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2010 Roth IRA Conversions

by Susan D. Diehl

As I am sure is the case with many of the readers of this article, our organization, through our Techline, has received many questions regarding the new rules on conversions to Roth IRAs effective this year. Under the Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA), the current-law conversion eligibility rules are being repealed with respect to conversions occurring after December 31, 2009.

Beginning in 2010 all taxpayers with money in an eligible retirement plan [traditional IRAs, SEP IRAs, SIMPLE IRAs, qualified plans, §403(b) plans and governmental §457(b) plans] will be permitted to convert to a Roth IRA without regard to the amount of his or her adjusted gross income or marital status. Before contemplating a conversion to a Roth IRA, it would be wise for taxpayers and their advisors to be well versed in the tax consequences and other rules applicable to conversions. There is apparently widespread confusion in this area and this article is meant to overview these rules and provide readers with the facts.

Qualified Rollover Contributions to a Roth IRA

On March 5, 2008, the IRS issued Notice 2008-30 that, among other issues, addressed the Service's interpretation of Section 824 of the Pension Protection Act of 2006. This provision was effective in 2008.

Prior to 2008, a Roth IRA could accept rollovers only from the following plans:

- Another Roth IRA;
- A conversion from a traditional IRA, SEP IRA or SIMPLE IRA; or
- A designated Roth account under an employer's §401(k) plan or §403(b) plan (effective in 2006).

These rollover contributions to Roth IRAs are technically called *Qualified Rollover Contributions* (QRCs). In the case of a conversion from a traditional IRA, SEP IRA or SIMPLE IRA, the individual must include in gross income any portion of the conversion amount that would otherwise be taxable. The pro-rata basis recovery calculation applies in determining the amount that is taxable. Prior to 2010, a conversion from a traditional IRA, SEP IRA or SIMPLE IRA was permitted only if the taxpayer's adjusted gross income for the year did not exceed $100,000 [not including the taxable amount converted or any Required Minimum Distributions (RMDs)] and, if married, the taxpayer must be filing a joint tax return. Under TIPRA and effective in 2010, all taxpayers are eligible to make conversions to Roth IRAs.

Section 824 of the Pension Protection Act of 2006 expanded the types of money that can be rolled over to a Roth IRA and permits any eligible rollover distribution from an employer's qualified plan, 403(b) or governmental 457(b) plan to be rolled over to a Roth IRA beginning in 2008. For purposes of the following explanation, we are describing the requirements for rolling over amounts, other than any designated Roth accounts. In other words, we are talking about "direct conversions" or "rollover conversions."

Additional guidance was provided in Section II of IRS Notice 2008-30 and it provided seven questions and answers on rollovers to Roth IRAs from employer plans, the highlights of which are described below:

- A rollover (direct conversion) from an employer's plan to a Roth IRA may be accomplished either as a direct rollover or as a 60-day rollover (where the employee first takes receipt of the distribution followed by a rollover contribution to a Roth IRA). However, in either case, the amount rolled over must be an eligible rollover distribution and the taxable amount must be included in the taxpayer's gross income for the year. Additionally, for years prior to 2010, the individual must be current-law conversion eligible (AGI not exceeding $100,000 and, if married, filing jointly).
- In addition to qualified plans, eligible rollover distributions from §403(b) plans or governmental §457(b) plans may be rolled over (converted) to a Roth IRA under these same requirements, taxation rules and limitations.
- Identical to conversions from traditional IRAs, SEP IRAs and SIMPLE IRAs to Roth IRAs, rollover conversions from an employer's plan are not subject to the 10% additional income tax under §72(t). However, if the conversion amount is withdrawn from the Roth IRA before that particular conversion has been in the Roth IRA for five years, the 10% additional tax is "recaptured" on the original taxable amount that was converted unless another exception under §72(t) applies at the point of distribution. This rule, referred to as the 10% recapturing rule, is identical to a conversion from a traditional, SEP or SIMPLE IRA that is withdrawn within five years.
- §401(a)(31), concerning the right of a participant to elect a direct rollover of an eligible rollover distribution to an eligible recipient plan, includes the right to elect a direct rollover conversion to a Roth IRA. [Note: This requirement will affect the language required to be included in a §402(f) Rollover Notice and any administrative forms used to effectuate such a direct rollover conversion to a Roth IRA.]
- Although the right to elect a direct rollover conversion to a Roth IRA is required, the plan administrator is not responsible for determining whether or not the employee has or will meet the conversion eligibility requirements (the $100,000 AGI rule and married, filing jointly) for years prior to 2010. However, if an employee elects a direct rollover conversion to a Roth IRA or completes a 60-day rollover conversion, but the taxpayer then determines that he or she is not eligible to have made such rollover conversion to a Roth IRA, the taxpayer may recharacterize the rollover amount to a traditional IRA. [Note: Although the Notice specifically mentions only being able to recharacterize an ineligible rollover conversion, the IRS verbally told PenServ that a recharacterization may be accomplished even if the individual is otherwise eligible to have converted, whether the individual is a spouse or nonspouse.]

