# ROTH IRA/401(K) CONVERSION OPPORTUNITIES

2013 AND BEYOND

Wolters Kluwer

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## INTRODUCTION

Roth IRA and Roth 401(k) conversions have been increasing in recent years. For many individuals, 2010 marked the opening of a rich new tax planning opportunity in the form of Roth IRA conversions that suddenly became available to many more individuals. Since then, billions of dollars have poured into Roth IRAs as conversions have become a recognized retirement and estate planning tool. Roth conversion opportunities of similar proportions continue to be available in 2013, and beyond.

Beginning in 2010, the income limitations that had prevented taxpayers with modified adjusted gross incomes of more than $100,000 from converting a traditional individual retirement account (IRA) to a Roth IRA were eliminated entirely. Equally as important to some couples, married taxpayers that filed their returns separately can also convert to Roth IRAs for the first time.

Everyone, regardless of income level or filing status, now has the opportunity to convert his or her IRA into a

Roth IRA. IRAs that are eligible for Roth conversion include not only the plain-vanilla IRA to which annual contributions have been made, but also rollover IRAs in which years of savings in an employer-based 401(k) plan may have been transferred. A variety of small-business based IRAs for employees such as SIMPLE IRAs (Savings Incentive Match Plan for Employees of Small Employers) or SEP plans (Simplified Employee Pension) can also qualify for a Roth IRA conversion. Distributions from qualified employer plans such as 401(k), 403(b) and 457(b) plans can also be converted directly to a Roth IRA if the funds are eligible for rollover to a traditional IRA. Especially for higher-income individuals, this presents a unique opportunity to convert their retirement savings into a Roth IRA, which will provide years of tax-free earnings and distributions during their retirement years. Unused portions can also be distributed tax-free

to their heirs, making Roth IRAs an important estate planning as well as income tax planning tool for many individuals.

## Roth 401(k) in-plan conversions

In recent years, plans with designated Roth accounts have been able to allow participants to roll over an amount from a non-Roth account into the participant's designated Roth account in the same plan. Generally, this treatment applied only to amounts the individual could have had distributed from the plan. As a result, this rule generally prevented individuals from making Roth 401(k) conversions prior to retirement, attainment of age 59½ or a separation from service.

The American Taxpayer Relief Act of 2012 (ATRA) modified this treatment. Beginning in 2013, a 401(k) (or 403(b) plan or governmental 457(b) plan) can permit this type of rollover for an amount that is not eligible for distribution at the time of the rollover. For example, a plan may allow a plan participant to make the rollover contribution even if the distribution is not as a result of the employee's severance from employment, death, disability, or attainment of age 59 ½.

> ***Planning note.*** Individuals considering a Roth 401(k) in-plan conversion should keep in mind that transfers result in taxable income. The taxable amount of the in-plan Roth rollover will be included in the participant's gross income. The taxable amount is the fair market value of the distribution reduced by any basis the participant has in the distribution. However, in-plan Roth rollovers are not subject to the 10% early penalty tax.

## Planning Considerations

The Roth IRA and Roth 401(k) conversion rules are not cut and dried, and converting can be a complicated procedure. Just as the benefits are often significant, mistakes can be costly. This guide provides an overview of the Roth conversion opportunities. It discusses:

- The tax advantages and disadvantages of traditional and Roth IRAs and Roth 401(k)s;
- Conversion rules for Roth IRAs/401(k)s;
- Who can benefit from a conversion;
- Paying the conversion tax;
- Conversion considerations;
- Estate planning opportunities; and
- Recharacterizing a conversion.

## INDIVIDUAL RETIREMENT ACCOUNTS

Traditional and Roth IRAs are trust or custodial accounts established for the exclusive benefit of an individual and/or his or her beneficiaries. Most financial institutions offer IRAs, with banks, mutual funds, and stockbrokerage firms

holding the lion's share of those assets. Although IRAs are generally established by individuals, employers can also set up and contribute to traditional IRAs under SIMPLE and SEP IRAs. Funds contributed by employers and employees to 401(k) and other retirement plans may also find their way into a traditional IRA through a rollover of those assets when the employee retires or otherwise leaves employment.

