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Roth IRA Conversion Strategies

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This article provides information on when a Roth individual retirement account conversion should be beneficial, building on an article that was published in the *Daily Tax Report* Dec. 22, 2009, titled ''The 2010 Roth Conversion: What is Known, What is Easy, and What is Hard.''*

The previous article included information about the tax aspects of a conversion and how to undo a conversion.

As noted in the Dec. 22 article, instinctively it is best to defer tax. The question then is whether the Roth conversion option is something that should cause an individual to act contrary to instinct. Areas where a Roth conversion very likely will be beneficial are discussed below.

Tax System Considerations

As discussed in the Dec. 22 article, the future tax system and (unfortunately) the political system are inextricably linked to each other and to the Roth conversion analysis.

In February 2007, Bruce Steinwald, the director of health care for the Government Accountability Office reported to Congress: ''Absent substantive reform of entitlement programs, federal spending will grow to unprecedented levels.'' GAO reported it anticipates entitlement spending on Medicare, Medicaid, and Social Security to reach 15.5 percent of gross domestic product by 2030, and approximately 18 percent of GDP by 2040. The 40-year historical average of total federal spending as a percentage of GDP was reported at 18.3 percent.

In its January 2010 update, GAO reported: ''Our long-term simulations show that absent policy changes the federal government faces an unsustainable growth in debt . . . . While the drivers of the long-term fiscal outlook have not changed, the sense of urgency has.'' Simply put, our government has outgrown our tax system.

Based on an analysis of the historical tax system of the United States and the projected financial problems of the country, as reported by various federal agencies (and noted in the Dec. 22 article), it is likely that income tax rates will increase in the future. The only ways that will not happen are:

- a significant value-added tax, sales tax, or other tax (or set of taxes) is added to supplement the income tax system;
- Federal Insurance Contributions Act taxes are increased very substantially; and/or
- federal government spending is reduced very substantially in the future.

For whatever reasons, many Roth conversion analyses do not consider this important factor. Because evasion would be less with a VAT than with a sales tax, a VAT is a much more likely possibility than a sales tax. Discussion of addition of a VAT is beginning to surface in Washington, D.C.

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How much revenue would a VAT raise? This question is relevant to how the income tax would need to be adjusted in terms of revenue production in the event a VAT supplemented the income tax. (Spending is the remaining uncertain piece of the equation.)

In 2000, the Joint Committee on Taxation issued a memorandum discussing the revenue neutral rate under H.R. 25 (the ''Fair Tax'' proposal). The Fair Tax is a proposal to replace income, FICA, and estate and gift

* 243 DTR J-1, 12/22/09.

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taxes with a broad-based retail sales tax on new goods and services. A poverty rebate (or ''prebate'') is supplied under the Fair Tax proposal. The memorandum concluded that a 59.5 percent tax-exclusive rate would be necessary to produce foregone revenue for the first five years of enactment, with the rate dropping to 57 percent thereafter. (A tax-exclusive rate means the tax is added to the cost of the product. For example, a good that sold for $1 without tax would cost $1.57 with tax if a 57 percent tax-exclusive rate applied.)

If the Fair Tax became law, absent some sort of equalizer from Congress, everyone who made a Roth election would lose. Since the proposal never came close to a vote with the Republicans completely in power, it seems the odds of it becoming law are close to none.

The income tax, FICA/retirement tax, and estate and gift taxes produced approximately 94 percent of federal revenue during the fiscal years ended in 1998, 1999, and 2000. Assuming a VAT would translate to the Fair Tax (which it would not in absolute terms, but should in approximate terms, assuming the base is the same), a 20 percent broad-based VAT without any rebate that had existed for many years would have produced revenue equal to approximately 35 percent to 45 percent of the revenue produced by the income, FICA, and estate and gift taxes in these years (assuming GDP would not have been negatively impacted).

As noted, the GAO expects, under current programs, for federal entitlements spending on Medicare, Medicaid, and Social Security to grow to approximately 18 percent of GDP by 2040. In recent years except 2009, the non-entitlement portion of the federal government budget has typically comprised approximately 10 percent of GDP, meaning federal spending is now projected to be approximately 28 percent of GDP by 2040.

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For 1998, 1999, and 2000, on average, federal taxes equaled approximately 20 percent of GDP. Thus, impacts on the economy aside, a VAT that was 35 percent to 45 percent the size of a VAT necessary to fund the forgone income from income, FICA/retirement, and estate and gift taxes would produce approximately 7 percent to 9 percent of GDP. Currently, few VATs from other countries have a rate that exceeds 20 percent.

