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The 2010 Roth Conversion: What Is Known, What Is Easy, and What Is Hard

BY ALLEN BUCKLEY

As titled, this article discusses what is known, what is easy, and what is hard with respect to a Roth individual retirement account conversion in 2010.

The most significant question with respect to the issue of whether a Roth conversion will be beneficial is the future tax system and rates relative to the system and rates at the time of conversion. A major objective of this article is to provide information practitioners and taxpayers can utilize to analyze this question. Estate tax considerations are briefly discussed. Practical considerations are provided. Finally, the future of the conversion is discussed.

The most significant question with respect to the issue of whether a Roth conversion will be beneficial is the future tax system and rates relative to the system and rates at the time of conversion.

Ordinarily, upon a conversion of an IRA or a qualified plan benefit to a Roth IRA, ordinary income is recognized with respect to the amount converted. As a general rule, if the income tax rate applicable at the time of distribution in the future will exceed the income tax rate applicable at the time of conversion, a Roth conversion is beneficial. Certain factors, such as how Social Security income is taxed, can impact the general rule.

Allen Buckley is a partner with The Saylor Law Firm LLP in Atlanta. Buckley is an attorney and certified public accountant. His practice emphasizes employee benefits, taxation, estate planning, and corporate law.
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Instinctively, it is best to defer tax. Is the Roth conversion option something that should cause an individual to act contrary to instinct?

Known General Parameters

The known general parameters of a Roth conversion in 2010 are as follows:

1. After 2009, anyone can convert a traditional IRA to a Roth IRA (whereas prior to 2010, individuals with adjusted gross income in excess of $100,000 and married individuals filing separately could not convert);
2. Income from a conversion or rollover from an IRA or tax-qualified plan that would have been taxable upon distribution is taxable (almost always as ordinary income);
3. Unless the taxpayer elects otherwise, 50 percent of the income from a 2010 conversion or rollover to a Roth IRA is included in income in both 2011 and 2012 (if an election is made otherwise, the income is recognized in 2010);
4. A taxpayer can elect otherwise under No. 2 above by the due date (including extensions) of his 2010 income tax return;
5. ''Except as provided by the Secretary'' (of the Treasury), a rollover or conversion in 2010 can be ''undone'' by the due date (including extensions) of the 2010 income tax return of the taxpayer;
6. A taxpayer can receive an automatic extension of six months from his ordinary filing due date of April 15 (meaning a 2010 Roth conversion could be undone as late as Oct. 15, 2011);
7. A Roth conversion is not subject to the 10 percent penalty of Internal Revenue Code Section 72(t);
8. Minimum distributions following attainment of age 70½ are not required with respect to a Roth IRA;
9. An amount must be potentially distributable to be rolled over to any IRA (including a Roth IRA), and in-service distributions are generally prohibited from tax-qualified plans;
10. Payment of an expense, including a tax liability, reduces a potentially taxable estate; and
11. Taxable distributions from an IRA or tax-qualified plan can make Social Security benefits taxable (or increase taxability thereof).

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What Is Easy

It is relatively easy to:

- determine whether a tax-qualified plan benefit or IRA exists that could be converted to a Roth IRA,
- determine the taxpayer's historical tax burden and current tax burden relative to other individual taxpayers,
- contact an IRA provider and set up a Roth rollover or conversion, and
- file an extension of the due date for Form 1040 for 2010 if a rollover or conversion is done.

What Is Hard

The following uncertainties make the Roth conversion issue hard:

- future tax rates and the future tax system,
- whether Roth benefits will continue not to be subject to income tax and whether the current system of taxation of employee benefits and IRAs will remain in place (or substantially in place),
- whether the Treasury Department has the power to and will limit a taxpayer's ability to undo a Roth conversion by the due date of the taxpayer's income tax return (plus extensions), and
- whether restrictions exist on an employer's ability to amend a tax-qualified plan to add an in-service distribution feature.

Of the foregoing uncertainties, the greatest concerns are the first two concerns. They are discussed in detail below.