Roth IRA conversions have been allowed since 1998. However, they had been significantly limited by income and filing status restrictions … until January 1, 2010. This date had been "much anticipated" not only because of the new benefits opened up to taxpayers but because the legislation during 2010 –the first year of expanded availability-- provided that tax on those new benefits could be delayed for several years. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) changed the requirements applicable to Roth IRA conversions effective beginning in 2010. The changes include:

- Repeal of the $100,000 adjusted gross income (AGI) limit for eligibility to convert;
- Repeal of the prohibition of conversions by married taxpayers filing separate returns;
- Optional postponement of income recognition into 2011 and 2012 from Roth conversions done in 2010.

### *Roth 401(k)s*

A 401(k) plan (as well as a 403(b) plan and a 457(b) plan) may provide for a designated Roth program. This allows participants to elect to have all or part of his or her elective deferrals contributed to a designated Roth account, which are included in income, rather than traditional pre-tax elective contributions.

**Comment.** With a designated Roth contribution, the employee irrevocably designates the deferral as an after-tax contribution that the employer must deposit into a designated Roth account. The employer includes the amount of the designated Roth contribution in the employee's gross income at the time the employee would have otherwise received the amount in cash if the employee had not made the election. It is subject to all applicable wage-withholding requirements.

**Comment.** A participant may only begin making designated Roth contributions to a 401(k), 403(b) or governmental 457(b) plan after the plan sponsor amends the plan to add this feature.

## Limitations

The combined amount contributed to all designated Roth accounts and traditional, pre-tax accounts in any one year for any individual is limited. For 2013 and 2014, the limit is $17,500. Individuals age 50 or older may make catch-up contributions in 2013 and 2014 of an additional $5,500.

## Planning note.

Individuals can contribute the maximum amounts to both a Roth IRA and a designated Roth account in the same year. For example, an individual age 40 in 2013 may contribute $17,500 to a designated Roth account and $5,500 to a Roth IRA. An individual eligible for catch-up contributions (age 50 and over) may contribute $17,500 regular and $5,500 catch-up to a designated Roth account and $5,500 regular and $1,000 catch-up to a Roth IRA for 2013 (subject to income limitations for Roth IRAs).

## Liberalization of rules

In 2010, the Small Business Tax Act provided for in-plan Roth rollovers. ATRA further liberalized the rules, *as discussed above.* Plans may be amended to allow in-service rollovers from traditional to designated Roth accounts without violating the distribution restrictions for the plan.

If the plan permits, in-plan rollovers to designated Roth accounts may be made of distributable as well as nondistributable amounts, as long as the amounts rolled over are vested in the plan. The plan may limit the types of funds that may be rolled over and the categories of employees eligible to make rollovers.

### *Traditional IRAs*

A *traditional IRA* is any IRA that is not a Roth IRA, a SEP, or a SIMPLE IRA. It may be an individual retirement account or annuity. You can establish and contribute to a traditional IRA if you have received taxable compensation for the year and have not reached age 70½ by the end of the year. If you participate in a retirement plan sponsored by your employer, traditional IRA contributions may continue to be used as a supplemental retirement savings vehicle, but on a nondeductible basis, unless your income falls below certain thresholds. While there is a maximum annual

contribution limit to all IRAs, there is no limit on the number of IRAs that you can establish. However, IRAs of the same type may be combined to reduce administrative costs and streamline investment decisions.

Those individuals eligible in any particular year to make contributions to an IRA are limited by the amount that they can contribute in that year. The annual contribution limits apply to both traditional and Roth IRAs. They are measured each year for inflation by the IRS under a formula that calls for upward adjustments, but only in $1,000 increments, based on cost of living factors.

For 2013 and 2014, the maximum annual contribution that can be made to all types of IRAs is the lesser of the amount of salary or other earned income realized during the year and $5,500. Individuals who will be at least age 50 by the end of the year can make additional annual "catch-up" contributions of $1,000 (for a $6,500 total) in 2013 and 2014. If an eligible individual misses making a contribution for the year, he or she cannot make up that amount in a subsequent year over and above any limit imposed for that subsequent year.

***Deductible contributions.*** Contributions to a traditional IRA, up to the annual maximum contribution limit, are generally deductible from gross income on your federal income tax return … provided you are not participating in another type of retirement plan and your income does not exceed certain threshold levels.

