Income Limits on Roth Conversions to Be Lifted in 2010*

By Michael J.R. Hoffman

Michael J.R. Hoffman explores the benefits and costs of taking advantage Roth conversions. In doing so, Michael examines who should consider Roth IRAs; the AGI limits and distribution rules for both traditional IRAs and Roth IRAs; and the income tax consequences resulting from a Roth conversion.

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With the enactment of the Taxpayer Relief Act of 1997 ("TRA 97"),[1] the Roth IRA was added to the options available to taxpayers considering the use of individual retirement accounts (IRAs) in their retirement planning. Whereas traditional IRAs encourage retirement saving by means of a tax deduction on contributions to the account, Roth IRAs provide tax savings by allowing distributions to be received tax-free so long as certain statutory requirements are satisfied. However, a taxpayer's eligibility to contribute to a Roth IRA is subject to AGI limitations. If a taxpayer's income exceeds the AGI limit, the Roth IRA is off the retirement planning table for that year. Similarly, if a taxpayer participates in an employer-sponsored qualified retirement plan, even lower AGI limits apply, and contributions to a tradition (non-Roth) IRA lose their deductibility. Thus, most moderate-to-high income taxpayers find themselves locked out of both traditional deductible IRAs and Roth IRAs. For these taxpayers, the only IRA left on the table is a nondeductible traditional IRA, the only advantage of which is that taxation of the return on the account is deferred until distributions occur. While the tax-deferred status of the return has its merits, there are other investments that offer deferral of taxation without the restrictions that come with investments in IRAs. For example, a non-IRA brokerage account funded with growth stocks (*i.e.,* little or no dividend yield) offers tax deferral without losing the tax advantaged treatment of long-term capital gains when investments are sold.

For taxpayers with existing traditional IRAs, Code Sec. 408A[2] allows the conversion of a traditional IRA into a Roth IRA. Any excess of the fair market value of the converted IRA over its tax basis (*i.e.,* nondeductible contributions) must be included in gross income when the account is converted. But, all subsequent investment returns are tax-free under the rules for Roth IRAs. However, as with contributions to a Roth IRA, a taxpayer's eligibility for a Roth conversion is subject to an AGI limit. So, moderate-to-high income taxpayers are also prevented from converting existing IRAs to Roth IRAs. However, in 2010, the AGI limit on Roth conversions is repealed permanently.[3] This prospective repeal of the AGI limit on Roth conversions creates retirement planning opportunities—both in 2010 and immediately. Effectively, a back door into Roth IRAs will be created. For taxpayers who have been locked out of Roth IRAs, and probably traditional deductible IRAs as well, non–Roth IRAs can be funded each year beginning with 2006[4] through 2010. In 2010, these newly funded IRAs, and other

Michael J.R. Hoffman, DBA, EA, is a Professor of Taxation in the H. Wayne Huizenga School of Business & Entrepreneurship at Nova Southeasten University.

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previously funded IRAs if desired, can be converted into Roth IRAs. Further, if the law remains as presently enacted, in each year after 2010, a non–Roth IRA can be funded and then converted to a Roth—almost seems too good to be true.

By means of alternative hypothetical retirement planning scenarios, this article explores the benefits and costs of taking advantage of this retirement planning opportunity. However, before presenting these retirement planning scenarios, it is critical that the fundamentals of using IRAs in one's retirement planning be clearly understood. Accordingly, the following areas will be reviewed briefly before discussing further the 2010 Roth conversion opportunity:

- A Roth IRA is not necessarily for everyone—who should or should not consider including Roth IRAs in his or her retirement planning?
- AGI limits for both traditional deductible IRAs and Roth IRAs
- Overview of distribution rules for both types of IRAs
- The income tax consequences resulting from a Roth conversion—especially when the taxpayer holds low- or no-basis IRAs

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Who Should Consider a Roth IRA?