It is hoped the tax system for 2011 and 2012 will be known by Oct. 15, 2011. However, it may not be known by then. Consider that in mid-December 2009 the law provides there will be no estate tax in 2010. Virtually everyone expects the estate tax to continue after 2009 is some form. Many people expect income tax rates to increase in 2011, at least with respect to the highest-income taxpayers. For high-income taxpayers, if the 2011 tax system is not known by the filing date of their 2010 return, electing to include the entire conversion amount in income in 2010 has little downside.

Little legislative history exists concerning the statutory language pertinent to the third uncertainty. Based on the language of the Internal Revenue Code, the Treasury Department's power is unlimited. However, the language has existed since 1998, and the Treasury Department has not acted to restrict taxpayers' ability to undo. Regulations exist that specify how to recharacterize, and nothing therein would restrict recharacterization under ordinary circumstances. Thus, it seems little risk exists.

Concerning the fourth uncertainty, generally, in-service distributions are not permitted with respect to pension plans and 401(k) elective deferral accounts of 401(k) plans, but they may be permissible with respect to matching contribution accounts and profit sharing accounts of most participants (or perhaps all participants) of 401(k) or 401(k)/profit sharing plans if the plan so provides. Discrimination rules might impact an employer's ability to amend a plan to provide in-service distributions.

Future Tax Rates and the Future Tax Burden

Historical Tax Burden

According to the Congressional Budget Office (CBO), since 1980, federal taxes as a percentage of gross domestic product (GDP) have ranged from a low of 16.3 percent in 2004 to a high of 20.9 percent in 2000. The average over the past 40 years has been 18.3 percent of GDP. According to the Tax Policy Center, the figure for 2008 was 17.7 percent.

From 1934 to 1942, the total did not exceed 7.6 percent. From 1942 to 1944, the percentage increased from 10.1 percent in 1942 to 20.9 percent in 1944. By 1949, the percentage dropped to 14.5 percent. The 16.3 percent figure for 2004 was the low going back to 1959, when the percentage was 16.2 percent.

During the 1950s, the low was 14.4 percent (1950) and the high was 19 percent (1952). From 1960 through 1999, the percentage remained between 17 percent and 20 percent.

Accordingly, over the past 49 years, with the exception of a few years at the beginning of this decade, the tax burden as a percent of GDP has remained within a relatively constant small range.

Future Tax Burden

For the past several years, the U.S. Government Accountability Office (GAO), the audit arm of the federal government, has been telling anyone willing to listen that federal fiscal policy (i.e. taxes and spending) must change tremendously.

In 2007, the GAO reported that the sum of existing debt plus the present value of the "unfunded liabilities" for Medicare and Social Security (i.e. liabilities for which there is no adequate future dedicated tax source) over the next 75 years equaled $52.7 trillion. This figure has grown. According to the 2009 Social Security and Medicare trustees report, the present value of the unfunded liabilities of Social Security and Medicare are, respectively, $17.5 trillion and $89.3 trillion.

The GAO produced the present value of the liabilities by discounting (i.e. reverse compounding) the liabilities at a rate of 5.7 percent per year.

As of Sept. 30, 2009, the net worth of all Americans combined was $53.4 trillion.

The foregoing liabilities analyzed by the GAO do not consider Medicaid, national defense, or any ordinary government functions, such as the federal justice system. Infrastructure needs, which are significant, are not considered. Practically, what this means is the U.S. is insolvent on a present value basis. Under current federal spending policy, in order for the country to persevere without tremendously increased immigration of people who can be taxed substantially, the federal government will need to consume all currently existing wealth and future earnings thereon, plus a substantial portion of future wealth.

The GAO liability figures take all sorts of pertinent actuarial factors into account, including anticipated immigration, increased longevity, and anticipated growth of the economy. In a sense, the liability figures are optimistic because they assume health care costs will grow at a rate of anticipated GDP per capita growth plus 1 percent, whereas over the past several decades, health care costs have grown at the GDP per capita rate plus 2.5 percent.