The deduction for contributions made to a traditional IRA is phased out if you are an active participant (or eligible to be an active participant) in an employer's retirement plan for any part of the year, and if your modified AGI exceeds a specific amount. The applicable modified AGI limit depends on an individuals' filing status and generally increases annually. For 2013, the phaseout for single individuals takes place between modified AGI of $59,000 and $69,000 ($60,000 and $70,000 for 2014); for married couples filing jointly between $95,000 and $115,000 ($96,000 and $116,000 for 2014); and married individuals filing separately between $0 and $10,000.

***Early distributions.*** If you withdraw or use your traditional IRA assets before reaching age 59½, and the distribution is not otherwise "qualified," you must pay not only income tax at your current rate bracket on the amount withdrawn but also an additional 10 percent tax on that amount unless certain exceptions apply. Qualified distributions that are not subject to the 10 percent additional tax include:

- Distributions for qualified medical expenses up to a certain dollar amount;

- Distributions for qualified higher education expenses, up to a certain amount;
- Distributions, up to $10,000, used to buy, build, or rebuild a first home;
- Distributions that are part of a series of substantially equal periodic payments based on life expectancy;
- Distributions made on account of disability; and
- Distributions to military personnel and reservists under certain situations.

***Required minimum distributions (RMDs).*** Once the owner of a traditional IRA reaches age 70½, he or she is no longer allowed to make contributions to a traditional IRA account irrespective of continuing to work. In contrast, this age limit does not also apply to Roth IRAs, as long as you have taxable compensation to cover the contributions. However, more relevant to the advantage of a Roth IRA, the owner of a traditional IRA must begin taking required minimum distributions (RMD) upon reaching age 70½.

Roth IRA owners, on the other hand, are not required to draw down any amount, at any age. Roth IRA owners can keep the full amount continuing to earn tax-free interest (or dividends or capital gains) year-in and year-out, until it is needed or until death, when it can pass income tax free to their heirs. More about this later.

This additional advantage of a Roth IRA may or may not fit your situation, depending upon what other assets you have to provide you with retirement income. Many retirees, for example, do not feel the pinch from RMDs because they are living off the account. For them, the problem may be in not distributing the retirement account too soon.

### Roth IRAs

Generally, many of the same rules that apply to traditional IRAs apply to Roth IRAs. Nevertheless, the few differences that do exist between traditional and Roth IRAs are significant. Special rules that apply to Roth IRAs involve:

- Who can contribute and the amount he or she can contribute each year;
- When penalty-free distributions can be made;
- The taxability of distributions; and
- Qualified rollovers.

First, while qualifying contributions to traditional IRAs are generally deductible, contributions to Roth IRAs are never deductible. This difference exists because contributions to Roth IRAs must be made with after-tax dollars, and the tax savings are achieved at the distribution stage, when withdrawals can be made tax-free.

***Income phaseouts for contributions.*** Although the income restrictions that prevented higher-income taxpayers from converting to a Roth IRA have been eliminated since 2010, the income phaseouts for making new contributions to a Roth IRA remain effective.

> ***Comment.*** An individual may be eligible to make nondeductible contributions to a Roth IRA even though he or she is ineligible to make deductible contributions to a traditional IRA because he or she is an active participant in a qualified plan and his adjusted gross income (AGI) exceeds the specified limits for making deductible contributions.

The maximum amount an individual can contribute annually to all IRAs, including both traditional and Roth IRAs, is the lesser of the applicable dollar limit ($5,500 for 2013 and 2014 plus $1,000 for catch-up amounts) or the individual's compensation. The limit on contribution to Roth IRAs is reduced and eliminated for individuals with adjusted gross income exceeding certain levels.

For 2013, the ability to make the full $5,500 (or $6,500 for individuals eligible to make catch up contributions) Roth IRA contribution begins to phase-out when an individual's adjusted gross income (AGI) reaches $112,000, and is completely phased out when AGI reaches $127,000 ($114,000 to $129,000 for 2014). For married taxpayers filing jointly, the ability to make a full contribution to a Roth IRA begins to phase out when AGI reaches $178,000, and fully phases out once AGI hits $188,000 ($181,000 to $191,000 for 2014). For taxpayers whose AGI falls within these phaseout ranges, a "prorated" contribution may be made. But if your income exceeds the income range you will not be eligible to make a Roth IRA contribution for the year in which your income exceeds the phaseout range.

