

LEGAL ALERT

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ROTH RULES REVISITED

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Despite the current excitement with regard to converting an IRA to a Roth IRA, it is important to keep in mind several rules that can become tax traps when an IRA is converted.

New Beneficiary Designations. A Roth IRA is a *new* IRA account. It needs to have *new* beneficiary forms completed. If there is no Roth beneficiary designation and the Roth IRA owner dies before his or her required beginning age (70½), the Roth account must be depleted within five years of the owner's death. One of the primary benefits to the Roth IRA is the ability to stretch out distributions and thus earn tax-free income over a long period. That advantage is lost if the entire Roth IRA is "flushed" of its assets on the fifth anniversary of the Roth owner's death.

Avoid 60 Day Rollover. The best way to transfer assets from an IRA to a Roth IRA is with a custodian-to-custodian transfer, i.e., a direct "rollover." Some IRA custodians do not offer this flexibility. Instead, they will simply issue a check to the IRA owner, who then has 60 days in which to place the funds into a Roth IRA. If the 60 day deadline is missed, the funds become taxable and are no longer eligible for a "rollover." If the IRA custodian does not participate in a direct rollover, request the IRA custodian to issue the distribution check made payable to the new Roth IRA custodian so that the owner is not able to cash the check. The check will be treated by the IRS as a direct transfer from one IRA custodian to another.

Caution: Income, not Tax, is Split. The year 2010 is the only calendar year that allows an IRA owner the opportunity to spread the income taxes on the IRA conversion over two years. This default rule

provides that an IRA owner who converts in 2010 does not have to include the conversion income on their 2010 tax return; rather, 50% of the income from the conversion is reported on their 2011 income tax return and the balance is reported on their 2012 tax return. But Congress promises us increased income taxes in the coming years. It is possible that when the conversion income is reported in calendar years 2011 and 2012, the income tax rates will be much higher. Consider electing to report all conversion income in 2010 when income tax rates are lower.

Credits, Exemptions and Deductions. Reported income from the conversion will increase in 2011 and 2012 because that is when the conversion income is reported on tax returns. But there are multiple tax credits, exemptions, and deductions that are phased out under the Tax Code depending upon the amount of reported income. The potential loss of these tax benefits needs to be balanced against the tax-free benefits of the Roth IRA. Generally Social Security benefits are excluded from a taxpayer's gross income. However, if there are other sources of income, it is possible that a taxpayer may report between 50% and 85% of their Social Security benefits as taxable income. Moreover, Medicare Part B premiums are based upon a taxpayer's reported income. If conversion income is going to be added to a taxpayer's income in calendar years 2011 and 2012, it is possible that Social Security retirement benefits or Medicare Part B premiums may increase with the additional conversion income. While this may seem to be a deterrent to a Roth IRA conversion, remember that even if a regular IRA is maintained, after attaining the age of 70½ the IRA owner will have to begin to pull out taxable income from the IRA which can also

negatively impact the taxation of Social Security benefits and Medicare Part B premiums.

Inherited IRAs. A problem exists with regard to inherited IRAs. Any non-spouse beneficiary who inherits a qualified plan (not an IRA) is eligible to convert that qualified plan account into an inherited Roth IRA. However, a non-spouse beneficiary who inherits an IRA *cannot* convert the inherited IRA into a Roth IRA. Unlike a Roth IRA which carries no required minimum distribution obligation, an inherited Roth IRA is subject to the obligation to begin to withdraw taxable income from that inherited Roth IRA; the failure to take a required minimum distribution from an inherited Roth IRA can trigger a 50% penalty on the amount that otherwise would have been a tax-free distribution. The law does not explain why rollovers from inherited qualified plans will qualify for a conversion, but not an inherited IRA.

Two Year Rule: SIMPLE IRA. All IRAs, including a SEP IRA and a SIMPLE IRA, are eligible for conversion to a Roth IRA. But there is a difference between the two. A SIMPLE IRA has a required two year holding period. That two years begins to run when the first contributions are made to the SIMPLE IRA. Any distribution of assets from the SIMPLE IRA in those first two years is treated as a taxable distribution that is *not* eligible for rollover, other than into another SIMPLE IRA. Consequently, with a SIMPLE IRA, make sure you have maintained it at least two years before you convert it to a Roth IRA. Violation of this rule results in a 25% penalty on the distribution.

10% Penalty. Generally there is an early withdrawal penalty of 10% when assets are withdrawn from an IRA before the owner attains the age of 59½. The Roth conversion is a statutory exception to this general rule. If some, or all, of the funds withdrawn from the IRA are used to pay the conversion income tax, then those funds are not actually rolled into the Roth IRA. As such, they will not only be taxable income but they will also attract the 10% penalty. In addition, when funds are converted to a Roth IRA and those funds are withdrawn within the first five years,

and the Roth IRA owner is under the age of 59½ the 10% penalty applies to the Roth withdrawals.

Recharacterization. One of the major benefits of a Roth conversion is the opportunity to recharacterize the Roth conversion that has subsequently “gone sour.” If IRA assets are converted to a Roth IRA and the Roth loses its value, the owner can, until October 15 of the year following the year of the conversion, “recharacterize” the Roth IRA back into a regular IRA, and thus avoid having to pay income tax on that lost value. However, if some of the assets pulled from the regular IRA were used to pay the income taxes on that conversion, those same dollars will *not* have been placed into the Roth IRA; therefore, those dollars used to pay the tax will not be eligible for a recharacterization.

Use a Separate Roth IRA. If a regular IRA is converted to a Roth IRA, it is better to use a new Roth IRA account, not a pre-existing Roth IRA account. If a pre-existing Roth IRA is used, then *all* its assets are consolidated to determine when to make a recharacterization decision; the owner must aggregate the gains and losses on all assets held in the consolidated Roth IRA account for the current year. This diminishes the flexibility of a recharacterization. If a separate Roth IRA is used, then it’s loss in value can be recharacterized without affecting the pre-existing Roth IRA assets.

Required Minimum Distribution. If the owner is just over age 70½ do not convert all of the IRA to a Roth IRA. IRA owners who have reached the required minimum distribution age must *first* take the required minimum distribution before they can convert the balance of their IRA to a Roth IRA. Not taking the required minimum distribution can result in an excess contribution to the new Roth IRA and a 6% excise tax.

The conversion of a Roth IRA may make a lot of tax sense. But be careful when you implement the decision. Tax traps and penalties litter the Roth landscape.

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