  If the amount is recharacterized to a traditional IRA and meets the other established rules and requirements for a recharacterization under §408A(d)(6), the amount is no longer taxable to the individual. And, although the Notice does not expressly explain, the recharacterization to a traditional IRA would be registered in the exact manner as the Roth IRA.
- If the rollover conversion to the Roth IRA is made in the form of a direct rollover, no Federal income tax withholding applies, even though the taxable amount is included in the taxpayer's gross income. Alternatively, if the eligible rollover distribution is actually distributed to the employee or the employee's spouse, the mandatory 20% Federal income tax withholding applies to the taxable amount of the distribution. However, even if 20% is withheld, the distributee may make up the amount withheld from other sources and roll it over just like he or she can under current law.

  Also, for a distribution that is directly rolled over in a rollover conversion to a Roth IRA by a nonspouse beneficiary to an inherited Roth IRA in accordance with the requirements of Notice 2007-7, the mandatory 20% Federal income tax withholding does not apply. However, an eligible distributee and payer or plan administrator may enter into a voluntary withholding agreement with respect to the direct rollover conversion amount since such amount is included in the distributee's gross income.

- If a beneficiary, spouse or nonspouse elects a direct rollover conversion from an employer's plan (but not a Roth IRA) to a Roth IRA under this provision, the AGI and marital filing status applicable to any conversions (until 2010) is determined by the status of the beneficiary and not of the deceased employee. In addition and pursuant to Notice 2007-7 and §402(c)(11), an employer's plan is not required to permit rollovers by nonspouse beneficiaries until plan years beginning on or after January 1, 2010 (WRERA made this change after Notice 2007-7). But if the plan does permit such nonspouse beneficiary rollovers, it must be accomplished only by a direct rollover.

  A nonspouse who elects a direct rollover conversion to an inherited Roth IRA can later decide, by the appropriate deadline, to elect a recharacterization to an inherited traditional IRA, the result of which is no amount is taxed until distributed from the recipient inherited traditional IRA.

  Notice 2008-30 also permits a surviving spouse of a deceased employee to elect a rollover conversion to a Roth IRA plus has a choice in how the Roth IRA is treated. The surviving spouse can either: (1) elect to treat the Roth IRA as an inherited Roth IRA and would be subject to the RMD rules as a beneficiary; or (2) elect to treat the Roth IRA as the spouse's own Roth IRA. If the spouse elects to treat the Roth IRA as an inherited Roth IRA, the same rules under Notice 2007-7 that apply to a nonspouse beneficiary, including how to determine the maximum amount eligible to roll over and the resulting distribution period applicable to the Inherited Roth IRA, will apply to the spouse as a beneficiary rather than as the Roth IRA owner.

Additional Issues under Notice 2008-30

The above discussion covers the seven Q&As in Notice 2008-30. There are other questions that came up as a result of the Notice.

- Can a spouse beneficiary elect a rollover conversion to a Roth IRA as an inherited Roth IRA and then elect a recharacterization under the rules of §408A(d)(6) to an inherited traditional IRA?

  It is the author's opinion that the answer to this question is "yes." In this case, not only will the spouse beneficiary avoid any taxation on the original amount, but also the spouse beneficiary can take penalty-free distributions from the inherited traditional IRA.

The real question is: Can a surviving spouse roll over from a qualified plan, §403(b) plan or governmental §457(b) plan into an inherited traditional IRA, or must the traditional IRA be in the spouse's own name and thus any distributions would be subject to the 10% additional income tax if the spouse is under the age of 59½? The author's answer to this question has always been "no" because of §402(c)(9) that says in the case of a surviving spouse beneficiary of a deceased employee, such spouse shall be treated in the same manner as the employee. In other words, if the spouse rolls over to an IRA, it's the same as if the employee rolls over to his or her *own* IRA.

There have, however, been a handful of private letter rulings over the years that permitted a spouse beneficiary to roll over to an inherited traditional IRA. But, in closely reading those PLRs, they indicate that the Service assumes that the spouse will always treat the IRA as an inherited IRA. Moreover, we can't rely on PLRs. We also know that the industry, as a whole, has never permitted a spouse beneficiary to roll over to an inherited traditional IRA unless the spouse obtained a PLR.

