Overview

• General concepts
• Taxation of Roth IRA conversions
• Taxation of Roth IRA distributions
• Mathematics of Roth IRA conversions
• Recharacterizations
• Estate tax considerations
• Other considerations
General Concepts
General Concepts

• 100% of growth is tax-exempt

• No required minimum distributions at age 70½
  
  − NOTE: Distributions from Roth IRAs cannot be used to fulfill the RMD from a traditional IRA

• RMDs on Inherited Roth IRAs
General Concepts

• Convertible accounts
  – Traditional IRAs
  – 401(k) plans
  – Profit sharing plans
  – 403(b) annuity plans
  – 457 plans
  – “Inherited” 401(k) plans (see Notice 2008-30)

• Non-convertible accounts
  – “Inherited” IRAs
  – Education IRAs
General Concepts

• Reasons for converting to a Roth IRA

  – Taxpayers have special favorable tax attributes including charitable deduction carry-forwards, investment tax credits, net operating losses (NOLs), high basis non-deductible traditional IRAs, etc.

  – Suspension of the minimum distribution rules at age 70½ provides a considerable advantage to the Roth IRA holder

  – Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax

  – Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields
General Concepts

• Reasons for converting to a Roth IRA
  – Taxpayers who need to use IRA assets to fund their Basic Exclusion Amount (BEA) bypass trust are well advised to consider making a Roth IRA election for that portion of their overall IRA funds
  – Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, thereby lowering the effect of higher estate tax rates
  – Federal tax brackets are more favorable for married couples filing joint returns than for single individuals
  – Post-death distributions to beneficiaries are tax-free
  – Tax rates are expected to increase in the near future
  – Impact of the new 3.8% Medicare surtax
Taxation of Roth IRA Conversions
Taxation of Roth IRA Conversions

• When a traditional IRA has non-deductible contributions, a portion of the conversion to a Roth IRA will be non-taxable “basis” to the IRA owner

• In determining the non-taxable portion of a Roth IRA conversion, all traditional IRAs and IRA distributions during the year (including outstanding rollovers) must be combined for apportioning “basis”
  – See IRS Form 8606
### Taxation of Roth IRA Conversions

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
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<tbody>
<tr>
<td>Current year non-deductible IRA contributions</td>
<td>$1,000</td>
</tr>
<tr>
<td>Prior year non-deductible IRA contributions</td>
<td>$6,000</td>
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<tr>
<td>Total non-deductible IRA contributions</td>
<td>$7,000</td>
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<tr>
<td>FMV of all IRAs</td>
<td>$580,000</td>
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<tr>
<td>Outstanding rollovers</td>
<td>$20,000</td>
</tr>
<tr>
<td>Distributions</td>
<td>-</td>
</tr>
<tr>
<td>Roth IRA conversions</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total value of IRAs, distributions and Roth IRA conversions</td>
<td>$700,000</td>
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</tbody>
</table>

**"Basis apportionment" factor**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Roth IRA IRA conversion</td>
<td>$100,000</td>
</tr>
<tr>
<td>Non-taxable portion</td>
<td>$(1,000)</td>
</tr>
<tr>
<td>Taxable Roth IRA conversion</td>
<td>$99,000</td>
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Taxation of Roth IRA Conversions

TAX REFORM REPEALED THE ABILITY TO RECHARACTERIZE A ROTH CONVERSION
Taxation of Roth IRA Distributions
Taxation of Roth IRA Distributions

- Qualified distributions
  - Not subject to income tax
- Non-qualified distributions
  - Potentially subject to income tax
Taxation of Roth IRA Distributions

• A Roth IRA distribution will be treated as a “qualified distribution” if both of the following requirements are met:
  – The distribution is made:
    – On or after the IRA owner turns 59½
    – To a beneficiary (or the IRA owner’s estate) on or after the death of the IRA owner
    – Because the IRA owner is “disabled”
    – For a “qualified special purchase” (i.e. first-time home buyer)
  – A five-year mandatory holding period has passed

CAUTION: If both requirements are not met, then the distribution is a “non-qualified distribution”
Taxation of Roth IRA Distributions

• For purposes of determining a “qualified distribution”, the five-year holding period for all of a participant’s Roth IRAs begins as of January 1st of the first year in which a contribution or conversion was made to any Roth IRA owned by that participant

  – If the participant dies during the five-year holding period, then the five-year holding period “tacks” to the beneficiary (i.e. the holding period of the decedent and the beneficiary combined must be five years)
Taxation of Roth IRA Distributions

• If a distribution is a “non-qualified distribution”:
  – The distribution is first determined to be a non-taxable return of the Roth IRA owner’s previously taxed amounts (i.e. basis)
  – If the distribution exceeds the Roth IRA owner’s previously taxed amounts, the excess distribution will be subject to income tax
Taxation of Roth IRA Distributions

Step 1: Contributions
- Regular contributions
- Rollovers from other Roth IRAs
- Rollovers from “designated Roth accounts”

Step 2: Conversions (First-in, first-out basis)
- Taxable portion of prior conversion
- Non-taxable portion of prior conversion

Step 3: Earnings
Taxation of Roth IRA Distributions

• To the extent that an IRA owner is less than age 59½ at the time he/she receives a non-qualified distribution, the taxable portion of the distribution (i.e. “earnings”) will be subject to the 10% early withdrawal penalty
  − Exceptions to the 10% early withdrawal penalty:
    − Death
    − Disability
    − Substantially Equal Periodic Payments (SEPPs)
    − Medical expenses > 7½ % of adjusted gross income
    − Health insurance premiums paid by unemployed individuals
    − Qualified higher education expenses
    − Qualified first-time homebuyer expenses
Taxation of Roth IRA Distributions

• To the extent that an IRA owner is less than age 59½ at the time he/she receives a non-qualified distribution, the taxable portion of a previous conversion amount will be subject to the 10% early withdrawal penalty if the distribution is within a five-year period following the conversion

  – The five-year holding period is determined on a conversion-by-conversion basis

  – The five-year holding period for each conversion begins as of January 1st

  – If the year in which the conversion is made the exceptions to that apply to the taxable portion of a non-qualified distribution (i.e. “earnings”) also apply to the taxable portion of a prior conversion amount (e.g. death, disability, etc.)
Taxation of Roth IRA Distributions

- The amount of a non-qualified distribution subject to the 10% early withdrawal penalty is determined as follows:

  Gross non-qualified Roth IRA distribution
  - First-time homebuyer expenses
  - Prior year Roth IRA contributions
  Gross non-qualified Roth IRA distribution subject to 10% tax
  - Taxable portion of prior year Roth IRA conversions > 5 years
  - Non-taxable portion of prior year Roth IRA conversions
  Net non-qualified Roth IRA distribution subject to 10% tax
Taxation of Roth IRA Distributions

<table>
<thead>
<tr>
<th>Age &lt; 59½</th>
<th>Distribution within 5 years</th>
<th>Distribution beyond 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax: Yes (earnings only)</td>
<td>Income Tax: Yes (earnings only)</td>
<td></td>
</tr>
<tr>
<td>10% Penalty: Yes (earnings &amp; taxable portion of prior conversion amounts)</td>
<td>10% Penalty: Yes (earnings only)</td>
<td></td>
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<th>Age ≥ 59½</th>
<th>Distribution within 5 years</th>
<th>Distribution beyond 5 years</th>
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<td>Income Tax: Yes (earnings only)</td>
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