> ***Comment.*** As in the case of nondeductible traditional IRA contributions, Roth IRA contributions may be made irrespective of whether the taxpayer is an active participant in an employer-sponsored retirement plan. While nondeductible traditional IRA contributions are not restricted by AGI levels, Roth IRA contributions are phased out based on AGI.

Thus, even if you are no longer prohibited by your AGI to convert to a Roth IRA, you may nevertheless be prevented from making the maximum (or any) annual contribution to the account due to your modified AGI.

**Example.** Jennifer is single and has a traditional IRA that she wants to convert to a Roth in 2010. Before the conversion, Jennifer's AGI is $118,000. But her modified AGI in 2013, after making certain adjustments, rises to $135,000. Her modified AGI completely phases out her ability to make any contribution to the Roth IRA that year in addition to any conversion amount.

On the other hand, being below the $127,000/$188,000 AGI level for any year means that you can keep adding to your Roth IRA (either a converted Roth IRA or a new one), thereby making earnings on that money also tax-free whenever you want to withdraw it in the future (subject to the five-year and age 59½ rules, discussed earlier).

Since there are no income restrictions on nondeductible contributions to traditional IRAs or on Roth conversions, the income restrictions on Roth contributions can be avoided by instead making the contribution to a traditional IRA and subsequently converting it to a Roth IRA. However, the tax on conversion would be based on the tax basis of all traditional IRA accounts, not just the amount being converted.

***No required minimum distributions.*** Unlike owners of traditional IRAs, Roth IRA owners are not required to take minimum distributions from their account upon reaching age 70½. Additionally, Roth IRA owners can continue to make contributions to their account after reaching age 70½, as long as they have taxable compensation and their AGI remains below the specified thresholds for making contributions.

**Note.** Your non-spouse beneficiaries of the Roth IRA, if you pass on with an account balance, will have to take required minimum distributions, but these distributions will be tax-free.

***Early withdrawals.*** Qualified distributions and returns of capital contributions from a Roth IRA are not included in gross income. A qualified distribution is completely tax-free as long as you have had that Roth IRA account opened for at least five years beginning with the first tax year for which you contributed to the Roth IRA, and you are age 59½ or older at the time of the withdrawal. The same list of limited exceptions for penalty free withdrawals of traditional IRA funds (discussed earlier) also apply to Roth IRAs: medical, higher education, first time home purchase or disability. If you make a premature withdrawal from your Roth IRA, it is taxable to the extent the amount exceeds prior contributions to the Roth IRA and any Roth conversion amounts previously deposited. The tax on this distributed amount (its net appreciation) is subject to ordinary income tax and a 10 percent

early withdrawal penalty (for those not yet age 59½, as well as potential state and local income taxes, just like premature withdrawals from a traditional IRA.

## ROTH IRA CONVERSIONS

With the $100,000 modified adjusted gross income (AGI) limit and filing status limit eliminated starting in 2010, many more taxpayers have been able to convert traditional IRAs and other eligible accounts into a Roth IRA. Individuals are able to convert funds held in a traditional IRA, SIMPLE IRA (Savings Incentive Match Plan for Employees of Small Employers IRA), and SEP (Simplified Employee Pension) plan.

A conversion to a Roth IRA may be accomplished by means of a rollover, trustee-to-trustee transfer, or account redesignation. Regardless of type of means you use to convert to a Roth IRA, amounts converted from a non-Roth IRA to a Roth IRA are treated as distributed from the non-Roth IRA and rolled over to the Roth IRA. Generally, a rollover in which you close out an existing traditional IRA and deposit the check into a new or existing Roth IRA account must be effectuated within 60 days.

The same conversion rules allow SEP and SIMPLE IRAs to be converted to Roth IRAs. However, if you have a SIMPLE IRA, you must wait at least two years from the date that you first

participated in any SIMPLE IRA maintained by the employer to convert. Once converted, amounts in these plans are treated as contributions to Roth IRA. As such, you cannot make any future SEP or SIMPLE contributions to the Roth IRA.

Distributions from qualified plans such as 401(k), 403(b) and 457(b) plans can also be converted directly to a Roth IRA if the funds would have been eligible for rollover to a traditional IRA.