The argument lies in the language of regulation §1.408-8, Q&A 7, and the use of the word "may." This regulation states that "If the surviving spouse of an employee rolls over a distribution from a qualified plan, such surviving spouse *may* elect to treat the IRA as the spouse's own IRA in accordance with the provisions in A-5 of this section." A-5 of this regulation deals with how a surviving spouse elects to treat an *IRA* as his or her own. In researching issues involved in a direct conversion (QRC), we went to the IRS. The IRS apparently has no problem with a surviving spouse rolling from an employer's plan into an inherited traditional IRA, notwithstanding the language in §402(c)(9). Although we have been aware of this argument since the 1987 RMD regulations were issued, the opposite of the word "may" in regulation §1.408-8, Q&A 7 must mean, "may not!" In other words, the spouse is not *required* to treat the traditional IRA as his or her own traditional IRA. It's important to note that although the nonspouse beneficiary direct rollover rule in §402(c)(11) clearly excludes spouse beneficiaries, the Service also did not want to give nonspouse beneficiaries any advantages over spouse beneficiaries.

[Caution: Before changing your organization's policy on this issue, you must consult with your own legal counsel and may need to amend

Before contemplating a conversion to a Roth IRA, it would be wise for taxpayers and their advisors to be well versed in the tax consequences and other rules applicable to conversions.

Those individuals who "jumped the gun" by starting the conversion process in 2009 and completing the transaction in 2010 may end up not being eligible for the conversion!

your IRA agreement and administrative forms accordingly.]

So, not only can a surviving spouse roll over to an inherited Roth IRA and then recharacterize to an inherited traditional IRA, he or she can also go the other direction—roll over to an inherited traditional IRA and then convert to an inherited Roth IRA.

- Can an inherited traditional IRA be converted to an inherited Roth IRA under the QRC rules, since a traditional IRA is included in the definition of "eligible retirement plan" under §402(c)(8)(B)?

  It depends. The author believes that a nonspouse cannot use the QRC rules to roll (convert) from an inherited traditional IRA to an inherited Roth IRA because §408(d)(3)(C) precludes a nonspouse beneficiary from rolling between inherited IRAs. However, a spouse beneficiary can, in fact, use the QRC rules to roll (convert) from an inherited traditional IRA to an inherited Roth IRA, subject of course to taxation, being conversion eligible, etc. Although §402(c)(11) relating to a nonspouse beneficiary rolling from an employer's plan to an IRA also refers to the definition of "eligible retirement plan," the Technical Corrections Act to the PPA amended that section to exclude IRAs.

Conversions are Taxable Income

The fact that the taxable portion of an amount converted to a Roth IRA is included in the taxpayer's gross income is nothing new. However, because many taxpayers were not eligible to make a conversion to a Roth IRA until 2010, and because qualified plans could only move directly to Roth IRAs since 2008, it seems that these new rules have created a flurry of activity and confusion over the repeal of the conversion eligibility requirements.

When is the Taxable Amount Included in Income?

The taxable amount of the conversion is included in gross income in the year the money leaves the IRA or employer's plan—not necessarily the year that the money gets to the Roth IRA. Thus, the repeal of the conversion eligibility requirements applies only to money that leaves the IRA or employer's plan *after* December 31, 2009. In other words, those individuals who "jumped the gun" by starting the conversion process in 2009 and completing the transaction in 2010 may end up not being eligible for the conversion!

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1 Reg. §1.408A-4, Q&A 7

Determining the Taxable Amount of a Conversion from Traditional IRA to Roth IRA[1]

If the traditional IRA owner has ever made any nondeductible contribution to any IRA he or she owns or has rolled over any "after-tax" employee contributions from an employer's plan, then, regardless of the type of IRA being converted to a Roth IRA (whether a contributory IRA, rollover IRA, SEP IRA or SIMPLE IRA), the individual must calculate the portion of the conversion that is attributable to the nondeductible or after-tax amounts. The taxpayer uses IRS Form 8606 to calculate the tax-free "return of basis" and the taxable amount of any IRA distribution (other than distributions from a Roth IRA) by treating all IRAs as one IRA. This calculation includes balances in contributory IRAs, rollover IRAs, SEP IRAs and SIMPLE IRAs. Having nondeductible funds in any IRA would also compound the confusion for those rolling from a qualified plan to a traditional IRA and then converting to a Roth IRA.

