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Converting Traditional IRAs to Roth IRAs: The Good, the Bad, and the Ugly

The Individual Retirement Account (IRA) first became a retirement savings option for many U.S. taxpayers in the 1970s. The basic concept of the IRA was to allow a taxpayer (1) to contribute pre-tax dollars to an account (either through direct contributions or the transfer of assets formerly held in other qualified retirement accounts), where such funds would grow tax-deferred (until withdrawn) through reinvestment of earnings and capital growth, and (2) to withdraw from the account following retirement, when the taxpayer likely would need the funds and be in a lower tax bracket.

Over the years, Congress has revised the laws governing IRAs and the technical requirements concerning their establishment and administration, including placing income limits on the deductibility of contributions to an IRA. Current law imposes strict rules as to when and how much can or must be withdrawn from an IRA. All withdrawals are subject to income tax, with penalties for (1) withdrawals taken prior to attaining age 59½ (with certain exceptions), and (2) failure to make the required withdrawals (known as "required minimum distributions").

In 1997, Congress established the Roth IRA, which differs significantly from the "traditional" IRA, discussed above. Certain restrictions, such as income limits, however, precluded many taxpayers from establishing Roth IRAs. Recent legislation removed some of these restrictions as of 2010, and now any taxpayer may convert a traditional IRA and/or distributions from an eligible retirement plan to one or more Roth IRAs. Annual contributions to Roth IRAs, however, are still subject to certain limitations.

THE ROTH IRA

A Roth IRA generally is funded with after-tax assets, i.e., assets on which income tax already has been paid. The account assets are invested, with earnings and growth tax sheltered. In addition, for the account owner, there are no required withdrawals. Thus, the Roth IRA assets can continue to grow income tax-free.

Withdrawals from the Roth IRA by the owner or a beneficiary are tax-free provided they are "qualified distributions," which must meet the following requirements:

1. The distribution is made after a five-year waiting period has expired. The five-year waiting period begins on the first day of the owner's tax year (usually January 1) in which the owner has made an initial contribution (or conversion) to any Roth IRA and ends on the last day of the owner's fifth consecutive tax year (usually December 31) following that initial contribution (or conversion); and
2. The distribution is made to:
    a. the owner on or after the owner attains age 59½; or
    b. a beneficiary or the estate of the owner on or after the owner's death; or
    c. the owner or a beneficiary who is disabled (as defined by statute); or
    d. a first-time homebuyer as defined by statute (usually limited to $10,000).
3. Withdrawals that are not deemed qualified distributions generate both a penalty and an income tax liability. A 10 percent penalty is charged on that portion of a nonqualified withdrawal representing earnings and growth on the post-tax contribution, and that same portion of the nonqualified withdrawal also is subject to income tax.

BENEFICIARIES OF THE ROTH IRA

Upon the death of the owner of a Roth IRA, the account passes to the designated beneficiary. Different withdrawal rules apply, depending on the identity of the beneficiary, but the beneficiary usually is still subject to the deceased owner's required five-year waiting period, unless the beneficiary makes certain elections (discussed below). Also, the beneficiary cannot combine or merge any Roth IRAs under which he or she is a named beneficiary and must maintain each such Roth IRA separately.

If a nonspouse is the beneficiary, one or two options may be available: (1) the beneficiary must withdraw the entire Roth IRA by December 31 of the fifth year after the owner's death; or (2) if the beneficiary is an individual, then the beneficiary may elect to withdraw from the Roth IRA based on the beneficiary's

life expectancy, starting in the calendar year after the year of the owner's death. (If the beneficiary is a trust that meets certain requirements, the trustee may similarly elect to withdraw from the Roth IRA based on the life expectancy of the oldest living beneficiary of the trust.) Both of these options, however, continue to be subject to the requirement of the deceased owner's five-year waiting period.

Thus, if the account owner names his or her estate as the beneficiary, then, to avoid income taxes and penalties, the executor must withdraw the entire Roth IRA by December 31 of the fifth year following the owner's death, but no sooner than the end of the deceased owner's five-year waiting period. If, however, an individual (or a qualified trust) is the beneficiary, he or she has the additional option of allowing the Roth IRA to continue to grow tax-sheltered, subject to required annual withdrawals, starting in the year after the decedent's death, subject, however, to income tax and penalties on withdrawals made prior to the end of the deceased owner's five-year waiting period.

If the account owner's spouse is the beneficiary, the spouse can choose either of the above options or one of the following: (1) the spouse may choose a variation on the second option above by electing to defer required minimum distributions until the year in which the deceased owner would have attained age 70½; or (2) the spouse may elect to become the owner of the Roth IRA, subject to all the rules applicable to account owners. This latter option allows the spouse to start the five-year waiting period from the earlier of (a) the first day of the tax year in which the deceased owner first established a Roth IRA, or (b) the first day of the tax year in which the spouse first established a Roth IRA.

Any contingent or secondary beneficiary who inherits the Roth IRA from a nonowner beneficiary must continue withdrawals from the Roth IRA based on the option elected by the primary beneficiary.

A charity may not be an ideal beneficiary of a Roth IRA. Although such a transfer of a Roth IRA will qualify for a charitable deduction for federal estate tax purposes, the inherent income tax benefits of the Roth IRA will be lost because a qualified charity is not subject to income taxes. Other assets payable to a charity at an owner's death (such as a traditional IRA) would provide both estate and income tax benefits.

Also, some taxpayers may consider naming grandchildren or more remote descendants as beneficiaries of a Roth IRA because they have long life expectancies. In such instances, although the Roth IRA could continue to grow income tax-free for a significant period of time, it could be subject to federal and state estate taxes and/or the federal generation-skipping transfer tax, which could significantly deplete it.