In theory, determining whether a Roth IRA makes sense is simple. In practice, this determination may be less clear. Usually, contributing to a Roth IRA means not contributing to another tax-advantaged retirement account, such as additional contributions to a 401(k) or to a traditional deductible IRA. If one has maxed out his or her voluntary 401(k) contributions and is locked out of contributing to a traditional deductible IRA, the decision really is easy—a Roth contribution, if allowed, is the only tax-advantaged retirement saving option available. If, on the other hand, the choice is between contributing $4,000 to a traditional deductible IRA or to a Roth IRA, the "right answer" may be less clear, because both options offer a tax advantage, but at different points in time. The traditional deductible IRA offers immediate tax savings from the deduction of the contribution. If we assume a 25-percent tax rate, the after-tax cost of funding a $4,000 contribution to a traditional deductible IRA is reduced to $3,000 by the tax savings resulting from the deduction of the contribution.

On the other hand, a contribution to a Roth IRA is not tax-deductible, so a $4,000 contribution to a Roth IRA costs $4,000. But, when distributions are taken from the Roth, they are tax-free. Too often one hears the words "tax-free" and critical thinking ceases. A Roth IRA is no more the right answer for every retirement planning situation than is investing in tax-exempt municipal bonds the right choice for every investment planning situation. Each type of IRA offers tax savings. The tax savings from a traditional deductible IRA is based on being able to deduct the contribution; the tax savings from a Roth IRA is based on its distributions being tax-free. So, the real question to be answered is, "Which tax saving is more valuable?" Tax savings are determined by the marginal tax rate applicable to each alternative—*i.e.,* tax rate now for deductible IRA contributions versus tax rate in the future when a distribution is taken from a Roth IRA.

In theory, the decision rule is simple: If one anticipates being in a higher tax rate in retirement than now, the Roth IRA is the right choice; if one anticipates being in a lower tax rate in retirement than now, the traditional deductible IRA is the right choice. Thus, whether a Roth IRA is or is not a retirement planning option is irrelevant if one's income tax rate in retirement is expected to be lower, because a deductible traditional IRA would be the better choice. But, how does one know with any degree of certainty what his or her tax rate will be in retirement? Someone at the beginning of a career can probably state with fair certainty that they will be in a higher tax rate at retirement, after a successful career. But, that certainty may be moot, because money to invest for retirement is scarce and retirement is so far in the future that motivation to save is all but nonexistent. Once one moves beyond this easy-decision stage of life, the crystal ball becomes more cloudy.

A common rule of thumb is to plan for retirement income to be somewhat less than earnings while still working. However, as one ages, medical costs are likely to rise. If one is still healthy, increased travel expenses may need to be budgeted. So, suggesting that one's income in retirement can be reduced *vis-à-vis* working years may be inappropriate. Further, tax rates now are at historic lows—many of us remember the 70-percent tax rate in effect prior to the enactment of Reagan's Economic Recovery Tax Act of 1981 (ERTA).[5] Is it reasonable to expect the maximum income tax rate to remain in the vicinity of 35 percent? These and other factors mitigate in favor of believing that ap-

plicable income tax rates may very well be higher in retirement, even if one's income level remains the same or is reduced.

Given the difficulties involved in predicting future income tax rates, one final argument in favor of Roth IRAs merits consideration. A well-accepted principle of investing is to diversify one's portfolio in order to reduce the risk of a devastating investment loss. The same argument could be made for including Roth IRAs in one's retirement planning, even though it is not clear that a Roth is necessarily the optimal choice. The workhorse of most taxpayers' retirement plans is the 401(k), which, in essence, is a mega-IRA. Thus, most of one's retirement plan implicitly assumes that income tax rates will be lower during retirement. By including Roth IRAs in one's retirement plan, a hedge is provided against the possibility that income tax rates turn out to be higher in retirement—*i.e.,* diversification of the risk associated with the uncertainty as to where income tax rates will be in 20 or 30 years.

IRA Options Available to Middle- to Upper-Income Taxpayers–AGI Limits

Above, a case was made for the inclusion of Roth IRAs in one's retirement plan. However, the reality is that for middle- to upper-income taxpayers, contributions to a Roth IRA are not an option. The AGI limits in effect for 2007 take the Roth IRA off one's retirement planning table once AGI equals $166,000 on a joint return ($114,000 on a single or head of household return).[6] In all likelihood, the more restrictive AGI limits applicable to traditional deductible IRAs also remove that type of account from consideration as well. If one participates in an employer-sponsored retirement plan, the deductibility of contributions to a traditional IRA is lost when AGI equals $103,000 on a joint return ($62,000 on a single or head of household return). Partial deductibility is allowed when AGI falls between $83,000 and $103,000 on a joint return (between $52,000 and $62,000 on single or head of household returns).[7] A nonparticipant spouse is subject to more liberal AGI limits. Full deductibility of contributions is retained for the nonparticipant spouse if AGI does not exceed $156,000; partial deductibility is permitted with AGI between $156,000 and $166,000; and when AGI equals or exceeds $166,000, no deduction is allowed.[8]

