

Section 5 - Expansion of Roth Conversions in 2010

nonspouse beneficiary's rollover rights.

✪ *Federal income tax withholding.* The mandatory withholding requirements under IRC §3405(c) also will apply to a nonspouse beneficiary in post-2009 plan years. Thus, any portion of an eligible rollover distribution that the nonspouse beneficiary does not elect to directly roll over to an inherited IRA will be subject to a federal income tax withholding rate of 20%.

* **Plan amendment required.** WREERA did not specify an amendment deadline for conforming plan documents to this law change. Presumably,

since the effective date of this rule post-dates the PPA 2006 amendment deadline explained in Section ①.A., the normal interim amendment deadline under section 5.05 of Rev. Proc. 2007-44 applies. Since this is a mandatory rule, the interim amendment deadline would be the later of: (1) the last day of the 2010 plan year, or (2) the due date (including extensions) for filing the employer's Federal income tax return for its taxable year that includes the first day of the 2010 plan year. However, as explained in Section ①.A., it would be advisable, if possible, to simply adopt this amendment as part of the plan's PPA 2006 amendment.

Section ⑤ - Expansion of Roth Conversions in 2010

Prior to January 1, 2010, an individual may not convert a non-Roth IRA into a Roth IRA unless the individual's modified adjusted gross income, as defined in IRC §408A(d), is not in excess of \$100,000 and, if married, the individual does not file a separate return.¹¹ This conversion limitation also applies to an individual who rolls over non-Roth funds in a qualified plan or section 403(b) plan to a Roth IRA (see Notices 2008-30 and 2009-75 for details, which were summarized in Issue #22 and Issue #28, respectively, of *eRISA Update*). The modified adjusted gross income limit does not apply to conversions that occur on or after January 1, 2010, due to law changes that were made by section 512 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). If the

income limits prevent a distribution of non-Roth funds from a qualified plan made in 2008 or 2009 to be rolled over to a Roth IRA, the rollover can be made to a non-Roth IRA and then, in 2010 or later, the non-Roth IRA can be converted to a Roth IRA.

* **No real effect on qualified plan administrative.** The fact that an income limit no longer will apply to Roth conversions will not really change a plan's distribution and rollover procedures, since the IRS does not require the plan administrator to determine whether a participant who is requesting a rollover of non-Roth funds to a Roth IRA satisfies the modified adjusted gross income limit. However, we wanted to include a "heads up" on this law change as part of this newsletter because plan sponsors may get questions from plan participants, and practitioners may get questions from their clients, particularly in light of the fact that more individuals will be eligible to do conversions with the elimination of the modified adjusted gross income requirements.

¹¹ If a married taxpayer files a separate return, the Roth conversion is prohibited under these income limits, even if the individual's modified adjusted gross income is less than \$100,000. This restriction also is repealed as of January 1, 2010. So, starting January 1, 2010, married taxpayers filing separate returns are eligible to elect Roth conversions.

Section 5 - Expansion of Roth Conversions in 2010

* Considerations for making a conversion.

There is no one easy formula that dictates whether or not an individual should take advantage of the Roth conversion rule. Some people believe that it is never a good idea because one shouldn't pay taxes any sooner than he or she has to! But for those that are weighing whether to rollover non-Roth funds in a qualified plan or section 403(b) plan to a Roth IRA, or to convert a non-Roth IRA into a Roth IRA, the following factors are typically taken into consideration.

✓ The individual's current tax bracket as compared to a reasonable projection of the tax rates that the individual may be subject to when the funds are expected to be paid out. Where the future tax rate is expected to be higher, a Roth conversion may be advantageous.

✓ For Roth conversions made in 2010, the amount of the conversion that must be includible in gross income is recognized in 2 equal installments in 2011 and 2012. Taxpayers who are subject to this 2-year ratable income rule would incur no taxation in 2010. However, the taxpayer may elect not to have the 2-year ratable income rule apply and include the entire taxable amount in income in 2010. Whether to elect the income inclusion in 2010, or ratably in 2011 and 2012, is a separate income tax planning decision.

✓ Amounts withdrawn later from a Roth IRA are treated as attributable first to basis (i.e., already-taxed portion of the Roth IRA) and then earnings, providing more flexibility in timing distributions to minimize taxation.