Because the current system raised approximately 18 percent of GDP in 2008, if a 20 percent VAT would increase revenue by approximately 8 percent of GDP, the total federal taxes by the current system plus a 20 percent VAT would equal about 26 percent of GDP. Looking forward, if federal entitlement spending was 18 percent of GDP and the remainder of the federal spending amounted to 10 percent of GDP (i.e., 28 percent in total), a deficit of roughly 2 percent of GDP would remain. (Some economists say annual deficits of 3 percent of GDP or less are manageable.)

Accordingly, with a 20 percent VAT, unless spending will be reduced substantially relative to projected spending, the FICA and/or estate and gift tax is greatly expanded in terms of revenue raised, or the federal government starts taxing property and/or something else substantially (or some combination thereof), the income tax system will likely remain essentially the same in terms of revenue raised as a percent of GDP. Absent a VAT or other additional tax (or taxes), income taxes will need to increase tremendously unless spending will be cut tremendously.

If a VAT was enacted, it would likely start with a very small rate and numerous exemptions (as most taxes do). Over time, the rate would increase and exemptions would diminish as federal spending increased.

The 2005 report of the President's Advisory Panel on Federal Tax Reform stated regarding a VAT: ''The VAT has been adopted by every major developed economy except the United States.'' Interestingly, many people in the United States think there is no way a VAT will ever exist.

What about the possibility of substantially less government spending? The less money is spent by the federal government, the less federal taxes would be needed.

According to a recent poll by *The New York Times*/CBS News, 56 percent of Americans polled said they would prefer smaller government and less government services, while 34 percent of Americans polled said they would prefer more government and more government services. In reality, a very significant portion of the population wants the entitlement benefits of the current government because they currently come out ahead.

There are two major political parties in the United States, and neither one of them has acted to reduce spending by the federal government. As noted in the Dec. 22 article, from 2001 to 2006, with the Republican Party (generally considered to be the major party seeking less government) in complete control of the federal government, spending grew approximately 7 percent per year on average, while the economy averaged growth of approximately 3 percent per year. Spending and deficit records were smashed during the fiscal year ended in 2009.

With gridlock, the need to satisfy special interest groups and fear of losing seniors' votes, it now appears unlikely either of the two major parties will do anything to reduce federal spending to any significant degree. However, with Democrats tending to favor lower- and middle-income persons as well as seniors (who would bear much of the burden of a VAT) and Republicans courting seniors and claiming to despise the thought of any new tax, it appears a VAT (if one should ever exist) is many years away. (In other countries, the political group bringing in a VAT has been swept from power. In the midst of a recession, it is doubtful many members of Congress have an appetite for needing to find work in the private sector.)

Instead, tremendously increased debt is the likely result in the near term. How long the tremendous growth of debt will continue is difficult to tell. From a finance perspective, the riskier a debtor is, the more he must

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pay in interest expense. Consider the current situation in Greece.

One more quote from GAO's January 2010 update that is very significant to the Roth conversion analysis: ''[A]ssuming revenue remains constant at 20.2 percent of GDP—higher than the historical average—by 2030 there will be little room for 'all other spending,' which consists of what many think of as 'government,' including national defense, homeland security, investment in highways and mass transit and alternative energy sources, plus smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families and farm price supports.'' With respect to the federal government, things must, and they will, change tremendously.

Strategies

Taking It to the Next Bracket

As noted in the Dec. 22 article and below, a good strategy is to make a Roth election with respect to all or part of an IRA and then, after year-end, recharacterize to a traditional IRA to the extent necessary to keep income below a particular federal income tax bracket.

For example, for someone who believes his or her retirement income will be taxed at a federal income tax rate in excess of 25 percent, the recharacterization might take place as necessary to keep Roth income below the 25 percent bracket. Assuming the Roth conversion option remains after 2010, this strategy could be repeated annually. The alternative minimum tax (AMT) can complicate this analysis.

The Safest Bet

Assuming the income tax burden in the future will be essentially the same or greater than the current system's burden, the safest bet for a Roth conversion is a person who is very wealthy, can pay the tax cost of a Roth election from personal funds (i.e. not from the IRA or another IRA) and will not need to spend the Roth IRA benefits in retirement, but instead can allow those benefits to accumulate for later payment to other persons following death.

A taxpayer in the highest federal bracket (35 percent) while working who anticipates being in the highest federal tax bracket in retirement, assuming the 2009 brackets, exemptions, etc., are indexed for inflation at 2.5 percent per year, would clearly benefit from a Roth election if the person could forgo distributions during retirement and allow the Roth benefits to accumulate.

The break-even incremental bracket for the beneficiary of such a 58-year-old person, assuming a 5 percent state income tax (i.e., 40 percent combined federal and state), 8 percent growth of assets until retirement at age 65 and 6 percent growth after retirement, would be between zero percent and 10 percent (meaning a Roth conversion would be beneficial if the beneficiary's incremental tax bracket will exceed 10 percent).