### *Tax Consequences of Roth IRAs Conversions*

A Roth IRA conversion is a taxable event. The conversion is treated as an immediate taxable distribution from your traditional IRA, but is not subject to the 10 percent early withdrawal penalty if done properly, which generally means "trustee to trustee."

You must include the value of the IRA being converted to a Roth IRA in your gross income under the rationale that

you got a deduction back when you made contributions to it (or you and/or your employee made pre-tax contributions to a retirement plan that was then rolled over into that IRA). The converted amounts are taxed on top of your other income in the year of conversion, at ordinary income tax rates.

The tax advantages of conversions are compelling. In addition, certain timing techniques may be employed by executing a plan to convert a large 401(k) plan balance, for example, in stages over the course of several years. Remember, also that the conversion of an IRA balance is not an all-or-nothing proposition. Executing a plan that may only partially convert your existing IRAs at this time, with the decision to convert the remainder of the assets postponed for a year or two, is another option that might be considered. A few additional considerations about paying the conversion tax:

- If you pay the tax from your IRA, you will lose the opportunity to benefit from the tax-free growth on that amount. Of course, if you're under 59½, withdrawing money to pay the tax could be an even worse idea, since you would also incur the 10 percent penalty.
- Ideally, you will have cash on hand to pay the income tax. If you need to sell appreciated assets to pay the conversion tax, the additional capital gains tax could work against the case for a Roth conversion.
- Assuming you have the cash available elsewhere to pay the conversion tax, you still need to account for the "opportunity costs" of what that money could have earned had it remained invested in a taxable account.

Despite the advantages of paying the conversion tax from funds other than in the IRA you are converting, the math does not dictate that using IRA funds automatically makes a conversion a bad idea. To the contrary, it is but one factor. The number of years you expect to keep the remaining funds in a Roth IRA, accumulating income that will never be taxed, is the countervailing factor that can continue to tip the scales in favor of a conversion. What's more, the decision on where to pay the tax is not an all-of-nothing proposition. The math may work best for you if you pay part of the conversion tax from outside funds and the other part from the IRA.

## ADVANTAGES OF ROTH IRA/401(k) CONVERSIONS

There are a number of tax advantages to converting to a Roth IRA or Roth 401(k). Add them up and the case for converting for many taxpayers is convincing.

> ***Comment.*** The most significant advantage to converting is the complete tax-free treatment of distributions at any time after turning age

59½. Remember, although contributions are not tax-deductible, subsequent interest, dividends and appreciation on those contributions grow tax-free since qualified withdrawals are tax-free.

***Tax-free withdrawals.*** Distributions from a Roth IRA of both capital contributions and earnings are tax-free, as long as they are "qualified distributions" On the other hand, distributions from a traditional IRA are taxable as ordinary income. To be a "qualified distribution," the distribution must be made after the five-year holding period has passed and after the accountholder has reached age 59½ (or on account of death, medical expense, disability, or the qualified purchase of a first home). This is a particularly beneficial aspect of owning a Roth IRA as opposed to a traditional IRA for taxpayers who anticipate falling in a higher tax bracket in future years.

***No RMDs.*** Another advantage of converting to a Roth from a traditional IRA is that Roth IRA owners are not required to take RMDs upon reaching age 70½. Roth IRAs are not subject to the minimum distribution rules that require traditional IRA owners to begin taking minimum distributions upon reaching age 70½ and prohibiting them from making contributions after reaching that age. Many Roth IRA owners don't plan to dip into their Roth accounts for living expenses until they are into their 80s, letting the funds grow tax free in the meantime. Others don't plan to touch their Roth accounts at all, leaving them as emergency funds and then as assets that they can eventually pass down to their heirs, tax free.

***Contributions after age 70½.*** As previously highlighted, you can continue to contribute to your Roth IRA after reaching age 70½ (to the extent you have taxable compensation and your income level does not phase out your ability to contribute). The ability to continue contributing to a Roth IRA, and not being required to take minimum distributions, allows your Roth funds to continue to appreciate, tax-free, until you need the money or the funds are passed on to your heirs.

***Social Security payments.*** Qualified distributions from a Roth IRA do not effect the calculation of tax owed on Social Security payments. On the other hand, the distributions from a traditional IRA may have the consequence of increasing the tax you must pay on Social Security benefits since the income reported when an individual takes a distribution from a traditional IRA may increase the portion of their Social Security benefit that is taxable.