✓ Once 5 taxable years have passed, starting with the taxable year in which the conversion occurs¹², any "qualified Roth IRA distributions" paid from the Roth IRA are entirely tax-free, even to the extent such distribution is attributable to investment earnings. For example, if the conversion occurs in 2010, the 5-year period is satisfied as of December 31, 2014 (i.e., 2010, 2011, 2012, 2013 and 2014). However, a distribution is not a qualified Roth IRA distribution unless, in addition to satisfying the 5-year rule, the distribution: (1) is made after the Roth IRA owner has reached age 59-1/2, has died, or has become disabled (as defined in IRC §72(m)(7)), or (2) qualifies as a first-time home purchase under IRC §72(t)(2)(F).

✓ The expected time horizon during which the Roth IRA funds will remain invested and the earnings on the Roth IRA will not be tapped for distributions are important considerations. The longer the post-conversion accumulation period, the greater the potential amount of investment earnings that can be distributed from the Roth IRA as a tax-free distribution (assuming the distribution is a qualified Roth IRA distribution).

✓ For purposes of distribution planning with respect to retirement savings, the tax-free treatment of Roth IRA distributions may be viewed as attractive. Tax-free treatment also means that any tax-free Roth IRA distributions will not affect the individual's

¹² This assumes that the Roth conversion is the first time a Roth IRA has been established by the individual. All Roth IRAs are aggregated and treated as a single Roth IRA for purposes of the 5-year rule. So, if the individual had made contributions to a Roth IRA in any prior taxable year, the 5-year period starts with that earlier taxable year.

Section 5 - Expansion of Roth Conversions in 2010

income for purposes of determining whether Social Security benefits are taxable.

✓ Roth IRAs are not subject to minimum distribution requirements until after the death of the Roth IRA owner. This is true even if the Roth IRA is funded by a conversion of non-Roth funds in a qualified plan or section 403(b) plan through the rollover procedures.

*** Income limits still apply to making regular Roth IRA contributions.** TIPRA did not change the rules for making regular Roth IRA contributions. Thus, only individuals whose adjusted gross income does not exceed a prescribed dollar amount (subject to cost-of-living adjustments) may make regular Roth IRA contributions. The adjusted gross income limits for 2010 are as follows:

Joint return	Single or head-of-household	Married filing separately
\$167,000	\$105,000	\$0

A phase-out applies, under which the taxpayer may make a partial Roth IRA contribution, if the adjusted gross income exceeds the applicable limit by no more than \$10,000 (\$15,000 for single or head-of-household filer). If an individual's adjusted gross income is too high to make a regular Roth IRA contribution, the individual, starting in 2010, can make a contribution to a traditional IRA and then elect to convert the traditional IRA to a Roth IRA due to the fact that no income limit will apply with respect to the conversion.

*** Multiple IRAs.** An individual needs to be aware that, when converting a non-Roth IRA to a Roth IRA, if the individual owns more than one IRA, they are aggregated to determine tax consequences. So, if only one of the IRAs is converted to a Roth IRA, the amount that is treated as taxable had the IRA been distributed is determined with reference to all of the individual's IRAs. This might mean that a greater portion of the value of the converted IRA is subject to taxation as a result of the conversion. This aggregation rule does not apply to a Roth conversion resulting from the rollover of non-Roth funds in a qualified plan to a Roth IRA. It is unique to multiple non-Roth IRAs.

*** Distribution of non-Roth funds from qualified plan required to do conversion.** Note that the conversion of non-Roth funds in a qualified plan or section 403(b) plan is permitted only if the amount is otherwise distributable, and the individual rolls over the amount to a Roth IRA, either as a direct rollover or through the 60-day rollover process. Thus, the funds have to leave the qualified plan or section 403(b) plan and become invested in a Roth IRA product. It is reported that legislation may emerge this year that would expand the conversion rule to allow for participants to internally convert non-Roth funds within a qualified plan or section 403(b) plan into designated Roth accounts under such plan. This might even be available if the non-Roth funds are not otherwise distributable at the time of the conversion. However, we emphasize that such an internal conversion would not be permissible without authorizing legislation being enacted.