Example #1: Janet owns two IRAs, a contributory IRA and a SEP IRA. Since 1987, she has contributed a total amount of $6,000 as nondeductible contributions. Janet decides to convert her entire IRA balances in both her contributory IRA and her SEP IRA that total $18,000. Since she is closing out all traditional IRAs, the $6,000 nondeductible amount is treated as the tax-free amount of the conversion and the remaining amount of $12,000 is the taxable amount of the conversion.

Example #2: The facts are the same as in Example #1, except that Janet also owns a Rollover IRA with a year-end balance of $40,000. This balance must also be included in the calculation in determining the taxable amount of her conversion of $18,000. Her calculation would look like this:

6,000/58,000	=	.103;
.103 x 18,000	=	$1,854 Basis Recovery

Therefore, of her $18,000 conversion, $16,146 is her taxable conversion amount ($18,000 – $1,854 = $16,146). She has a remaining basis in her traditional Rollover IRA of $4,146 ($6,000 – $1,854 = $4,146). She would continue recovering the remaining $4,146 basis as she takes subsequent distributions from her traditional IRA(s). Janet would use Part I and Part II of Form 8606 (following the instructions closely) to compute the taxable conversion amount.

Example #3: If a taxpayer owns a rollover IRA (or any other traditional IRA) and is planning on rolling any IRA into an employer plan, only the taxable amount can be rolled over.

As in Example #2, in the following year, if Janet decides to subsequently roll her Rollover IRA to her employer's qualified plan, the remaining basis of $4,146 cannot be rolled over at that point; the only amount remaining in any of Janet's IRAs is the unrecovered basis of $4,146. Janet could then take a distribution of $4,146 and recover all of it tax-free. Or, she could convert the remaining basis of $4,146 to her Roth IRA and the entire amount would not be taxable.

Example #4: Mark owns a traditional IRA valued at $100,000, which has a basis of $20,000. He takes a total distribution of $100,000, converts $80,000 to a Roth IRA and keeps $20,000. Can he attribute the entire $20,000 he kept as the return of basis? No!

Mark must use Part I and Part II of Form 8606 to calculate the portion of the $80,000 conversion amount that is taxable and also the portion of the $20,000 that is taxable. Mark determines that of the $80,000 converted, $64,000 is taxable and of the $20,000 he kept, $16,000 is taxable. He attributes his basis as follows:

$ 80,000	conversion	$ 16,000	basis recovered
$ 20,000	kept	$ 4,000	basis recovered
Total		$ 20,000	basis recovered

The total taxable amount is $80,000. Of the $20,000 he kept, $16,000 is taxable. The $16,000 is part of his AGI to determine whether he is eligible to have converted the $80,000. Also, the $16,000 is subject to the 10% premature tax if Mark is under age 59 1/2. The $64,000 taxable amount of his conversion is not subject to the 10% premature tax.

Two-year Spread Election

If a taxpayer converts an eligible retirement plan to a Roth IRA in 2010, the entire taxable amount of the conversion can be either: (a) included in gross income for the year of the conversion (2010); or (b) included in gross income by including only 1/2 of the taxable amount the year following the conversion (2011) and the remaining 1/2 of the taxable amount the next year (2012). Using the two-year spread will be an irrevocable election and will be notated on the Form 8606 filed with the IRS by the taxpayer. For example, Christine converts her traditional IRA in the amount of $50,000 to a Roth IRA in 2010. Assume she has no basis in her traditional IRA, thus the entire $50,000 is taxable. Christine can either: (a) include the entire $50,000 in her gross income in 2010; or (b) include $25,000 in her gross income in 2011 and the remaining $25,000 in her gross income in 2012. If she includes the entire $50,000 in her gross income in 2010, she will pay income taxes based upon her tax bracket applicable to 2010. If she elects the two-year spread, the $25,000 included in her 2011 gross income is taxed based upon her tax bracket applicable to 2011. The final $25,000 included in her 2012 gross income is taxed based upon her tax bracket applicable to 2012. In other words, Christine is spreading the *income* over 2011 and 2012—she is NOT spreading the tax liability as if the amount were taxed in 2010.

No Conversion of Required Minimum Distribution to Roth IRA[2]

The law prohibits the rollover (or transfer) of any required minimum distribution to another plan, including a Roth IRA. If a minimum distribution is required for a year (including the year during which the participant attains age 70 1/2) with respect to the eligible plan being converted to a Roth IRA, (regardless of the methodology used in the conversion) the first dollars distributed during that year are treated as consisting of the required minimum distribution until an amount equal to the required minimum for that year has been distributed.