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Prior to the $800-plus billion Troubled Asset Relief Program (TARP), the $787 billion American Recovery and Reinvestment Act (ARRA) and the deficit of approximately $1.4 trillion for the fiscal year ended Sept. 30, 2009 (on approximately $2.1 trillion of revenue), the GAO termed fiscal policy as ''unsustainable,'' and said, ''GAO's long-term simulations continue to show ever larger deficits resulting in a federal debt burden that ultimately spirals out of control.'' The deficit for the current fiscal year is estimated at $1.5 trillion.

Consistent with the foregoing conclusions, *The Economist* magazine reported in its Feb. 28-March 6, 2009, edition that, using reasonable policy assumptions, economists Bill Gale of the Brookings Institution and Alan Auerbach of the University of California at Berkeley recently concluded regarding the Obama administration's spending plans that ''higher taxes or lower spending equal to a staggering 8% of GDP a year are necessary to contain those costs and stabilize the long-run debt.'' For 2008, GDP was $14.2 trillion. Eight percent thereof is $1.136 trillion—which equates to 38 percent of federal spending for the fiscal year ended Sept. 30, 2008.

On Jan. 18, 2007, David M. Walker, then comptroller general of the United States (head of the GAO), said to the U.S. Senate Budget Committee:

> We are on an imprudent and unsustainable long-term fiscal path, and while the short-term fiscal deficits have improved in recent years, the long term is getting worse every second of every minute of every day and the time for action is now.

On the same day to the same committee, Federal Reserve Board Chairman Ben Bernanke said we needed to start fixing these problems 10 years ago.

Regarding Social Security and Medicare, in an Oct. 30, 2008, article by Walker titled *Call This a Crisis? Just Wait*, he said, ''The costs of these programs start to threaten our solvency in the next several years.''

The anticipated growth of health care costs is a very large piece of the problem. On July 9, 2007, the CBO reported that if health care costs continue to grow at the rate that they have over the past four decades (i.e. GDP per capita plus 2.5 percent), and raising tax rates will be the only solution to the problem, then by 2050 the income tax rates will need to increase from 10 percent for the lowest bracket, 25 percent for the middle bracket, and 35 percent for the highest bracket to 26 percent, 66 percent, and 92 percent, respectively.

Clearly, for both public and private health care, cost increases must be significantly curtailed. However, even if this need is accomplished, substantial other changes will be needed. Medicare is the primary driver—too many people (baby boomers) living too long with health care cost increases regularly exceeding the rate of inflation. The health care bills being considered by Congress in early December 2009 would do little to address these problems.

Money printing aside, if nothing will be done to substantially curtail the growth of health care costs, the only means of dealing with these problems are increased taxes, increased debt, increased immigration, and decreased government. With total debt now approximately $12 trillion and the debt owed to the public now exceeding $7.5 trillion (and anticipated to grow substantially very soon), low interest rates can continue for only so long. Given the magnitude of the liability figures, the increases and decreases (of whatever combination) will need to be very significant.

Concerning substantially increasing immigration of people who would produce a lot of tax revenue, unless the immigrants and their offspring would reproduce at a much greater rate than 1-to-1 and the economy grew correspondingly, the need for a pyramid scheme would be created (or exacerbated), thus necessitating even greater immigration in the future. Because of the progressivity of Social Security and the standard benefits structure of Medicare, adding lower-income workers only creates a much larger mess for the future.

On Aug. 25, 2009, White House and congressional reports were issued that estimate $9 trillion more debt over the next decade. In August 2009, CBO reported:

> Debt held by the public is projected to exceed 61 percent of GDP by the end of next year, which is the highest level since 1952, and reach 68 percent by the end of 2019. That accumulating federal debt, coupled with rising interest rates, would lead to a near tripling of net interest payments (relative to the size of the economy) between 2009 and 2019 . . . . Over the long term (beyond the 10-year baseline projection period), the budget remains on an unsustainable path. Unless changes are made to current policies, the nation will face a growing demand for budgetary resources caused by rising health care costs and the aging of the population. Continued large deficits and the resulting increases in federal debt over time would reduce long-term economic growth by lowering national saving and investment relative to what would otherwise occur, causing productivity and wage growth to gradually slow.
>
> Last year, outlays for Social Security, Medicare, and Medicaid combined accounted for about 9 percent of GDP. Outstripping the growth of GDP, spending for those programs is expected to rise rapidly over the next 10 years, totaling nearly 12 percent of GDP by 2019. Under long-term projections recently published by CBO, such spending would continue to rise under current laws and policies and could total 17 percent of GDP by 2035.