INCOME TAX CONSEQUENCES OF CONVERSION

Usually, the value of the assets converted to a Roth IRA is reported as taxable income on the owner's income tax return for the year of the conversion. That reported value is based on the fair market value of the converted assets as of the date of the conversion.

For conversions made in 2010, the taxpayer may elect either (1) to report one-half of the value of the converted assets on the taxpayer's 2011 federal income tax return and the other half on the taxpayer's 2012 federal income tax return (this is the default option), or (2) to report all of the taxable income from the conversion on his or her 2010 federal income tax return. The first option allows the taxpayer to defer the tax payment, but subjects the income to the 2011 and 2012 federal tax rates, which may be higher than the 2010 tax rates. Once made, this election cannot be changed after the due date (including extensions) of the taxpayer's 2010 tax return.

If the taxpayer uses the default option, any converted amounts distributed before 2012 will be included in the taxpayer's federal taxable income for the year of distribution. Any converted amounts not so distributed will continue to be reported as required under the default option.

Further, if the taxpayer dies before all converted amounts have been included in the taxpayer's taxable income, then all remaining amounts are reported on the taxpayer's federal income tax return for the year of death. If the account owner's spouse, as the designated beneficiary, however, assumes ownership of the Roth IRA, the spouse may elect to use the two-year reporting procedure that would have applied to the taxpayer.

Other factors could also impact the tax liability and the timing of payment. For example, the taxpayer may be subject to the Alternative Minimum Tax (AMT), which could increase the federal income taxes resulting from the conversion, and/or the taxpayer's state income tax reporting requirements for such conversion may differ from the federal ones.

For all of these reasons, taxpayers should consult their accountant or other tax/financial advisor to calculate the likely tax consequences.

RECHARACTERIZATION

Taxpayers who convert a traditional IRA or a distribution from an eligible retirement plan to a Roth IRA and later wish they had not done so (whether due to changes in personal and/or financial circumstances, the tax payment being too onerous, a significant decrease in the value of the converted assets, or any other reason) can "recharacterize" or "undo" the conversion by transferring all the assets held in the Roth IRA, plus any earnings and growth, to a traditional IRA. This transfer must be done by the due date, including extensions, of the federal income tax return for the year of the conversion. If the taxpayer's return has already been filed and the taxes have been paid on the converted assets, the taxpayer can file an amended return to claim a refund, provided it is filed within the extension deadline for that tax year.

If the taxpayer has more than one Roth IRA, all Roth IRAs need not be recharacterized, but to the extent that a given Roth IRA is recharacterized, it must be done as to all the assets in that Roth IRA. For this reason, some financial advisors suggest that taxpayers establish more than one Roth IRA, each funded with a different asset category.

TO CONVERT OR NOT TO CONVERT – FACTORS TO CONSIDER

The Roth IRA provides certain benefits, such as (1) income tax-free earnings and growth, (2) tax-free withdrawals, (3) no required distributions for the owner, (4) the potential for diversification, and (5) the payment of income taxes on the converted assets as a means of reducing the owner's taxable estate for federal and/ or state estate tax purposes.

The Roth IRA also has certain disadvantages, such as (1) significant state and federal income tax liabilities to be paid, and (2) potential penalties and tax consequences if funds are withdrawn before the end of the five-year waiting period.

Each taxpayer should review his or her personal and financial circumstances when considering whether to convert traditional IRAs or distributions from other eligible retirement plans to Roth IRAs. As part of that review, several questions should be addressed, including the following:

- Do I have sufficient cash on hand (outside of the accounts to be converted) to pay the resulting federal and state income taxes, including any AMT?
- Do I have a sufficient income stream from other sources to meet my current needs and to allow me to continue enjoying my current lifestyle?
- Can I wait the longer of the required five-year waiting period or until I am 59½ before making a withdrawal?
- Do I expect to be in a higher income tax bracket in future years, due to an increase in my taxable income and/or an increase in the federal and/or state income tax rates?
- Do I have deductions I can claim to offset the taxable income generated by the conversion, and if so, can I time the payment of those deductions for the tax year(s) in which I will report the conversion income?
- Do I expect the assets transferred to the Roth IRA to appreciate significantly? If so, would that appreciation offset the income tax paid on the conversion?
- In what tax year(s) should I report the income from a 2010 conversion for federal income tax purposes?
- Do the state income tax laws applicable to the conversion differ from the federal ones, and if so, what are the state tax consequences?
- Whom should I name as the beneficiaries, and what are their life expectancies?
- Which beneficiaries have long life expectancies to best take advantage of the required withdrawals, without generating any unwanted federal generation-skipping transfer tax?
- Should I transfer all converted accounts into one Roth IRA or establish multiple Roth IRAs?
- Do any of the traditional IRAs or distributions from other eligible retirement plans to be converted include nondeductible contributions? (If so, a more complicated calculation is required to determine the portions attributable to pre-tax and post-tax contributions.)

SUMMARY

The Good — Roth IRAs can provide significant long-term income tax savings for a taxpayer and his or her family.

The Bad — The five-year waiting period can limit availability of Roth IRA assets, and early withdrawals can create taxes and penalties.

The Ugly — Deciding whether to convert to a Roth IRA is not a simple process. Each taxpayer's personal and financial circumstances will dictate whether he or she should convert all, a portion or none of his or her traditional IRA (or distributions from other eligible retirement plans) to a Roth IRA.

Consequently, before converting any assets, a taxpayer should evaluate the potential impact of a conversion on his or her overall financial and estate plan, consult with financial/tax advisors and, to the extent appropriate, involve family members in the decision-making process.

Individual Clients Group

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