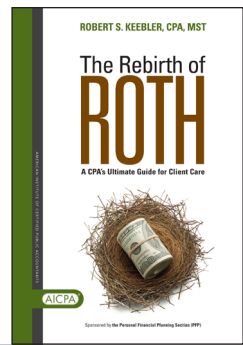




2010 Update



The Rebirth of **ROTH**

A CPA's Ultimate Guide for Client Care

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The Small Business Jobs Act of 2010 (SBJA) (P.L. 111-240) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act) (P.L. 111-312) made several changes that affect planning for Roth individual retirement accounts (IRAs). The SBJA, for example, created the opportunity for in-plan conversions to Roth accounts, and the Tax Relief Act extended the ability to make direct IRA contributions to charities through 2012. This document highlights the changes made by the SBJA and the Tax Relief Act that have application to Roth IRAs and *The Rebirth of Roth: A CPA's Ultimate Guide for Client Care* (2009 edition).¹

Conversion Eligibility Limitations

First and foremost, the elimination of the \$100,000 income limitation and filing requirements for Roth conversion eligibility (discussed in chapters 1 and 2 of *Rebirth*) is now in full effect beginning in 2010. This opened a new door of opportunity for those interested in the Roth IRA who were previously unable to take advantage of Roth conversions because their modified adjusted gross income (AGI) was too high or because they were married and filing separately.

Income Limitation for Contributions

Chapter 1 of *Rebirth* discusses the annual contribution limits to Roth IRAs. While the contribution limit remains at \$5,000 in 2011 (\$6,000 for taxpayers age 50 or older), the AGI phase out amount has changed. For 2011, the maximum contribution that can be made to a Roth IRA is phased out for single taxpayers with AGI between \$107,000 and \$122,000 and for joint filers with an AGI between \$169,000 and \$179,000.² If the taxpayer is a joint-return filer covered by an employer plan, the maximum contribution that can be made to a Roth IRA is phased out between \$90,000 and \$111,000 for joint filers and between \$56,000 and \$66,000 for single or head-of-household filers. For a married person filing separately, the phase-out range is between \$0 and \$10,000.

Individual Income Tax Rates

Before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the individual income tax brackets were set at 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent. EGTRRA created a new 10 percent tax bracket and reduced the top four tax brackets to 25 percent, 28 percent, 33 percent, and 35 percent. These reduced rates, however, were set up to expire after December 31, 2010. The Tax Relief Act delayed the expiration of these rates until December 31, 2012.

¹ This update has been prepared by Michelle L. Ward, JD, CSEP.

² Internal Revenue Code (IRC) Section 408A(c)(3). Notice 2010-78, 2010-49 IRB 808.

The rates for taxable year 2011 are:³

Tax Rate	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10%	\$0–\$8,500	\$0–\$17,000	\$0–\$8,500	\$0–\$12,150
15%	\$8,501–\$34,500	\$17,001–\$69,000	\$8,501–\$34,500	\$12,151–\$46,250
25%	\$34,501–\$83,600	\$69,001–\$139,350	\$34,501–\$69,675	\$46,251–\$119,400
28%	\$83,601–\$174,400	\$139,351–\$212,300	\$69,676–\$106,150	\$119,401–\$193,350
33%	\$174,401–\$379,150	\$212,301–\$379,150	\$106,151–\$189,575	\$193,351–\$379,150
35%	\$379,151 and above	\$379,151 and above	\$189,575 and above	\$379,151 and above

With the top tax rates potentially increasing on January 1, 2013, when the current rates expire, Roth conversions will continue to be a very powerful planning strategy. If the top tax rate increases from 35 percent to 39.6 percent, for example, a taxpayer currently in the 35 percent tax bracket with a \$1,000,000 IRA would save \$46,000 on the conversion (see chapters 2 and 5 of *Rebirth* for further discussion on how higher future tax rates make a Roth IRA advantageous).

Tax-Free Distributions From IRAs for Charitable Purposes

As discussed in more detail in chapter 2 of *Rebirth*, the Pension Protection Act of 2006 permitted taxpayers to make direct IRA distributions to charity without having to include the distribution in gross income. In particular, the law allowed up to \$100,000 to be contributed each year directly to charity.⁴ Before the Tax Relief Act, however, such tax-free charitable IRA distributions were only permitted from 2006 to 2009. The Tax Relief Act expanded the availability of this provision to tax years 2010 through 2012. The Tax Relief Act also contains a special rule permitting taxpayers to elect to have qualified charitable distributions made in January 2011 treated as having been made on December 31, 2010, for purposes of Internal Revenue Code (IRC) sections 408(a)(6), 408(b)(3), and 408(d)(8). Thus, a qualified charitable distribution made in January 2011 is permitted to be (1) treated as made in the taxpayer's 2010 taxable year and thus permitted to count against the 2010 \$100,000 limitation on the exclusion and (2) treated as made in the 2010 calendar year and thus permitted to be used to satisfy the taxpayer's minimum distribution requirement for 2010.