More bad news from the GAO: State and local governments face similar challenges. (Their pension plans and post-retiree medical plans are not subject to the funding requirements of federal law applicable to private employer plans.)

Historically, at least since the advent of World War II, government has generally only grown relative to the size of the economy. For example, from 2001-2006, with the Republican Party (generally considered the major party seeking less government) completely in power, government spending grew approximately 7 percent per year (on average), while the economy averaged growth of approximately 3 percent per year. The only logical conclusion is that, unless there is a dramatic change in direction in the United States in terms of the services and entitlements provided by the federal government, substantial tax increases are inevitable.

Nature of the Future Tax System

Generally, user fees and excise taxes aside, there are four common tax types:

- income tax,
- sales and use or value-added tax,
- property tax, and
- transfer tax (e.g. estate and gift tax).

The U.S. government is drawing the vast majority of its revenues from income taxes (including the Social Security and Medicare taxes).

If it is as it has been since the income tax system was enacted in 1913, i.e. that an income tax system but not a sales tax or value-added tax (VAT) will exist in the future, and entitlements will not be cut significantly, then, given the financial problems, it is highly likely that income tax rates will increase substantially in the future. In that case, if the increase was applied to all income levels pro rata, then there is a very good chance that the majority of people would benefit from a Roth conversion.

For comparative analysis purposes, adjusted for inflation by the consumer price index (CPI), the 1954 federal income tax rate on taxable income in excess of $61,345 was 34 percent. Adjusted for inflation, the 1954 income tax rate on taxable income in excess of $122,686 was 50 percent. Looking back, since 1954 and prior to 1981, adjusted for inflation, the rates system (which changed often) was typically much more like the 1954 code rates system than today's system. (Today, the highest rate is 35 percent.) Because the current maximum corporate income tax rate is relatively high, it is unlikely much revenue would be sought from the corporate income tax.

In contrast, if entitlements will not be cut substantially, and a sales tax or a VAT will be implemented in addition to the income tax, then the value of the Roth conversion could turn on the amount of the sales tax or VAT (i.e. the higher the sales tax or VAT rate, the lower the income tax rates would need to be, and the less likely it is that a Roth conversion is a good choice). In this regard, a 2000 memo of the chief of staff of the Joint Committee on Taxation concerning the proposed "Fair Tax" revenue-neutral rate said that studies from other jurisdictions show that the evasion rate becomes substantial when a sales tax rate exceeds 10 percent.

If entitlements will be cut substantially, would the current tax system remain essentially the same as it is today? If so, few people would benefit from a Roth conversion.

Concerning the possibility of a sales tax or a VAT to supplement the income tax, a major fight can be anticipated if and when such a proposal is first raised. Concerning a sales tax, the chief counsel of the Joint Committee on Taxation stated in her 2000 memorandum that the "revenue neutral" rate would need to be 59.5 percent for the first five years after enactment, if the tax replaced current income, payroll, and estate and gift taxes.

Similarly, the President's Advisory Panel on Federal Tax Reform said that, simply to replace the income tax, a national sales tax that provided a cash grant to everyone in order to provide relief for lower-income persons would need to have a rate of at least 34 percent. The income tax currently produces between 40 percent to 50 percent of the federal government's revenue. This means that, even at a rate of 10 percent, a sales tax would increase federal revenue by only 10 percent to 20 percent. If entitlements will not be cut substantially, future tax revenue would not be enough to hold income tax rates constant. Rather, income tax rates will need to increase.

This means that, assuming the federal government and entitlements will not be cut substantially, and a VAT will not be added but a sales tax that does not exceed 10 percent will be added, it is likely that most upper-middle-income-and-above earners would benefit from a Roth 401(k) conversion.