***AGI-based deductions and tax attributes.*** If your adjusted gross income (AGI) is above a certain amount, you may, in the future, lose part of your

itemized deductions, such as the itemized deduction for home mortgage interest and charitable contributions. Tax-free distributions from a Roth IRA do not affect your ability to take AGI-based tax breaks, such as itemized deductions which are otherwise phased-out based on AGI. Thus, Roth IRA accountholders can continue to take advantage of favorable tax attributes. On the other hand, traditional IRA owners who must take RMDs may not be able to deduct AGI-based tax breaks if the RMD pushes up their AGI.

***Beneficiaries.*** Although beneficiaries of Roth IRAs must take required minimum distributions from the account, the distributions are generally tax-free. Those heirs can withdraw the Roth IRA earnings tax-free, even if the beneficiary is under age 59½ and the decedent was under 59½.

## CONVERSION CONSIDERATIONS

There are a number of important considerations to keep in mind when deciding whether to convert to a Roth IRA or Roth 401(k). Such a decision inevitably involves assessing many tax and financial factors. Some factors to consider include:

- The total income tax you will pay on the conversion (ordinary income tax rates apply);
- The availability of outside funds to pay the income tax on the conversion;
- The miscellaneous costs that you will incur due to the conversion (including transaction fees and sales charges);
- Your anticipated tax bracket at the time of receiving traditional IRA distributions (at which time they would be subject to ordinary income tax rates);
- Your age at the time of conversion and the length of time before you reach retirement age; and
- The length of time it will take you (and the IRA plan) to recoup the tax and other expenses incurred because of the conversion.

***Traditional IRA aggregation rule.*** Traditional IRA balances are aggregated so that the amount converted consists of a prorated portion of taxable and nontaxable money. Therefore, if you have made nondeductible contributions to your traditional IRA in the past, you cannot "cherry pick" what traditional IRA assets pick you want to convert to a Roth. The IRS looks at all of your traditional IRAs as one when it comes to distributions, including Roth conversions.

***Outside funds to pay for conversion.*** There can be significant opportunity costs associated with paying the conversion tax from funds inside your IRA.

By using IRA funds to pay the income tax due on the conversion, you lose the opportunity of the potential tax-free growth on the amount used to pay the tax. Moreover, if you are under age 59 ½ and use funds in the IRA to pay the conversion tax, you will also incur the 10 percent penalty tax for premature withdrawals. Ideally, you should use outside funds to pay the conversion tax, such as from savings in a regular bank account or brokerage account.

***Current and future income tax rates.*** A key consideration when deciding whether to convert to a Roth IRA involves determining whether you will be in a lower or higher tax bracket after retirement, when withdrawals will be made from your IRA. The tax deferral rules that apply to traditional IRAs work well for individuals who will be in a lower tax bracket during retirement, since distributions from their traditional IRAs will be subject to the ordinary income tax rates in effect in the year the distributions are made. However, higher-income taxpayers often end up in the same or higher bracket at retirement, and therefore would benefit more from converting to a Roth IRA, from which distributions in retirement are tax-free.

## WHO SHOULD CONVERT?

Although a Roth conversion opportunity may be a good decision for many individuals, it may not be for everyone. One size never fits all when the tax law is involved.

If you are a higher-income taxpayer and expect to fall into an even higher income tax bracket in future years, converting your IRA to a Roth may be a wise move.

If you can afford to pay the costs associated with converting to a Roth (including the ordinary income tax that will result) by using other assets, a conversion becomes more valuable. However, if you need to use money from the converted account itself to pay the associated costs and taxes, the potential resulting future lower earnings in the account, due to its initially lower account balance, may not be worth the conversion. Evaluating that option also depends upon the number of years to go before retirement and if you are able to regenerate the funds used to pay taxes on the conversion relatively quickly when compared to the overall longevity of your account; then, the initial tax cost becomes significantly less important.

A Roth IRA is generally a better retirement savings vehicle for individuals who do not anticipate needing the funds from the IRA to pay for retirement expenses immediately upon reaching age 70½, so funds held in the Roth IRA can continue grow tax-free until needed.