Any converted amount is treated as a distribution from the other plan, even if the conversion is accomplished as a direct transfer or as a direct rollover. Thus, the minimum distribution must be made first before the remaining amount can be converted.[3]

Example: Sally is required to receive a minimum distribution from her traditional IRA of $10,000. If Sally attempts to convert $11,000 to a Roth IRA prior to receiving the required distribution amount, then $10,000 of the conversion amount would be treated as a required minimum distribution and would be ineligible for conversion. This result would be the same regardless of the methodology used in completing the conversion (rollover or transfer) or whether an amount greater than or equal to $10,000 remains in Sally's traditional IRA after the conversion.

If a required minimum is contributed to a Roth IRA, it is treated as having been distributed to the individual, subject to the normal taxation rules, and then contributed as a regular contribution to a Roth IRA and an excess contribution could arise. The required minimum distribution cannot be treated as an eligible conversion contribution.

Although a required minimum cannot be converted to a Roth IRA, beginning in 2005 the RMD amount was to be ignored in determining conversion eligibility.

Acceleration of Income Inclusion

If a taxpayer elects the two-year spread rule and then takes a distribution from the Roth IRA prior to including in gross income the entire taxable amount of the conversion, the income inclusion will be accelerated.

For example, Paul converts his qualified plan in the amount of $20,000 to a Roth IRA in 2010 and he is using the two-year spread. Assume that the entire $20,000 is taxable. Without any distributions, Paul would include in gross income $10,000 in 2011 and $10,000 in 2012.

Assume next that during 2011 he takes a distribution of $5,000. The normal Roth IRA ordering rules continue to apply. For purposes of this example, further assume that Paul has

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2 §408A(e), §408(d)(3)(E) and Reg. §1.408A-4, Q&A 6
3 Reg. §1.408A-4, Q&A 1(c)

never made any regular Roth IRA contributions. Therefore, the $5,000 distribution taken in 2011 is "deemed" coming from his taxable conversion. He will include in gross income for 2011 the normal 1/2 scheduled to be included, $10,000, plus the $5,000 distribution for a total of $15,000.

In 2012, he will include in gross income the remaining $5,000 of the original $20,000 taxable conversion where he is using the two-year spread rule. Under this acceleration rule, Paul will not include in gross income more than the original taxable conversion. If Paul withdraws $5,000 in 2010, he will include $5,000 in his 2010 gross income; $10,000 in 2011; and the remaining $5,000 in his 2012 gross income. Note that since Paul is under age 59 1/2, he will be subject to the recapture tax as he has made a distribution of conversion funds before they have been in the Roth IRA for five years.

How is the Taxable Amount of the Conversion Determined?

Any "basis" that is part of the amount being converted is not included in the taxpayer's gross income. Basis in a traditional IRA includes nondeductible regular IRA contributions, after-tax employee contributions that were rolled over to any traditional IRA, and repayments of qualified reservist distributions to any traditional IRA. For example, Sophie has made nondeductible contributions to her traditional IRA over several years of $20,000. In 2010, she takes advantage of the new conversion rules, but decides to convert just $20,000, although she has other traditional IRAs. Sophie cannot isolate just her "basis" amount of $20,000 and treat the entire conversion amount as nontaxable. As a result, part of the $20,000 will be taxable based upon the pro-rata taxation requirements under §408(d)(2) by taking into consideration balances she holds in all traditional-type IRAs, including SEP IRAs and SIMPLE IRAs. Sophie must file Form 8606 with her 2010 income tax return and complete Part II based on the instructions to that form. In this example, the distributing IRA trustee or custodian will issue a 2010 Form 1099-R entering $20,000 in both Boxes 1 and 2a; the receiving Roth IRA trustee or custodian will issue a 2010 Form 5498 entering $20,000 in Box 3 (since in this example the conversion is coming from a traditional IRA).

Employer Plans Converted to a Roth IRA

Basis in an employer's plan includes after-tax employee contributions and loan repayments after a default which also create basis in the account. For this discussion, we are not talking about designated Roth accounts under the employer's §401(k) or §403(b) plan. We are talking about the other portions of the plan, such as pre-tax deferrals, matching, profit sharing, rollovers and after-tax employee contributions. For example, Amber has a total balance of $100,000 in her employer's §401(k) plan. Amber has never made any designated Roth contributions to her §401(k) plan.

The $100,000 is comprised of the following:

- $40,000 pre-tax elective deferrals, including attributable gains and losses;
- $30,000 employer matching contributions, including attributable gains and losses;
- $20,000 employer profit sharing contributions, including attributable gains and losses; and
- $10,000 after-tax employee contributions, consisting of $8,000 basis and $2,000 of gains.