Thus, most taxpayers who would consider using an IRA in their retirement planning find themselves locked out of both the Roth IRA and the traditional deductible IRA. This leaves the traditional, but nondeductible, IRA as the only IRA option left to them. Rather than contribute to a nondeductible IRA, many would opt instead to invest in a non-IRA type investment. A brokerage account heavily weighted with growth stocks offers the tax-deferred growth that a nondeductible IRA would, but without the restrictions or adverse tax consequences that accompany the IRA.[9] In conclusion, for most middle- to upper-income taxpayers, IRAs are unlikely to have played a significant role in their retirement planning.

Treatment of Distributions from IRAs

The treatment of distributions from traditional IRAs is fairly straightforward. A brief review is provided here.

Traditional, Non–Roth IRAs

Distributions from non–Roth IRAs result in gross income, except to the extent that the amounts contributed to the account were not deducted when made.[10] The nondeductible contributions represent the tax basis of the IRA, which can be distributed tax-free. Thus, if all contributions were tax-deductible, all distributions are fully taxable as ordinary income. If a taxpayer has more than one IRA and any of such IRAs possess tax basis, the determination of the gross income resulting from a distribution is made by treating all non–Roth IRAs as one account and all distributions in a given year as one distribution.[11] Thus, regardless of how much is distributed or from which IRA the distribution is made, the portion of the distribution that results in gross income is the same.

If the recipient of a distribution is not 59 1/2 years of age, a 10-percent penalty applies to the gross income resulting from the distribution.[12] This 10-percent penalty is viewed as additional income tax—*i.e.,* in addition to any (normal) income tax on the gross income resulting from the distribution. There are numerous exceptions to this penalty provision, including distributions to the estate of, or to a beneficiary of, a deceased IRA owner,[13] distributions following disability,[14] distributions not in excess of deductible medical expenses,[15] and substantially equal periodic payments made over the distributee's life.[16] A detailed discussion of the exceptions to the

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10-percent penalty on premature distributions is beyond the scope of this paper.

Roth IRAs

Qualified distributions from a Roth IRA are excluded from gross income and are not subject to the 10-percent penalty on premature distributions.[17] A distribution is considered to be a qualified distribution if it satisfies the five-year holding period requirement[18] and at least one additional requirement found in Code Sec. 408A(d)(2)(A) (*e.g.,* distributee is at least 59 1/2 years of age). The five-year holding period begins on the first day of the first tax year in which a contribution to a Roth IRA or a Roth conversion is made and ends on the last day of the fifth consecutive tax year thereafter. Thus, if one's first contribution to a Roth IRA is made anytime during the calendar tax year 2007, a distribution will not be considered to be a qualified distribution until January 1, 2012—*i.e.,* the first day of the tax year following the end of the five-year holding period. A contribution made before the due date of the prior year's return can be treated as made in the prior tax year. In this case, the five-year holding period begins on the first day of the tax year to which the contribution relates, not necessarily the year in which it is made.[19]

The death of the owner of a Roth IRA does not affect the determination of whether the five-year holding period requirement has been satisfied.[20] A beneficiary steps into the shoes of the deceased with respect to the determination of holding period. Except for a surviving spouse, the holding period for an inherited Roth IRA is determined independently of the holding period of a Roth IRA already held. In the case of a surviving spouse, the holding period of all Roth IRAs owned by that spouse is determined with reference to the starting date of either the inherited Roth IRA or the Roth IRA already owned, which ever is earlier.[21]

Roth Conversions, Current Law

Code Sec. 408A allows the conversion of a traditional IRA to a Roth IRA. A Roth conversion is treated like a normal distribution. Accordingly, the value of the converted IRA is included in gross income, but only to the extent such value exceeds tax basis. As with contributions to a Roth IRA, there is an AGI limit on Roth conversions. A Roth conversion is only allowed if one's AGI does not exceed $100,000.[22] In this regard, AGI does not include any gross income resulting from the Roth conversion.[23] Thus, the taxpayer whose AGI is too great to contribute to a Roth IRA is also barred from converting a traditional IRA to a Roth.