In its 2005 report, the President's Advisory Panel on Federal Tax Reform considered a VAT as possible replacement for part of the income tax. The panel did not reach a consensus with respect to the VAT, but deemed it to be "worthy of further consideration." The Panel's discussion noted, "The VAT has been adopted by every major developed economy except the United States." VAT rates from various countries around the world are as follows:

Argentina	21%
Austria	20%
Brazil	17%
China	17%
Denmark	25%
Finland	22%
France	19.6%
Germany	19%
Italy	20%
Norway	25%
Russia	18%

Japan maintains a 5 percent sales tax. All of these countries have an income tax (often, similar to the U.S. system) in addition to their VAT (or sales tax).

To replace current revenue, the panel determined that a 15 percent tax-inclusive VAT (17.6 percent, on a tax-exclusive basis) coupled with a simplified income tax system with a maximum rate of 15 percent, would currently (i.e. in 2005) work. The panel noted that to provide the progressiveness of the current system, lower-income and middle-class individuals and families would need to receive tax credits.

The panel rejected the creation of a VAT to replace part of the income tax. Included in its reasoning is the following passage:

> The Partial Replacement VAT proposal would add a major new federal tax without eliminating any existing taxes from the federal system. One important factor in the Panel's decision not to recommend the Partial Replacement VAT proposal was several Panel members' concern about how introducing a supplemental VAT might affect the size of the federal government in the medium or long run. These Panel members were concerned that adding a VAT on to the current income tax structure could, over time, lead to growth of federal outlays as a share of GDP—as the tax rate of the Partial Replacement VAT could rise, or corporate and individual income tax rates could return to their present levels. The Panel members who were concerned about this possibility viewed growth in the government's share of the economy as undesirable. Other Panel members were not concerned about this possibility, either because they were more confident that Congress would use the VAT only to offset existing taxes, or because they believed that allowing some growth in tax revenues as a share of GDP would offer a means to finance the growing cost of entitlement programs.

The last sentence provides information that is pertinent to the Roth conversion.

Because a VAT would carry less evasion than a sales tax, it is a more likely alternative than a sales tax. If a VAT would be implemented in the future, and entitlements and government in general will not be cut substantially in the future, the question then becomes how much would the future VAT rate and/or income tax rates increase to pay for the government's spending

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needs? Concerning permanency and rate increase potential, the panel said:

> Some members of the Panel who opposed a Partial Replacement VAT suggested that once a VAT was enacted, it would never be repealed. International experience suggests that few countries retreat from a VAT, and that VAT rates generally do not decline. These Panel members were unwilling to support the Partial Replacement VAT proposal given the lack of conclusive empirical evidence on the impact of a VAT on the growth of government.

Given the size of the U.S. economy, a 15 percent VAT, such as that considered by the President's Advisory Panel on Federal Tax Reform, would produce a lot of revenue. But consider that federal taxes typically comprise about 16 percent to 20 percent of GDP. Then consider the anticipated entitlement spending, assuming no cuts in entitlements. By 2040, entitlements alone are anticipated to comprise of approximately 18 percent of GDP.

Then consider all of the ordinary costs of the federal government, including national defense. These non-entitlement costs currently substantially exceed the costs of entitlements. For the 2004 fiscal year, entitlement spending was 36 percent of federal spending and non-entitlement spending was 64 percent of federal spending. Thus, non-entitlement spending amounted to 10.4 percent of GDP. Adding 18 percent and 10.4 percent produces 28.4 percent.

Will Benefits Be Tax-Free Indefinitely?

Will the promise of tax-free Roth benefits be kept? Consider such a previous promise with respect to Social Security benefits.

Given the large number of retirees in the future and the tremendous amount of taxable distributions from various types of qualified plans and IRAs, query whether political pressure will exist to reduce the income tax rate on ordinary distributions? At one point, the capital gains rate applied to distributions. (Some distributions remain potentially subject to the capital gains rate.) If the tax rate on retirement distributions will be less than the rate applied to non-retirement income, will the difference be enough to make a Roth election a bad choice (in hindsight)? Alternatively, traditional IRA/qualified benefits in excess of certain amounts may be subject to additional taxes.

Means testing is now applied with respect to Medicare Part B premiums. Perhaps means testing will be applied in the future with respect to Roth benefits to make some (or perhaps all) benefits taxable with respect to some taxpayers.