If Amber has a distributable event under the §401(k) plan, and she takes a distribution, the taxable amount would be $92,000. The $8,000 after-tax principal amount comes out of the plan as nontaxable return of basis. If Amber doesn't want to pay any income taxes on her distribution, she could elect a direct rollover to her traditional IRA of at least $92,000 that represents the taxable amount of the distribution. She could also roll over the $8,000 after-tax principal amount to her traditional IRA that would then become part of her total traditional IRA "basis" subject to the pro-rata taxation rules of §408(d)(2). Or, she could direct the payer to direct roll the $92,000 to her traditional IRA and distribute the $8,000 directly to her. In this example, none of the distribution is taxable to her. In this case, the §401(k) plan would issue Form 1099-R and the receiving traditional IRA would issue Form 5498 entering the amount of her rollover in Box 2. She could then convert the $92,000 to a Roth IRA.

What about a conversion directly from the qualified plan to a Roth IRA? If Amber rolls over the $100,000 to her Roth IRA, this will be considered a conversion and she must include $92,000 in her gross income (where she can decide whether to include the $92,000 in her income for 2010 or use the two-year spread discussed earlier). Can Amber isolate just the basis amount of $8,000 in the employer's plan (after-tax employee contributions) and elect a rollover conversion of just that basis to a Roth IRA, while at the same time electing a rollover of the taxable portion ($92,000) to a traditional IRA thus escaping any taxation? The general answer is "no." However, it has been the author's opinion that if the participant receives his or her *entire* balance in the plan, and part of the distribution consists of after-tax employee contributions, then the participant can elect a direct rollover of the after-tax principal to a Roth IRA and elect a direct rollover of the taxable amount to a traditional IRA. This would result in none of the distribution being subject to Federal income tax.

This same situation could also be accomplished by a 60-day rollover. If Amber takes a partial distribution of the after-tax employee portion of the §401(k) plan, the prorated taxation rules would apply to the partial distribution. However, there may be one exception to the prorate taxation rules if the participant is *not* receiving a total distribution. If the employer's plan as of May 6, 1986, permitted in-service withdrawals of the employee's after-tax contributions, then the principal amount of the employee's after-tax contributions already in the plan as of December 31, 1986, may be withdrawn. (This exception is often referred to as the "pre-1987 grandfather rule.") In this case, the pro-rata taxation rules would not apply, but only if the participant meets the criteria explained above. Again, the §401(k) plan will issue the Form 1099-R entering the taxable amount of the conversion in Box 2a, and the receiving Roth IRA will issue the Form 5498 entering the amount converted in Box 2 (rather than Box 3). Caution: Do not give tax advice! If a client asks, "can I direct roll $92,000 to my traditional IRA and convert $8,000 to my Roth IRA?" the answer is absolutely "YES." We strongly recommend that you not specifically address the tax consequences in this situation.

Conversions of an Annuity Contract

Final regulations under §1.408A-4, Q&A 14 regarding converting an IRA Annuity in kind to a Roth IRA were published in the Federal Register on July 29, 2008. These regulations are applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. These final regulations provide guidance concerning the tax consequences of converting a traditional IRA Annuity to a Roth IRA and how to value such conversion for purposes of issuing Form 1099-R to the taxpayer. These final regulations adopt the provisions of the proposed regulations issued in 2005, with certain modifications.

Eligibility Requirements Still Apply to Regular Roth IRA Contributions

As a reminder, the eligibility requirements for making regular Roth IRA contributions continue to apply. However, if a taxpayer cannot make regular Roth IRA contributions because his or her AGI is too high, that individual may be able to make a regular contribution to a traditional IRA as a nondeductible contribution (if under age 70 1/2). After the regular contribution is made to the traditional IRA, the individual could then convert from the traditional IRA to a Roth IRA. However, it is critical to remember that the amount converted is still subject to the pro-rata basis recovery calculation by considering balances held in all traditional-type IRAs, including SEP IRAs and SIMPLE IRAs. Moreover, the IRA owner will be required to complete both Parts I and II of Form 8606.

Keep in mind that an individual could contribute to his or her employer plan and make an annual conversion.

Recharacterizations[4]

A taxpayer may recharacterize a contribution to or from a Roth IRA under two different circumstances:[5]

- By transferring a current year regular contribution plus earnings (from a traditional IRA to a Roth IRA or from a Roth IRA to a traditional IRA); or
- By recharacterizing a conversion made to a Roth IRA from a traditional IRA or an employer's plan by transferring the converted amount plus earnings to a traditional IRA.