As discussed further below, estate tax benefits would also exist.

Shades of Gray

For an upper-middle-income taxpayer or someone earning less, the answer is not so clear. Whether a Roth election will be beneficial will turn on a few factors.

The following example considers a worker who makes $250,000 in 2010 absent a Roth election. The person converts a $140,000 IRA benefit to a Roth IRA in 2010 and includes all the income in his 2010 tax return (i.e., elects to do so instead of taking the ordinary 50/50 spread between 2011 and 2012, as explained in the Dec. 22 article). The combined net worth of the taxpayer and his or her spouse is approximately $1 million, making estate tax considerations unnecessary under current and recent law.

The following assumptions apply:

- The tax system used is the current tax system for 2010, including exposure to the AMT. (Historically, the AMT exemption has often been increased to reduce the burden on taxpayers.)
- Going forward, the 2009 tax system is utilized, with brackets and exemptions, etc., indexed for inflation at a rate of 2.5 percent per year.

Other assumptions are provided in the chart at the end of this article titled ''2010 Roth IRA Conversion Analysis—No Roth Minimum Distributions.''

This analysis compares (a) someone who takes the minimum required distributions from a traditional IRA, dies at age 80, and has the remaining IRA assets immediately distributed to descendants to (b) a person identically situated except makes a Roth election and does not receive required minimum distributions. The required minimum distributions in the traditional IRA scenario are saved and invested. The final results show how low the income tax rate applicable to the final distribution would need to be in order to make the Roth conversion unprofitable.

The combined federal and state income tax detriment for the taxpayer and family (including a spouse and two dependent children) due to the $140,000 Roth conversion is $54,096. The $140,000 grows to $340,352 at age 71 with 8 percent compounding until age 65 and 6 percent compounding thereafter.

Using BNA's tax calculator, the tax difference for 2010 is as shown on the following chart titled ''Joe Roth and Family Summary Report.''

For an upper-middle-income taxpayer or someone earning less, the answer is not so clear. Whether a Roth election will be beneficial will turn on a few factors.

As noted, the break-even incremental bracket with respect to distribution is between 25 percent and 30 percent—pretty risky unless it is assumed there will be no VAT and the beneficiaries will be in relatively high brackets. Note that the combined federal and state income tax on the conversion was 38.6 percent of the IRA value (i.e., $54,096/$140,000). The future tax situation of the beneficiaries is an unknown that must be ''guesstimated.''

If the excess of required annual minimum distributions with respect to a traditional IRA over annual incremental tax due to failure to make a Roth election is distributed from the Roth account each year (even though not required), then the break-even bracket is between 30 percent and 35 percent, thus making a Roth conversion less appealing. Again, these assumptions as-

Joe Roth and Family Summary Report

	Case 1	Case 2
Income:		
■ Wages	$240,000	$240,000
■ Interest and Dividends	10,000	10,000
■ Other Income	0	140,000
Total Income	$250,000	$390,000
Total Adjustments	0	0
Adjusted Gross Income	$250,000	$390,000
Personal Exemptions	14,600	14,600
Itemized Deductions (assumed):		
■ Charitable Contributions	5,000	5,000
■ Taxes	20,390	28,790
■ Interest Expense	15,000	15,000
Total Itemized Deductions	$40,390	$48,790
Standard Deduction	11,400	11,400
Total Deductions From AGI	54,990	63,390
Taxable Income	$195,010	$326,610
Regular Tax, by Table	$42,846	$85,562
Net Alternative Minimum Tax	11,054	14,538
Total Federal Taxes	53,900	100,100
Resident State Tax	12,317	20,213
Total Net Tax Due	$66,217	$120,313
Difference		$54,096
Marginal Nominal Federal Rate	28 percent	28 percent
Marginal Federal Rate With Phase-Outs	35 percent	28 percent
Marginal Resident State Rate	6 percent	6 percent

sume that the 2009 tax system, as indexed for inflation, remains in existence. Of course, the tax system will change.

It is important to note in the example analyzed at the end of the text that the taxpayer is in a 15 percent incremental federal income tax bracket and a 5 percent state incremental tax bracket during retirement. What if the taxpayer had greater income in retirement, thus resulting in a higher incremental tax rate? If the assumed incremental federal and state income tax rate applicable to minimum distributions, earnings on taxes saved, earnings on minimum distributions and taxable Social Security benefits (all of which would not exist had a Roth election been made) is 30 percent, then the break-even incremental rate with respect to beneficiaries is approximately 15 percent. If there will not be a VAT, absent the voting power of seniors, it would appear that a 30 percent rate would be a realistically possible rate to replace the 15 percent rate.

Note in the analysis at the end of the text, that the most important tax considerations are those applicable at the time of the election and those applicable at the time benefits are distributed. However, the tax system during the interim is significant to the equation as well. Assumptions must be made regarding how the system will change throughout the entire period under analysis.