If a VAT is added or the tax system is changed substantially to make prior Roth conversions and Roth 401(k) elections detrimental, would some sort of relief be granted by Congress to alleviate the tax detriment, at least to some degree? The answer to such a question might turn on how many people have made such a conversion or how many people have made a Roth conversion and/or a significant Roth 401(k) investment. Politicians tend to pay attention to numbers, particularly numbers of people who vote. The tendency of people to procrastinate and the tendency of people to defer taxes could make the converters a relatively small group.

The financial problems of the federal government very likely will hurt the U.S. economy. There has been a tremendous shift in recent years toward defined contribution plans and away from defined benefit plans. This shift puts pressure on defined contribution accounts (which are often participant-directed) to earn solid investment returns in order for the participant's retirement income to be sufficient. If the U.S. economy is hurt, then stock market returns of domestic companies will be hurt as well.

Politicians tend to pay attention to numbers, particularly numbers of people who vote. The tendency of people to procrastinate and the tendency of people to defer taxes could make the converters a relatively small group.

It is unlikely that those unknowns—i.e. the amount by which entitlements will be reduced in the future (if any), the future income tax rates, and the future tax system—will become known in the foreseeable future. It is hoped the Roth conversion gains the certainty of no additional taxes on the amount contributed or its earnings with the realization that, in hindsight, the election could be a bad choice.

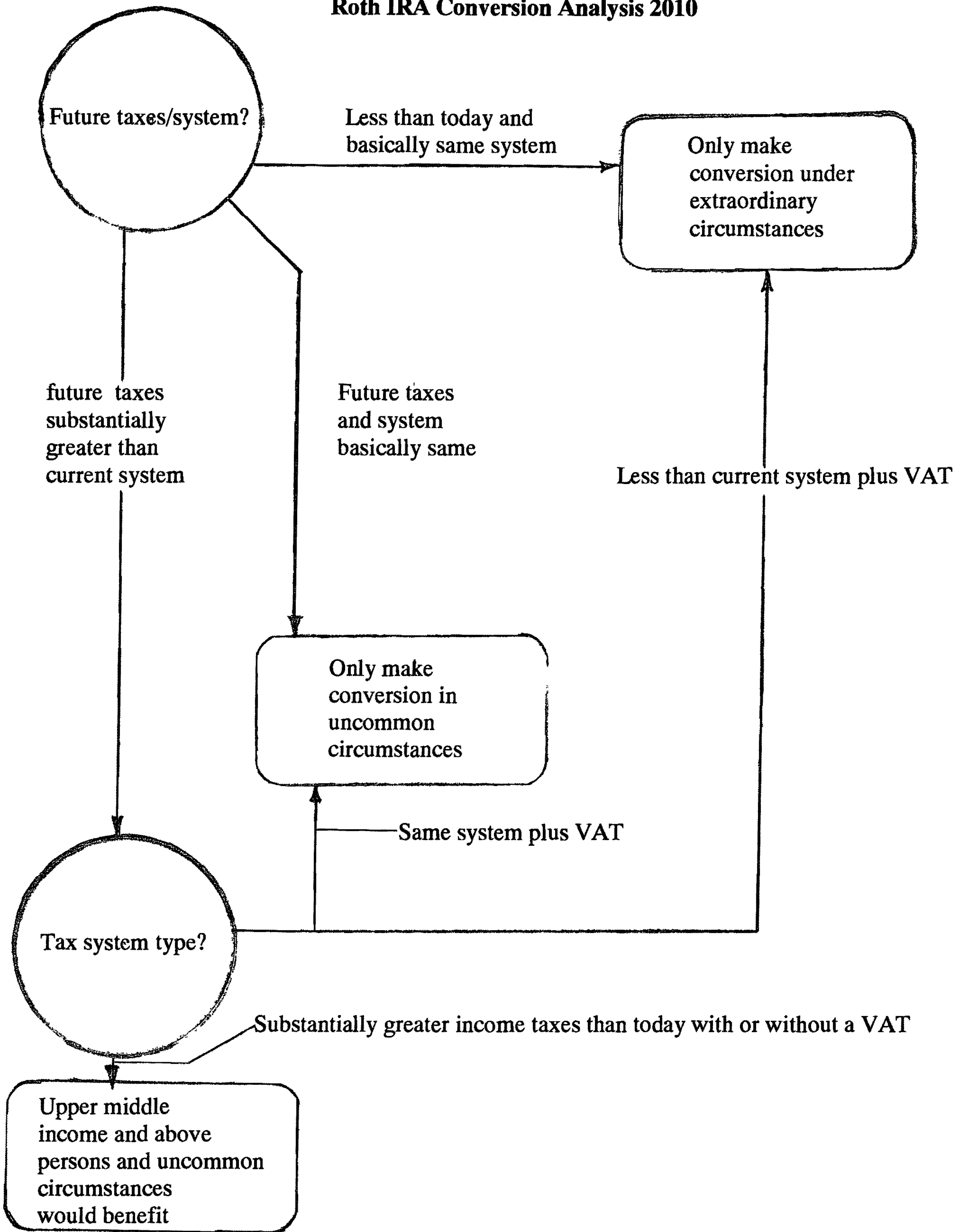
Query whether the federal financial situation will get so bad that the federal government will attempt to tax all retirement benefits, including Roth benefits, in some substantial additional manner? Query could something worse happen, thus making a prior utilization of assets to fund an elective tax an imprudent act (in hindsight)?

