Not To Convert—That Is The Question!," *Journal of Retirement Planning* (CCH, May–June 2007 issue).

Keebler, R.S., *et al.*, "Roth Segregation Conversion Strategy," *Taxes* (CCH), June 2003, page 3.

Schmidlin, Carol, RFC, "Retirement Planning for Federal Employees." April 2014 *Ed Slott's IRA Advisor*, p. 5. Unique Roth conversion opportunities for some of the 2.7 million civilian employees of the federal government. Advisors with clients in this category are advised to benefit from Ms. Schmidlin's extensive knowledge in this area.

Steiner, Bruce D., Esq., "Roth Conversions are More Attractive under ATRA." April 2013 *Trusts & Estates*, p. 13. Reviews the advantages of Roth IRAs.

Appendix C
Roths for the Rest of Us

The following was first published in www.MorningstarAdvisor.com November 10, 2017.

Imagine an investment account with no income tax whacking the returns. There is such a thing. It's called a Roth account. Here's a list of nine safe legal ways to acquire a Roth retirement account—without a costly conversion of your existing traditional plans.

These are thumbnail sketches to spur thinking. See disclaimers and resources at the end to follow up. All dollar limits are for 2017.

You work for a company that has a 401(k) plan. The Tax Code permits employees to have up to $18,000 ($24,000 if 50 or older) withheld from their paycheck and contributed directly to the 401(k) plan. This is called a "cash or deferred arrangement" (CODA). **#1:** If permitted by your company's plan, the CODA contribution can be made to a traditional pretax account (so you don't pay tax on it the year it's contributed; this is attractive if you're in a high bracket) *or to a designated Roth account* ("DRAC") (you pay tax on the contribution, future qualified distributions will be tax-free). **#2:** If your plan allows DRACs, find out if it *also* permits voluntary nondeductible employee contributions. If allowed, and you are within applicable contribution limits, make a nondeductible contribution, then do an "in-plan conversion" to *convert the after-tax contribution into the designated Roth account*.

You have AGI under $133,000/$196,000 and compensation income. Compensation income includes salary, wages, tips, taxable alimony [see Appendix D] and combat pay. **#3:** You can contribute $5,500 to a Roth IRA ($6,500 if 50 or older), if your modified adjusted gross income (MAGI) is under $118,000 (single) or under $186,000 (married filing jointly). You can contribute a reduced amount if your AGI is between $118,000 - $133,000 (single) or between $186,000 - $196,000 (married filing jointly). In either case your contribution may not exceed your compensation income. **#4:** If your MAGI is too high to contribute directly to a Roth IRA, and you will not be 70½ or older in 2017, make a nondeductible contribution to a traditional IRA of $5,500 ($6,500 if 50 or older) (but not more than your compensation income), then convert the IRA to a Roth. The conversion will be all or mostly nontaxable if you have no other traditional IRAs.

#5: You have after-tax money in your company's qualified retirement plan and you are entitled to take a distribution from the plan (*e.g.*, because you are retiring). You open a traditional IRA and a Roth IRA (if you don't have such accounts already). You direct the plan administrator to send the after-tax money from your plan account via direct rollover to the Roth IRA (tax-free Roth conversion), and to send the pretax money from your plan account via direct rollover to the traditional IRA (traditional tax-free rollover).

#6: You inherited a 401(k) or other qualified retirement plan directly as named "designated beneficiary" (not through an estate). Your deceased benefactor had after-tax money in the plan. You open a new traditional "inherited IRA" account and a new "inherited Roth IRA" account. You direct the plan administrator to send the after-tax money from your inherited plan account via direct rollover to the inherited Roth IRA (tax-free Roth conversion), and the pretax money from the inherited plan account via direct rollover to the inherited traditional IRA (traditional tax-free rollover). Or convert it all to the inherited Roth IRA if income tax on the conversion would be low (perhaps due to a large 691(c) deduction).

#7: You have a traditional IRA that has after-tax money in it and you also participate in a qualified retirement plan that accepts rollovers from IRAs. You roll the pretax portion of your IRA accounts (*all* your traditional IRA accounts—multiple IRAs are considered one account for income tax purposes) into the qualified plan. This leaves your traditional IRA holding nothing but after-tax money. You convert the traditional IRA to a Roth IRA, tax-free. Do not roll money into or otherwise contribute to any traditional IRA for the rest of the calendar year.

You are self-employed with no employees. #8: Determine your "net self-employment income" (Schedule C net profit reduced by the deductible portion of the self-employment tax). Now adopt a "solo 401(k) plan" that allows designated Roth accounts and voluntary nondeductible employee contributions. You can do a CODA contribution of up to $18,000 ($24,000 if 50 or older), or up to your total net self-employment income if less, to either a regular traditional 401(k) account (if you want to reduce current taxes) *or a designated Roth account*. **#9:** You can also (subject to applicable dollar/percentage contribution limits) make additional voluntary nondeductible contributions and then convert them to the Roth account (in-plan conversion).

You can't take the above ideas to the bank. Instead take them to your tax advisor to figure out which idea(s) might work for you. For example, though the Code permits total annual qualified retirement plan contributions up to 25% of compensation (the CODA contribution is not subject to that limit) or (if less) $54,000 ($60,000 if 50 or older) (including the CODA contribution), your employer's plan may impose lower limits. Also, the CODA dollar limit applies per individual not per plan. So don't try this at home—consult a tax expert!

Appendix D
Proposed Changes in the Tax Law

The tax law as detailed in this Outline is subject to change at any time. The Outline is up to date only to the date on the front page.

On November 2, 2017, a bill entitled the "Tax Cuts and Jobs Act" was introduced in the House of Representatives. If enacted as written, this bill would reduce and eventually eliminate estate taxes, and would modify income tax rules by reducing tax rates for lower income levels while eliminating some deductions. For details on those proposed changes please consult other sources.

In addition to all general references to estate (and other transfer) taxes, and to particular income tax rates, statements in this outline on the following specific subjects would be rendered inaccurate to a greater or lesser degree if the Tax Cuts and Jobs Act is enacted as written. Unless otherwise noted, the following proposed changes made by the Tax Cuts and Jobs Act that impact statements made in this Outline would be effective January 1, 2018.

✓ "Recharacterization" of IRA contributions (¶ 5.6) would no longer be permitted. This would eliminate the ability to "undo" (reverse) a Roth IRA conversion and would also eliminate recharacterization as a tool to fix mistakes. See ¶ 5.6.09.

✓ § 68, which reduces the benefit of itemized income tax deductions for higher-income taxpayers, would be repealed.

✓ The income tax deduction for medical expenses (§ 213) would be eliminated.

✓ The permitted age for early distributions from pension plans (§ 401(a)(36)) would be changed from 62 to 59½.

✓ The income tax deduction for alimony (§ 215) would be eliminated, and alimony payments received would no longer be includible in gross income.

The Tax Cuts and Jobs Act would *not* make any changes to the "minimum distribution rules," despite a number of legislative proposals in recent years to replace the life expectancy payout with a "5-year rule" for most retirement plan death benefits.