Funding a Business With an IRA

With credit tight and many people out of work, some people have considered using retirement plan benefits to fund a business. Funding a business with retirement plan assets is risky from a financial perspective and complex from a tax perspective.

From a financial perspective, it is not good to put all of one's eggs in one basket. Accordingly, the fiduciary duty rules of the Employee Retirement Income Security Act of 1974 (ERISA) require that pension plan assets ordinarily be diversified to reduce risk. An exception exists for ''eligible individual account plans,'' such as employee stock ownership plans (ESOPs), stock bonus plans, and 401(k)/profit-sharing plans that are designated as eligible individual account plans. There is no diversification requirement with respect to IRAs.

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From a tax perspective, investing all of one's IRA funds or tax-qualified plan funds in a single business can potentially run afoul of the prohibited transaction rules. With respect to an IRA, a prohibited transaction results in disqualification of the IRA, meaning the IRA ceases to exist upon the occurrence of a prohibited transaction and the assets of the IRA are deemed distributed on the first day of the year in which the prohibited transaction occurs. For a tax-qualified plan, a prohibited transaction can be undone, and can also be subject to a 15 percent excise tax that increases to 100 percent if the transaction is not corrected within a statutorily specified period of time.

In 2008, the Internal Revenue Service issued its ''ROBS'' (rollovers as business startups) memorandum, listing all the things that could potentially be wrong with a business financed through an ESOP that permits a single equity infusion into the business, with that infusion being made upon formation from the account of the person who establishes the business with funding from a tax-qualified plan or IRA. The ROBS scenario builds off a Tax Court case won by the taxpayer, *Swanson v. Commissioner*, 106 T.C. 76 (1996), wherein the initial funding of a corporation followed by distributions of profits did not result in a prohibited transaction. The taxpayer was awarded attorneys' fees in the case.

Virtually all of the issues discussed in the ROBS memorandum relate to utilization of an ESOP or a tax-qualified plan to fund a start-up business. Those issues are many. Based on the ROBS memorandum, using an IRA to fund a business has less risk than using an ESOP or a tax-qualified plan. However, use of an IRA would still need to clear the hurdles of the prohibited transaction rules. Those rules are murky, particularly when the person who establishes the business will draw compensation from the business (as will almost always be the case) in the future.

Based on the ROBS memorandum, using an IRA to fund a business has less risk than using an ESOP. However, use of an IRA would still need to clear the hurdles of the prohibited transaction rules.

Under the right circumstances, assuming a prohibited transaction can be avoided, a Roth conversion can be quite appealing. Consider a business formed by two individuals with one of them contributing the capital through his IRA and a third person granted a small equity interest (perhaps to break voting ties). If the two individuals own equal equity interests (with one owning through his IRA) and both of those interests are less than 50 percent interests, the value of the ownership interest of the contributor of capital through the IRA will very likely be less than his proportionate interest in the initial cash account of the venture, particularly if the Roth election is made shortly after formation and shortly after a substantial amount of the cash has been expended on a risky new business (as are virtually all new businesses). Should the business succeed, the tax-free rewards of the Roth could be tremendous.

If the venture was a limited liability company, the IRA would need to include its share of annual income as unrelated business taxable income. However, proceeds received upon sale or liquidation from a source other than disposition of inventory would likely be tax-free.

If several IRAs exist but less than all are involved in a prohibited transaction, only those involved in the prohibited transaction are disqualified. In other words, there is no aggregation for purposes of applying the prohibited transaction rules. Accordingly, if a taxpayer is considering undertaking a transaction and plans on using less than all of the IRA assets, it would be safest to split the IRA into two IRAs and only subject one of the IRAs to the potential risk of a prohibited transaction.

Making the Best Use of After-Tax Money

Occasionally, after-tax funds will exist in an IRA. These funds likely came from either nondeductible contributions to an IRA or a tax-qualified plan. Depending on the circumstances, it may be possible to reduce taxability of a Roth conversion by planning.

Under Internal Revenue Code Section 408(d)(2), when analyzing distributions for tax treatment under code Section 72, all IRAs are treated as one IRA and all distributions are treated as one distribution. Under code Section 72(b), the taxpayer's investment in the contract is excluded from gross income with respect to annuity distributions. Under Treasury Regulations Section 1.408A-4, A-7(a), when after-tax money exists in an IRA and a distribution is made, the distribution is a tax-free return of capital to the extent of after tax-money. If less than all of the account is distributed, the after-tax money is prorated between distributed and retained amounts. End-of-year figures are used when performing calculations. An amount in a tax-qualified plan is not considered for these purposes.