³ Rev. Proc. 2011-12, 2011-2 IRB.

⁴ As described in IRC Section 170(b)(1)(A).

Conversion of Qualified Retirement Plans to Roth 401(k) Plans

The SBJA allows the conversion of 401(k), 403(b), and governmental 457(b) plans to Roth accounts. Absent an election to the contrary, income will be recognized equally over a period of two years (2011 and 2012) when the conversion occurs in 2010. On November 29, 2010, the IRS released guidance relating to rollovers from 401(k) and 403(b) plans to designated Roth accounts within the same plan, an option added by the SBJA.

The rollover from the qualified plan to the Roth account may be accomplished by a direct rollover or by a distribution of funds to the individual who then rolls over the funds into his or her designated Roth account in the plan within 60 days.

Any vested amount held in a plan account for a plan participant (other than an amount held in a designated Roth account) is eligible for an in-plan Roth rollover to a designated Roth account in the same plan. However, note the following:

- An amount is not eligible for an in-plan Roth rollover unless it satisfies the rules for distribution under the IRC and is an eligible rollover distribution as defined in IRC Section 402(c)(4). Thus, in the case of a IRC Section 401(k) plan participant who has not had a severance from employment, an in-plan Roth rollover from the participant's pretax elective deferral account is permitted to be made only if the participant has reached age 59½, has died or become disabled, or receives a qualified reservist distribution. As an example, if the client is age 48 and fully vested, he or she can only convert the employer match. If a taxpayer is separated from service, an in-plan rollover would be allowed regardless of age.
- An amount is eligible for an in-plan Roth rollover only if the plan provides for such rollovers (taking into account the allowance for retroactive amendments for this purpose).

Generally, the taxable amount of a distribution that an individual rolls over in an in-plan Roth rollover is includible in gross income in the taxable year in which the distribution occurs. For distributions made in 2010, however, that are rolled over in an in-plan Roth rollover, the taxable amount is includible in gross income half in 2011 and half in 2012 unless the individual elects to include the taxable amount in gross income in 2010 (or unless the acceleration rules discussed in the next paragraph applies). An individual's election of 2010 income inclusion may not be changed after the due date (including extensions) for filing the individual's 2010 income tax return. The election applies to all of an individual's 2010 distributions that are rolled over in an in-plan Roth rollover. The election is independent of any election made with respect to qualified rollover contributions to a Roth IRA from either a non-Roth IRA or a plan account other than a designated Roth account.

If the participant receives a distribution of an amount in 2010 or 2011 allocable to the taxable amount of a 2010 in-plan Roth rollover that would otherwise not be includible in gross income until 2011 and 2012, then the participant's gross income for the year of the distribution is increased by the amount of the distribution that would otherwise not be includible in gross

income until a later year. In such a case, the amount that would otherwise be includible in the participant's gross income in 2012 is reduced by the income accelerated. Also, if the distribution is made in 2010, the amount that would otherwise be includible in the participant's gross income in 2011 is reduced by the amount the income accelerated to 2010 exceeds the amount that would otherwise be includible in income in 2012.

Example

If a participant makes an in-plan Roth rollover in 2010 with the taxable amount of the rollover, \$8,000, being deferred to 2011 and 2012 and then takes a distribution in 2010 or 2011 from the designated Roth account that consists of \$5,000 allocable to the taxable amount of the 2010 in-plan Roth rollover, then the participant's gross income for the year of the distribution must be increased by the taxable amount of the rollover that would otherwise be deferred to a later year. If this distribution occurred in 2010, the \$5,000 is included in the participant's 2010 gross income, and the remaining taxable amount of the 2010 in-plan Roth rollover, \$3,000, is included in the participant's 2011 gross income. If this distribution occurred in 2011, then all \$8,000 would be includible in 2011 income—none in 2012.

Example

Same facts as in the previous example except the participant then takes a distribution in 2010 or 2011 from the designated Roth account that consists of \$3,000 allocable to the taxable amount of the 2010 in-plan Roth rollover. If this distribution occurred in 2010, the \$3,000 is included in the participant's 2010 gross income, \$4,000 is included in the participant's 2011 gross income, and the remaining \$1,000 is includible in 2012. If this distribution occurred in 2011, then \$7,000 would be includible in 2011 income, and the remaining \$1,000 would be includible in 2012.

While this acceleration rule does not apply to a distribution that is rolled over to another designated Roth account of the participant or to a Roth IRA owned by the participant, it does apply to subsequent distributions made from such other designated Roth account or Roth IRA in 2010 or 2011.

If an individual who is using the two-year spread dies before the full taxable conversion amount has been included in gross income, then the remainder must be included in the individual's gross income for the taxable year that includes the date of death. However, if the sole beneficiary of all the decedent's Roth IRAs is the decedent's spouse, then the spouse can elect to continue the two-year spread.