A taxpayer may recharacterize regular contributions or conversions if he or she is ineligible for the contribution or merely wishes to change his or her mind. Also, a taxpayer is permitted to recharacterize all or just a portion of a regular contribution or conversion.

If a conversion contribution is determined to be ineligible (a failed conversion) and it is not recharacterized in accordance with these rules, the contribution amount will be treated as a regular contribution to the Roth IRA, and, thus, may be an excess contribution if it exceeds the individual's regular contribution limit. In addition, the distribution from the traditional IRA that was converted in error will not be eligible for the two-year spread and will be subject to the 10% additional tax for premature distributions unless an exception applies.[6]

If an individual makes a contribution to an IRA (the FIRST IRA) for a taxable year and then transfers the contribution (or a portion thereof) in a trustee-to-trustee transfer to another IRA (the SECOND IRA), the individual treats the contribution as having been made to the

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4 §408A(d)(6)
5 Reg. §1.408A-5, Q&A 1
6 Reg. §1.408A-4, Q&A 3

SECOND IRA, instead of the FIRST IRA, for Federal income tax purposes.

Miscellaneous Recharacterization Rules

- . A traditional "conduit" rollover IRA that is converted to a Roth IRA but subsequently recharacterized back to a traditional IRA retains its status as a "conduit" rollover IRA.[7]
- A recharacterization is not a designated distribution, and therefore is not subject to Federal income tax withholding.[8]

Nothing in the law or the regulations prevents an IRA owner from recharacterizing a regular contribution and then re-recharacterizing it again back to the FIRST IRA, provided, however, that the election is timely made. For example, Alice made a regular contribution to her traditional IRA of $3,000 in 2010 for 2010. Knowing that none of the contribution would be deductible, she recharacterizes the contribution, plus earnings, to a Roth IRA in January of 2011. In preparing her 2010 tax return, she realizes that she would rather the amount be in her traditional IRA. She then re-recharacterizes the amount, again plus earnings, back to her traditional IRA on a timely basis and reports it as a nondeductible contribution on her Form 8606.

- Recharacterizations must be reported by both the FIRST IRA and the SECOND IRA in accordance with the instructions for Forms 1099-R and 5498.
- If the participant makes a direct rollover or 60-day rollover from a designated Roth account under a §401(k) or §403(b) plan to a Roth IRA, the Roth IRA owner cannot recharacterize such amount to a traditional IRA. Also, the amount cannot be rolled back into a §401(k) or §403(b) plan.

- If the participant makes a rollover conversion contribution from an employer's qualified plan, §403(b) plan or governmental §457(b) plan (from funds other than a designated Roth account) to a Roth IRA (either by way of a direct rollover conversion or 60-day rollover conversion), the Roth IRA owner may elect to recharacterize such amount to a traditional IRA even if the taxpayer was eligible to have converted the amount to a Roth IRA.
- If a spouse beneficiary makes a conversion contribution from an employer's qualified plan, §403(b) plan or governmental §457(b) plan (from funds other than a designated Roth account) to a Roth IRA (either by way of a direct rollover conversion or 60-day rollover conversion), the spouse beneficiary may elect to recharacterize such Roth IRA to a traditional IRA. If the spouse beneficiary elected to treat the Roth IRA as his or her own Roth IRA, the traditional IRA receiving the recharacterization must also be the spouse's own traditional IRA. However, if the spouse beneficiary elected to treat the Roth IRA as an inherited Roth IRA (as permitted in Notice 2008-30), the traditional IRA receiving the recharacterization must also be an inherited traditional IRA.
- If a spouse beneficiary makes a direct rollover or 60-day rollover from a designated Roth account under an employer's §401(k) or §403(b) to a Roth IRA (either as his or her own Roth IRA or as an inherited Roth IRA), such Roth IRA cannot be recharacterized to a traditional IRA.
- If a nonspouse beneficiary makes a direct rollover conversion contribution from an employer's qualified plan, §403(b) plan or governmental §457(b) plan (from funds other than a designated Roth account) to an inherited Roth IRA (which must be done only as a direct rollover), the nonspouse beneficiary may elect a recharacterization from the inherited Roth IRA to an inherited traditional IRA.
- If a participant, spouse beneficiary or nonspouse beneficiary makes a rollover from an employer's plan (from funds other than a designated Roth account) to a traditional IRA, such rollover cannot be recharacterized to a Roth IRA. The only type of contribution made to a traditional IRA that is eligible for recharacterization to a Roth IRA is a regular contribution. However, if a participant or spouse beneficiary makes a rollover from an employer's plan to a traditional IRA, the participant or spouse beneficiary could elect a conversion to a Roth IRA.
- If a nonspouse beneficiary rolls over (direct rollover) from an employer's plan (from funds other than a designated Roth account) to an inherited traditional IRA, such nonspouse beneficiary cannot elect a conversion to an inherited Roth IRA.
- If a nonspouse beneficiary rolls over (direct rollover) from a designated Roth account under an employer's §401(k) or §403(b) plan to an inherited Roth IRA, such inherited Roth IRA cannot be recharacterized to a traditional IRA.