Based on these rules, an individual may be able to plan to maximize use of after-tax contributions. For example, an individual with $100,000 of assets in an IRA that is composed of $5,000 of after-tax contributions, and $200,000 in a tax-qualified plan, would only recognize $95,000 of income if he converted his IRA to a Roth IRA. On the other hand, if he rolled over the $200,000 of tax-qualified benefits to a traditional IRA and then converted the $100,000 IRA to a Roth IRA, only one-third of the $5,000 of after-tax money (i.e., $1,667) would be deemed included in the $100,000 rolled over, meaning that amount subject to tax would be $98,333 instead of $95,000.

Conversely, if the person originally held $100,000 in one IRA (including $5,000 of after-tax money) and $200,000 in another traditional IRA, transfer of the $200,000 account to a tax-qualified plan prior to a Roth conversion in a subsequent year with respect to the $100,000 IRA should result in taxation of only $95,000 upon the conversion. (It may be that the Roth conversion could take place in the year of the transfer with the same result.) Of course, not all taxpayers will have the ability to roll IRA assets into a tax-qualified plan.

If the taxpayer wished to only use the after-tax money to fund a Roth conversion, assuming a tax-qualified plan exists that will accept roll-ins from IRAs, all but the after-tax money could be rolled to the tax-qualified plan. Under code Section 408(d)(3)(H), the income would be deemed to transfer to the tax-qualified plan, leaving only after-tax money, which should produce no income tax upon a Roth conversion.

If the desire existed to convert more than the after-tax amount but less than all of the benefits, then the desired amount could be retained in the IRA for later conversion and the remainder transferred to the tax-qualified plan. In that case, with respect to the amount retained, the excess of the amount converted over the after-tax amount would be subject to income recognition.

A taxpayer could make a tax-deductible contribution to an IRA and, shortly thereafter, make a Roth conversion. For example, a taxpayer might make a $5,000 tax-deductible contribution for 2009 on April 14, 2010, and then make a 2010 Roth election with respect to the IRA on April 15, 2010. The 2010 Roth income could be picked up entirely in 2010 or 50/50 in 2011 and 2012. Assuming the law does not change, this action could be repeated each year (except the 50/50 option, which is available only for 2010), thus creating a one-time tax benefit that creates Roth IRA benefits. Similarly, a taxpayer could make a $5,000 nondeductible contribution to a new traditional IRA and, subject to the rules previously discussed regarding aggregation with other IRAs, convert the account to a Roth account soon thereafter for tax-free (instead of taxable) earnings growth.

Offsetting an NOL or Other Deduction or Credit

An area where a Roth conversion can be helpful is a situation where the taxpayer has a net operating loss or an operating loss for the year. Under current law, generally, an NOL may be carried back two years and then carried forward 20 years. Alternatively, a taxpayer can choose to only carry forward the NOL. (For 2008 and 2009, different rules potentially applied that allowed for a greater carryback period for either 2008 or 2009. Those rules, which have expired, could be extended.) Also, NOLs die with the taxpayer, thus making a Roth conversion of potential value with respect to someone who has an NOL and is dying.

An NOL can be used to offset income from a Roth conversion. If an NOL is set to expire in the near future, using the NOL to offset Roth income can be a very beneficial. Also, if a taxpayer has capital gains (including qualified dividends) which he or she planned to offset with the NOL, using the NOL to instead offset the Roth income is better from a cost-benefit perspective because capital gains receive preferential tax treatment (generally subject to a maximum federal rate of 15 percent, whereas Roth conversion income is almost always ordinary income, subject to a maximum federal rate of 35 percent).

The alternative minimum tax needs to be considered. The AMT NOL is different than the regular tax NOL because it is computed using AMT adjustments. Also, for AMT purposes, the AMT NOL can only be used to the extent of 90 percent of AMT income, as determined without regard to the AMT NOL and the deduction under code Section 199 for domestic production activities.

Similar considerations apply with respect to tax credits that are available for utilization, and for charitable deductions (including carryovers). Also, it might be worthwhile to make a significant charitable bequest in the year of a significant Roth conversion, to offset the income to the extent desired.

Estate Tax, GST, And Unified Credit Exemption Maximization

Utilizing Roth funds, instead of traditional IRA funds, to fund a generation-skipping transfer tax exemption or unified credit exemption (assuming the estate tax and GST tax return in the same or similar form to that which existed prior to 2010) could add tremendous value to the exemption.

If the exemption is $3.5 million, a Roth bequest could immediately produce $3.5 million of cash benefits, whereas a $3.5 million traditional IRA bequest would produce benefits equal to $3.5 million less the tax on distributions. Furthermore, as discussed in the Dec. 22 article, paying income taxes on a Roth conversion will generally be beneficial from an estate tax perspective.

Finally, to be most tax-efficient, any estate tax burden should be borne by sources other than Roth IRA assets.