## ROTH IRA CONVERSIONS AND ESTATE PLANNING

Converting a traditional IRA to a Roth IRA is an advantageous estate-planning strategy, in addition to being a valuable

income tax planning tool, particularly for high worth individuals. First, the income tax that you paid at the time you converted to a Roth IRA, preferably from assets outside of the Roth IRA, will reduce the value of your gross estate. ATRA imposes a maximum estate tax rate of 40 percent on estates of decedents dying after 2012.

However, the true value of the Roth IRA in your estate lies in the hands of the beneficiaries of your Roth IRA. The gross value of Roth IRAs, traditional IRAs, and qualified retirement plans are included in your gross estate when you pass away. These accounts are deemed to be "Income in Respect of a Decedent" (IRD) and, as such, do not receive a step-up in basis to a decedent's date of death. Traditional IRAs, as items of IRD, are assessed income tax on distributions occurring after the accountholder's death. The beneficiary/heir must pay this income tax based on his or her own tax rate. Beneficiaries/heirs of Roth IRAs pay no tax upon receipt of the proceeds.

Inherited traditional IRAs cannot be converted to a Roth IRA if the IRA is inherited from someone other than a spouse. A surviving spouse can elect to treat an inherited IRA as his or her own and then convert to a Roth IRA.

## RECHARACTERIZATIONS

"Recharacterizations" essentially allow you to lock in the benefits of a conversion at a particular point in time while allowing you to grab a better conversion deal instead if one comes along before a specific window of time closes; or while allowing you to back out of a conversion altogether if hindsight indicates that is the better course. If you convert from a traditional IRA to a Roth IRA, but later change your mind and want to put the money back into a traditional IRA, the Tax Code allows you to do so, subject to time limitations.

You have until October 15th of the year after the year of conversion to recharacterize the Roth conversion. Essentially, a recharacterization enables you to undo the transaction in which you converted to a Roth IRA and to go back to a traditional IRA. If you properly recharacterize the conversion, it rolls back the tax consequences as well, so you would recoup the tax liability that would have

been otherwise due on the amount converted to the Roth IRA.

If the market value of your Roth IRA significantly drops after conversion, you may want to consider undoing the transaction and thus undoing the tax consequences, thereby recouping the tax you paid on the larger value of the IRA that was converted to a Roth. You can then convert back to a Roth IRA and pay the resulting, lower tax bill.

***Timing.*** The election to recharacterize and the transfer of the assets must both take place on or before the due date (including an automatic six month extension) of your federal income tax return for the year for which the contribution was made for the first IRA. For the 2013 tax year, including the automatic six month extension, that deadline comes to October 15, 2014. Once a recharacterization election has been made, it cannot be revoked. However, in some situations, the amount may be reconverted at a later date.

For example, the timetable for a 2013 Roth IRA conversion is as follows:

| | |
|---|---|
| January 1, 2013 | The first date that a Roth IRA conversion for 2013 can occur. |
| December 31, 2013 | The last date that a Roth IRA conversion for 2013 can occur. |
| April 15, 2014 | The due date for your 2013 federal income tax return, and the last date a tax liability for a 2013 Roth IRA conversion can be paid without interest and penalties. |
| October 15, 2014 | The last date on which a recharacterization of a 2013 Roth IRA conversion can be made. |

Partial recharacterizations are also allowed. For example, if in hindsight you find you are getting pushed into a much higher tax bracket because of other, unexpected income, you can take just a portion of your total Roth conversion account and recharacterize it back to a traditional IRA. Likewise, but in reverse, you should consider taking one large traditional IRA and converting it into several, smaller Roth IRAs if you anticipate the need for greater flexibility. Reconverting a portion of it back before the October 15th deadline in the next year becomes that much easier, too, under such a strategy.

## CONCLUSION

A Roth conversion must be considered in light of each individual's tax and financial situation, taking into account a number of factors that must be assessed in each case. Some of these key factors include the fair market value of your account, the account's asset mix, your outside funds and ability to pay the income tax on conversion with nonqualified funds, as well as your age, your current and future cash flow needs, current and projected future marginal tax rates, and estate planning objectives.

It is imperative that you speak with a tax advisor before undertaking a Roth conversion. As discussed in this booklet, there are many variables that must be considered. Missteps when dealing with relatively significant amounts of assets can be expensive. Your advisor will be able to customize your Roth conversion to maximize all the significant tax benefits that have opened up in 2013 and that will continue to be available in the future.