If an amount allocable to the taxable amount of an in-plan Roth rollover is distributed within the five-taxable-year period beginning with the first day of the participant's taxable year in which the rollover was made, the amount distributed is treated as includible in gross

income for the purpose of applying the 10 percent early distribution penalty.

An in-plan Roth rollover can be elected by a beneficiary only if he or she is a surviving spouse and by an alternate payee only if he or she is a spouse or former spouse.

Keeping the retirement funds in a Roth 401(k) rather than converting to a Roth IRA can be beneficial from an asset protection standpoint. When an individual moves funds from a qualified plan to an IRA, they leave the asset protection safe haven of a plan protected by the Employee Retirement Income Security Act (ERISA). In some states, the individual may still have creditor protection; however, in other states, the protection may be diminished. In bankruptcy, an individual is generally able to protect at least \$1,000,000 of IRAs and often times an unlimited amount if the rollover can be traced to an ERISA plan.

It is also important to note that, that unlike an IRA to Roth IRA conversion, the SBJA does not provide for a recharacterization (recharacterizations are discussed in more detail in chapters 1, 4, and 6 of *Rebirth*). In limited circumstances, when the account is invested in bonds or perhaps real estate, a Roth conversion may still make sense. However without the recharacterization provision, there is no “escape” from a Roth conversion gone awry. If tax rates increase substantially, if the securities market(s) fall, or if a client’s income changes dramatically, there is no avoiding paying a hefty conversion tax.

Example

Tim, age 60, converts \$200,000 from his 401(k) to a Roth 401(k). The account later falls to \$120,000, a decrease of 40 percent. It appears that a recharacterization is not available.

Example

Tim also converts a traditional IRA to a Roth IRA and the market falls 40 percent. In this situation, a recharacterization is available, and a prudent person would utilize this privilege.

Not having the ability to recharacterize makes an in-plan Roth rollover less attractive. A recharacterization allows ones to make a well-informed decision based on the benefit of hindsight if the value of the Roth assets declines in value. Despite the loss of this option, however, the benefit of keeping the assets in the plan wrapper is the added ERISA protection. Whether an in-plan Roth rollover outweighs the lost ability to recharacterize is something that each advisor will need to consider before moving forward with such a conversion.

Private Letter Ruling Filing Fees

A private letter ruling (PLR) request is a written submission to the IRS asking for a ruling regarding a specific tax matter. In relation to Roth IRAs, a PLR request might be needed to

resolve a problem with the Roth IRA, such as a late recharacterization, or to determine the applicable life expectancy factor after the death of the Roth IRA owner. Chapter 6 of *Rebirth* discusses the requirements for a PLR in more detail. Each year, the filing fee required by the IRS to submit a PLR is outlined in a revenue procedure. In 2011, under Revenue Procedure 2011-8,⁵ the IRS submission fees for a ruling request involving a Roth IRA are as follows:

- Reduced user fee for taxpayers with income below \$250,000—not available
- Substantially identical letter rulings—not available
- Request on Roth IRA recharacterization—\$4,000
- Standard letter ruling request—\$10,000

Estate Planning

Estate planning considerations for Roth IRAs are discussed thoroughly in chapter 9 of *Rebirth*. Prior to enactment of EGTRRA, the estate tax and generation-skipping transfer tax (GST) exemption amounts were \$1 million and the top tax rate was 55 percent. EGTRRA gradually increased the exemption amount and decreased the maximum tax rate until they reached \$3.5 million and 45 percent, respectively, in 2009. The gift tax exemption amount stayed at \$1 million. In 2010, the estate tax and GST tax were repealed, but they were to return in 2011 at their pre-EGTRRA levels (that is, \$1 million exemption and 55 percent maximum rate). The gift tax was left in place for 2010 and was also set to return in 2011 to pre-EGTRRA levels. The Tax Relief Act created a maximum estate and gift tax rate of 35 percent and an exclusion amount of \$5,000,000 for 2011 and 2012 (indexed for inflation in 2012). The GST tax exemption for decedents dying, or gifts made, after December 31, 2009, is equal to the applicable exclusion amount for estate tax purposes. These numbers are again set to return in 2013 to pre-EGTRRA levels.

Conclusion

The Roth IRA continues to be an exciting planning technique that will be used by both wealthy and middle-class families. Roth conversion planning is complex and advisors and CPAs must work together to determine which clients should convert and which clients should maintain their traditional IRAs. In an overgeneralization, the wealthier a person is, the greater the need to carefully study the Roth conversion question. Recent developments, including those discussed in this document, have made it necessary to reexamine our clients' existing Roth IRA planning. *The Rebirth of Roth: A CPA's Ultimate Guide for Client Care*, brings you, the planner, up to date and offers suggestions for planning in today's changed legal and economic environment.

⁵ 2011-1 IRB 237.

Other Books by Robert Keebler



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