Benefits for Grandchildren, Grandnieces, Etc.

An older person who is not in a high tax bracket (or perhaps is paying no federal income tax whatsoever) could provide significant benefits to his or her grandchildren or grandnieces and grandnephews (or perhaps for children, nieces, nephews, or any other person for whom the IRA owner wished to provide benefits) by making a Roth conversion. The benefits could be particularly helpful if it is anticipated that the beneficiaries will be in relatively high income tax brackets.

Under current law, the IRA could be structured (perhaps using a trust) to provide for income payments over the life expectancies of the beneficiaries, with early payments possible in the event of need.

The ability to recharacterize a Roth IRA as a traditional IRA in whole or in part after year-end and before the due date of the income tax return (including an extension, if applicable) allows a person to adjust the Roth conversion to the degree desired with respect to tax liability.

Assuming the Roth conversion option will remain in the future beyond 2010, a Roth conversion could be made once per year, in an amount necessary to keep the federal tax liability at $0 or at an amount acceptable to the IRA owner (e.g., nothing taxed at a rate in excess of 10 percent). The ability to recharacterize a Roth IRA as a traditional IRA in whole or in part after year-end and before the due date of the income tax return (including an extension, if applicable) allows a person to adjust the Roth conversion to the degree desired with respect to tax liability.

If family members agreed that a Roth election would be beneficial to the future beneficiaries, they might agree to reimburse the IRA owner for making a Roth election, to the extent of any tax detriment incurred. The agreement might include a tax "gross-up." It is likely that any such payment would be taxable income to the recipient and produce no tax benefit for the payer(s). The numbers would need to be "run" on a present value basis to determine if such a plan is worthwhile.

To determine whether such a plan would be beneficial, the anticipated future tax system (which must be

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guesstimated) would need to be utilized. Also, a discount rate would need to be determined. If the tax rate the IRA owner is subject to is zero percent, there would be no need to do any analysis. Similarly, if the tax rate was low (e.g., 15 percent), again, it would appear there would be no need to perform an analysis, assuming that a significant income tax will exist in the future and the beneficiaries will be middle-income or higher taxpayers for a long period of time.

A person close to retirement could benefit by waiting until retirement, when he or she will be in a lower tax bracket, to make a Roth conversion.

Using Roth Distributions in Low Deduction Years

As noted in the Dec. 22 article, a potential strategy for retired persons would be to have both Roth assets and traditional IRA assets, and take distributions from the traditional IRA in years when substantial deductions exist, while taking Roth distributions in relatively lean deduction years.

For example, under current law, medical expenses are deductible as itemized deductions to the extent they exceed 7.5 percent of adjusted gross income. If a taxpayer had $100,000 of medical expenses due to an operation in a year, he or she might take $80,000 from his traditional IRA and use other income to cover the expenses. If AGI was $110,000, he or she could deduct $91,750 as a medical expense on Schedule A (i.e., $100,000 – (110,000 x 0.075)). If in the next year no medical expenses or other deductible expenses existed, the taxpayer could draw substantially from his or her Roth IRA.

Obviously, a Roth IRA would be needed to accomplish this strategy and the current tax burden of creating the Roth benefits remains a significant piece of the equation.

Early 2010 Conversion

Some professionals advocate making a Roth election early in 2010, because the conversion can be recharacterized earlier, thus permitting a new Roth election sooner, if the taxpayer is not happy with the investment results following the conversion. Significant to the issue is the following rule of Treasury Regulations Section 1.408A-5 Q&A9 regarding new elections: A new election can be made no earlier than the later of the first day of the taxable year following the year of the conversion or 30 days following the recharacterization.

Since the earliest a new Roth election can be made is the tax year following the year of the original election, and a 30-day wait must follow a recharacterization, it would appear that the only downside of not converting early in 2010 (as opposed to later in 2010) is an additional wait not to exceed 30 days to make a new Roth election.

Consider a Roth election with respect to $100,000 of IRA assets in March 2010. If those assets increased in value to $120,000 by October 2010, presumably the taxpayer would be content with the result, knowing he or she had until the due date of his or her 2010 income tax return (including any extension) to undo the election wholly or partially.

In contrast, if the assets decreased in value to $75,000 in October 2010, would it be prudent to undo the election via recharacterization at that time? What if the assets later appreciated to $110,000 by December 2010? Would the taxpayer then desire to make a new Roth election in January 2011? Given the minimal downside of waiting to recharacterize (i.e., a maximum of a 30-day wait) and the inability of anyone to know exactly where asset values of assets with respect to which they have little control are headed, it would seem little could be gained by making an election early in 2010. A possible exception would be an investment with respect to which the taxpayer has a reasonable basis to expect appreciation (e.g., a small business about which the taxpayer is very knowledgeable and optimistic).