The flow chart that follows may be of help to persons who can decide what they anticipate with respect to future taxes and the future tax system. For purposes of the chart, extraordinary circumstances would include an expiring net operating loss (NOL) situation and a little or no income situation when substantial income is anticipated for many years in the future (e.g. a medical intern). It might also include a temporary unemployment situation that results in a tremendous dent in income. Uncommon circumstances would include extraordinary circumstances and less uncommon situations, such as unemployment for a substantial part of the year by a person who expects to make substantial income for many years to come.

A person's age could be relevant to the foregoing analysis. Someone close to age 65 (or older than 65) might be reasonable in believing that any significant tax increases will be distant enough in the future not to affect him in a significant manner. It would be more difficult for a younger person to have such a reasonable belief.

Estate Tax Reduction

A benefit of a Roth conversion is payment of the tax liability would reduce a person's net worth, thereby potentially reducing estate tax liability. If the estate tax will be retained in present form after 2009, each dollar of tax payment with respect to a Roth IRA would save 45 cents, resulting in a net cost of 55 cents, or 55 percent of the tax paid. The Roth account would then be tax-free for income tax purposes (it is hoped indefi-



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nitely), and beneficiaries could receive distributions tax-free, potentially over many years.

In performing an analysis, the income tax deduction under Internal Revenue Code Section 691(c) for the portion of the estate tax attributable to income in respect of a decedent would also need to be taken into account.

For example, a payment of $100,000 of income tax from non-IRA assets on a $250,000 Roth conversion would reduce a taxpayer's net worth by $100,000. If the taxpayer had a taxable estate of $5 million (which would have been $5.1 million without the tax payment) and died soon after the conversion, the beneficiaries would receive $55,000 less due to the payment. Thus, the true tax cost of the conversion would be $55,000 plus the value of the foregone income tax deduction under Section 691(c) instead of $100,000. The beneficiaries could then receive benefits free of tax from the Roth IRA.

An analysis could be undertaken of the present value of anticipated tax-free benefits versus taxable benefits, with $55,000 plus the value of the foregone Section 691(c) deduction being an addition to the cost of the tax-free Roth benefits. (If it is likely the beneficiaries would be subject to estate tax, it might be appropriate to take the Roth implications thereof into account.)

Practical Considerations

Assuming the ability to reverse (undo) a Roth conversion will not be limited by the U.S. Treasury Department, for those who feel a conversion is in their best interest, little risk exists in converting at any time in 2010. If the assets depreciate after the conversion, the conversion could be undone by the due date of the 2010 return (including an extension). Obviously, a taxpayer would prefer to pick the low point in terms of value for a particular asset or group of assets to be converted.