▲ ▲ ▲

7 Preamble to the Final Regulations
8 Preamble to the Final Regulations

Additional IRS Guidance Issued in 2009

IRS Notice 2009-75 reiterated the tax consequences of rolling over (converting) an eligible rollover distribution from a qualified plan [including a §401(k) plan], a §403(b) plan or a governmental §457(b) plan to a Roth IRA of amounts that are not designated Roth accounts. It also provided an explanation of rolling a designated Roth account under an employer's §401(k) or §403(b) to a Roth IRA.

In the Background section of the Notice, the IRS states ". . . a rollover from an eligible employer plan (other than from a designated Roth account) to a Roth IRA results in the same federal income tax consequences for a participant as a rollover to a [traditional] IRA immediately followed by a conversion to a Roth IRA [except that the special rule at §408(d)(2) for aggregating after-tax amounts would not apply]." This statement equates to requiring a pro-rata calculation when "after-tax" contributions are a part of the employer's plan.

Therefore if the employee has made after-tax employee contributions, the taxable amount of the conversion equals the total amount converted reduced by the after-tax amount. It now appears that the employee cannot isolate just after-tax employee contribution amounts, convert that amount and claim that nothing is taxable.

Thus, if an employee splits the eligible rollover distribution by rolling part of the amount to a traditional IRA and converting the other part to a Roth IRA, any after-tax employee contribution amounts is pro-rata allocated to each part as if the entire amount were first rolled over to a traditional IRA and then immediately converted to a Roth IRA.

However, if the conversion is made directly from the employer's plan to a Roth IRA, the person's other traditional IRAs are NOT aggregated in determining the taxable conversion amount.

On the other hand, let's assume that the employee first rolls over to a traditional IRA (with or without after-tax employee contributions), and then converts from the traditional IRA to a Roth IRA. The aggregation of all of the person's traditional-type IRAs are included in determining the taxable amount of the conversion.

Rollovers from Designated Roth Accounts

This Notice also describes the tax consequences of rolling over a designated Roth account from an employer's §401(k) or §403(b) to a Roth IRA. In this case, none of the amount rolled over is taxable even if the distribution is not a qualified distribution from the designated Roth account (one that is after a five-year aging period and after the employee is 59 1/2, has died or has become disabled).

Ordering Rules for Distributions from a Roth IRA

If an employee rolls over to a Roth IRA from a designated Roth account under an employer's §401(k) or §403(b), the principal amount is added to the Roth IRA owner's "bucket #1" money (the regular contribution source); the earnings go in "bucket #3" (the earnings source). (On the other hand, in the future when these distributions are "qualified distributions" where the earnings are tax-free and the participant rolls over the designated Roth account to a Roth IRA, the entire amount will be added to the Roth IRA owner's "bucket #1" money.) If an employee directly converts to a Roth IRA from an eligible employer's plan (other than from a designated Roth account), the entire amount is added to the Roth IRA owner's "bucket #2" money (the conversion source).

When there are conversion funds in a Roth IRA and a distribution occurs, there are specific ordering rules for the funds being distributed (instead of pro-rata). Note: All Roth accounts are aggregated for these rules (Roth and non-Roth are not aggregated). The Roth ordering rules are as follows:

- First: Roth IRA contributions (This step also includes rollovers from designated Roth accounts, rollovers of the military death gratuity and SGLI payments, and rollovers from the airline carrier bankruptcy and Exxon Valdez litigation.)
- Second: Converted funds
  - — FIFO: Funds that were taxable
  - — FIFO: Funds not taxable, such as non-deductible IRA
- Third: Earnings

Ordering Rules Example

In 2009, the Roth IRA has a cumulative amount of $15,000 of Roth IRA contributions, excluding earnings. In addition, there is $40,000 of conversion from a non-Roth IRA in 2008. In 2009, the taxpayer (age 35) withdraws $16,000. The first $15,000 is treated as from the regular Roth IRA contributions. $1,000 is treated as from the conversion amount. The $1,000 is subject to the 10% penalty, due to withdrawal being made before five years of conversion.

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