Using Non-IRA Assets to Pay the Tax

From a financial perspective, it is best to pay the tax attributable to a conversion from assets other than the IRA's assets because doing so permits the maximum amount possible to grow tax-free.

Separate Elections/Best Assets

Taxpayers can make Roth elections with respect to one or more IRAs. One IRA could be split into two or more IRAs, so that separate Roth elections could be made for each IRA. (It may be possible to make separate elections from one IRA.) When rolling over benefits, taxpayers need to be cognizant of the one-year rule of code Section 408(d)(3)(B). A trustee-to-trustee transfer is exempt from this rule. Under Treas. Reg. Section 1.408A-4, Q&A 7, and code Section 408A(e), a Roth conversion is not treated as a rollover for this purpose.

Accordingly, a taxpayer might choose to make separate elections with respect to various mutual funds, asset classes, or with respect to different investment types (e.g., energy stocks versus health care stocks), and then adjust (i.e., recharacterize) on an IRA-by-IRA basis after year-end based on results. For conversions with favorable investment results, the Roth election would be retained. For unfavorable results, recharacterization could be done.

The best assets for Roth conversion are assets expected to substantially appreciate in value. "Covered calls" generally require little start-up capital, and can produce substantial returns. Because recordkeeping outside an IRA would be burdensome, an IRA is the best place to undertake these transactions. Real estate is relatively depressed at this time, making it a good potential Roth asset candidate.

Rollovers of Death Benefits From Qualified Plans

As noted in IRS Notice 2008-30, a death beneficiary under a tax-qualified plan may roll over death benefits from a tax-qualified plan to a Roth IRA. (Income recognition would apply upon the rollover.)

This provision may be particularly beneficial for a person who does not have access to IRA funds (e.g., someone without an IRA, or without a significant IRA, but with a significant retirement benefit in his or her employer's tax-qualified plan that is not reachable without terminating employment). As of March 17, a bill was pending in Congress that would allow a Roth conversion for assets in a tax-qualified plan that are currently distributable.

Extend the Due Date

Aside from an extended statute of limitations on assessment, there appears to be no downside to extending the due date for the individual income tax return of someone who makes a Roth election. Extending the re-

turn due date provides greater time to make decisions about recharacterization.

No Tail Wagging

The tax tail should not wag the financial dog. For someone with creditor problems, bankruptcy and state insolvency laws need to be considered. Assets held in tax-qualified plans are free from creditors' claims. Assets in IRAs generally are free from claims of creditors in a bankruptcy context, but might not be safe outside bankruptcy. State laws would need to be considered.

Conclusion

The preceding analysis shows some means by which a Roth conversion could create value to taxpayers. Of course, as noted in the Dec. 22 article, the future tax system and whether the Roth promise will be fully kept remain the difficult questions for any analysis.

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2010 Roth IRA Conversion Analysis—No Roth Minimum Distributions

Assumptions:

Taxpayer is 58 years old

Absent Roth conversion income, AGI is $250,000

Absent Roth conversion income, itemized deductions for 2010 are $40,390

Taxpayer is married and has two dependent children

All assets invested earn 8 percent per year until age 65, then earn 6 percent per year

Incremental combined tax bracket after 2010 is 32 percent before age 65 and 20 percent ages 65 to 71

State income tax from 2010 conversion will be paid in 2010, and amount to $8,400 ($140,000 x 0.06)

Upon attainment of age 65 in seven years, the taxpayer will receive:

- pension of $30,000 per year, without cost of living adjustment
- $8,000 of interest income, with amount increasing by 2.5 percent per year
- $18,000 of Social Security benefits, with 2.5 percent COLA per year

Brackets, Social Security benefits, interest amount, personal exemption, and standard deduction grow 2.5 percent per year

State tax rate on and after attaining age 71 is 5 percent

Tax savings growth in 2017 equals $54,096 multiplied by 1.0544 ((0.08 x (1-0.32)) + 1) for seven years; similar growth occurs thereafter until age 71 using 6 percent and a 20 percent tax rate