Less than all of an IRA or qualified plan benefits could be converted. It may be prudent to convert just enough assets to keep taxable income below a particular tax rate bracket. In that case, the ability to undo a conversion (assuming that right is not detrimentally limited by U.S. Treasury action) makes converting a larger amount than necessary prudent, since the excess amount could be recharacterized. Any earnings would need to be recharacterized as well. Given the potential need for tracing, if a Roth IRA already exists, it would be best to set up a new Roth IRA to accept converted funds. Assuming the Roth conversion option will remain, it might be best to do conversions over a number of years, thereby keeping income in relatively low brackets for all years.

Generally, any amount distributed from a Roth IRA to fund a first home purchase or following death, disability, or attainment of age 59½ is tax-free. However, if a distribution is taken from a Roth IRA within the five-year period beginning on the first day of the first year in which an amount is contributed or rolled over to any Roth IRA by the taxpayer, income recognition is required to the extent the amount distributed exceeds the amounts contributed and converted (or rolled over). If Roth contributions exist in the IRA (in addition to the converted amount), distributions are sourced first from contributions, then from converted amounts, and then from earnings.

If a distribution is taken from a Roth IRA within the five-year period beginning on the first day of the first year in which an amount is contributed or rolled over to any Roth IRA by the taxpayer, income recognition is required to the extent the amount distributed exceeds the amounts contributed and converted (or rolled over).

Under Treasury Regulations Section 1.408A-5, Q&A 9, a taxpayer who makes a Roth conversion followed by a recharacterization may not make another Roth conversion until the later of the taxable year following the taxable year of the Roth conversion or, if later, 30 days after the recharacterization. This rule would prevent a conversion, followed by a recharacterization and then followed by another Roth conversion in the same year. (Someone might wish to undo a conversion if the value of the asset converted decreased following the initial conversion.) However, a Roth conversion can follow a rollover to a traditional IRA within the same taxable year.

Subject to the IRA exceptions to the 10 percent penalty of code Section 72(t) (including the age 59½ exception), if a distribution is made from a converted Roth IRA within the five-year period beginning on the first day of the first taxable year that includes the conversion (or rollover), then the penalty applies to the distribution to the extent the distribution is allocable to the amount converted (or rolled over). The amount subject to the penalty is limited to the amount included in income due to the conversion/rollover. This rule applies separately to each conversion. Also, subject to the ordinary IRA exceptions, any distribution included in income is subject to the penalty. (Note: An argument could be made that Section 72(t) does not apply to a distribution included in income.)

If income is spread 50/50 between 2011 and 2012 with respect to a fully taxable conversion and an amount is distributed from the Roth IRA in 2010 or 2011, then the amount distributed is included in income in the year of distribution from the Roth IRA. In addition, for 2011 and 2012 (respectively), the lesser of half of the total amount to be taken into income due to the conversion or the total amount of income from the conversion not yet taken into income is included in income.

An individual can create more than one Roth IRA. A possible strategy would be to set up numerous Roth IRAs and transfer different assets to the various Roth IRAs. By the due date of the 2010 income tax return, the individual might choose to keep the Roth election with respect to Roth IRAs that have appreciated substantially and undo the election with respect to assets that have depreciated.

Adding a Roth IRA to a taxpayer's portfolio would add tax diversification. People attempt to diversify investments. A Roth IRA would diversify taxes. Diversification might be helpful in retirement years to match

large medical expense years with traditional IRA distributions, while taking Roth IRA distributions in other years.

Conversion would not make sense if IRA or tax-qualified plan assets will definitely be left to charity.

The Future

As this article is written, there is talk in Congress of eliminating or reducing availability of the conversion option. A concern apparently exists that some employers will terminate 401(k) plans to grant employees access to elective deferral accounts for rollovers to Roth IRAs. Perhaps a conversion option will be granted with respect to 401(k) accounts to deal with this perceived problem. It seems unlikely that the option will be taken away for 2010.

While it is instinctively best to defer tax, the financial condition of the country may make following instinct imprudent. The bottom line to a participant is that a Roth conversion is essentially a gamble based on future unknowns. Hindsight can be 20/20 for those who wish to look back.

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