Year	Traditional IRA	Roth IRA	Sum Net Received + Income
2023 Beginning Balance	$340,352.00	$340,352.00	
RMD (/26.5)	12,843.47	0.00	
Incremental Tax	(3,065.27)	0.00	
Net Received	9,778.21	0.00	9,778.21
Beginning Balance Less RMD	327,508.53	340,352.00	
Growth to 2024 (x 1.06)	$347,159.04	$360,773.12	
RMD (/25.6)	13,560.90	0.00	
Incremental Tax	(3,342.62)	0.00	
Net Received	10,218.28	0.00	20,583.18
Beginning Balance Less RMD	333,598.14	360,773.12	
Growth to 2025 (x 1.06)	$353,614.03	$382,419.51	
RMD (/24.7)	14,316.36	0.00	
Incremental Tax	(3,642.81)	0.00	
Net Received	10,673.54	0.00	32,491.71
Beginning Balance Less RMD	339,297.67	382,419.51	
Growth to 2026 (x 1.06)	$359,655.53	$405,364.68	
RMD (/23.8)	15,111.58	0.00	
Incremental Tax	(3,967.33)	0.00	
Net Received	11,144.24	0.00	45,585.46
Beginning Balance Less RMD	344,543.95	405,364.68	
Growth to 2027 (x 1.06)	$365,216.59	$429,686.56	
RMD (/22.7)	15,948.32	0.00	
Incremental Tax	(4,317.75)	0.00	
Net Received	11,630.57	0.00	59,951.16
Beginning Balance Less RMD	349,268.27	429,686.56	
Growth to 2028 (x 1.06)	$370,224.36	$455,467.75	
RMD (/22.0)	16,828.38	0.00	
Incremental Tax	(4,695.72)	0.00	
Net Received	12,132.66	0.00	75,680.90
Beginning Balance Less RMD	353,395.98	455,467.75	

Year	Traditional IRA	Roth IRA	Sum Net Received + Income
Growth to 2029 (x 1.06)	$374,599.74	$482,795.82	
RMD (/21.2)	17,669.80	0.00	
Incremental Tax	(5,192.81)	0.00	
Net Received	12,476.99	0.00	$92,698.74
Beginning Balance Less RMD	356,929.94	482,795.82	
Growth to 2030 (x 1.06)	$378,345.74	$511,763.57	
RMD (/20.3)	18,637.72	0.00	
Incremental Tax	(5,802.85)	0.00	
Net Received	12,834.87	0.00	111,095.53
Beginning Balance Less RMD	359,708.02	511,763.57	
Growth to 2031 (x 1.06)	$381,290.50	$542,469.38	
RMD (/29.5)	19,553.36	0.00	
Incremental Tax	(6,428.05)	0.00	
Net Received	13,125.30	0.00	130,886.57
Beginning Balance Less RMD	361,737.14	542,469.38	
Growth to 2032 (x 1.06)	$383,441.37	$575,017.54	
RMD (/18.7)	20,504.89	0.00	
Incremental Tax	(7,094.98)	0.00	
Net Received	13,409.91	0.00	152,149.67
Beginning Balance Less RMD	362,936.48	575,017.54	
Growth to 2033 (x 1.06)	$384,712.67	$609,518.60	
Three months' growth (x 1.015) (B)	$390,483.36	$618,661.37	$155,192.67
Value of Tax Savings Growth and Net Received From RMDs (A)			$332,640.35

A sample tax calculation, for 2030, follows:

	Traditional IRA	Roth IRA
Taxable Social Security	1,406.00	
Pension	30,000.00	30,000.00
Interest	11,028.09	11,028.09
Tax Savings Earnings	8,939.31	
Minimum Distribution	18,637.72	
Minimum Distribution Earnings	5,561.92	
AGI	75,573.04	41,028.09
Personal Exemption	12,260.48	12,260.48
Standard Deduction	22,841.93	22,841.93
Taxable Income	40,470.64	5,925.68
Federal Tax	4,668.17	592.57
State Tax	2,023.53	296.28
Total Tax	6,691.70	888.85
Difference		$5,802.85

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Analysis of Results

Tax rate applied to distributions from traditional IRA:

Rate	1 - Rate	Distribution (B) x (1-rate)	Tax Savings and RMDs (A)	Total
0	1.00	$390,483.36	$332,640.35	$723,123.71
10	0.90	351,435.03	332,640.35	684,075.37
15	0.85	331,910.86	332,640.35	664,551.21
20	0.80	312,386.69	332,640.35	645,027.04
25	0.75	292,862.52	332,640.35	625,502.87
30	0.70	273,338.35	332,640.35	605,978.70
35	0.65	253,814.19	332,640.35	586,454.53
40	0.60	234,290.02	332,640.35	566,930.36
50	0.50	195,241.68	332,640.35	527,882.03

Comparison to Roth:

Tax Rate	Traditional	Roth	Difference
0	$723,123.71	$618,661.37	$104,462.34
10	684,075.37	618,661.37	65,414.00
15	664,551.21	618,661.37	45,889.83
20	645,027.04	618,661.37	26,365.66
25	625,502.87	618,661.37	6,841.50
30	605,978.70	618,661.37	(12,682.67)
35	586,454.53	618,661.37	(32,206.84)
40	566,930.36	618,661.37	(51,731.01)
50	527,882.03	618,661.37	(90,779.35)

Note: Distributions could (and in many cases would) be taken post-death over life expectancy. The Roth benefits can only be more valuable after death, since they are tax-free.