In principle, the income tax consequence of a Roth conversion is simple: the value of the converted account is included in gross income to the extent such value exceeds the tax basis of the account. The tax basis of the account represents amounts that were not deductible when contributed to the IRA. The income tax consequences of a distribution from, or a conversion of, a traditional IRA will vary depending on the tax basis of the account. The following example will illustrate this point.

Facts

On January 1 of the years 2002 through 2006, Taxpayer A and Taxpayer B each contributed the maximum allowable amount to an IRA ($3,000 in 2002 through 2004 and $4,000 in 2005 and 2006). Taxpayer A's contributions were fully deductible, and Taxpayer B's contributions were not deductible. Assuming both accounts earned an eight-percent return, the value of each account on January 1, 2007, would be $21,254.

Consequences of a Roth Conversion in 2007

If each taxpayer converted her traditional IRA to a Roth IRA on January 1, 2007, Taxpayer A would have to report the entire $21,254 account value as gross income in 2007. On the other hand, Taxpayer B would only report $4,254 as gross income, the amount by which the account value of $21,254 exceeds her $17,000 of nondeductible contributions to that account (*i.e.,* tax basis).

Clearly, the tax consequences of a conversion of an IRA with a high tax basis are less severe than the tax consequences of a conversion of an IRA with little or no tax basis. Now consider the taxpayer who holds several IRA accounts—some with no tax basis, some with tax basis. Can a taxpayer pick and choose which IRA will be converted to a Roth IRA? The answer is yes, but with a catch. While the taxpayer can choose which accounts to convert and which to leave as is, the income tax consequences of the conversion are not dependent solely on the value and tax basis of the converted account(s). Rather, the value and tax basis of all IRAs, whether converted or not, are considered.[24] Based on this analysis of all IRAs, a determination is made as to the overall ratio of tax basis to account value. This ratio is used to determine the gross income resulting from the account(s) actually

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converted. The following example will illustrate the application of this rule.

Facts. Taxpayer C owns two different traditional IRAs. The value of IRA 1 is $21,250. The value of IRA 2 is also $21,250. Taxpayer's tax basis in IRA 1 is zero. Taxpayer's tax basis in IRA 2 is $17,000. Taxpayer will convert one of the traditional IRAs to a Roth IRA.

Consequences. It does not matter which, or how much, of the two IRAs is converted. The total value of both accounts is $42,500, and the total tax basis is $17,000, which represents 40 percent of the combined account value. Accordingly, however much of the traditional IRA balance is converted, 40 percent is treated as tax-free recovery of tax basis, and 60 percent is included in the taxpayer's gross income. Thus, if IRA 2 were converted to a Roth IRA, gross income of $12,750 results (60 percent of the converted balance). Tax basis equal to the nontaxable part of the conversion amount (*i.e.,* 40 percent) is also converted to a Roth IRA—however, tax basis has no significance in a Roth IRA because all distributions are tax-free. The other $8,500 of tax basis that was not converted is reallocated to IRA 1, which likewise was not converted.

As can be seen, one cannot pick high–tax-basis IRAs for Roth conversion just to minimize the gross income resulting from the conversion. The overall ratio of tax basis to account value is used to determine the consequences of the conversion. Any tax basis not converted to Roth status is reallocated to the account(s) not converted. Thus, undertaking a Roth conversion can be a fairly expensive proposition if one has a low overall ratio of tax basis to account value.

Prospective Repeal of AGI Limit on Roth Conversions

As discussed above, middle- to high-income taxpayers have been pretty much locked out of using tax-advantaged IRAs in their retirement planning. However, effective after December 31, 2009, the AGI limit on Roth conversions is scheduled to be repealed.[25] Accordingly, beginning in 2010, even high-income taxpayers can convert traditional IRAs to a Roth IRA. As discussed above, gross income is recognized on the conversion to the extent the value of the converted account(s) exceeds the tax basis. If the Roth conversion is undertaken in 2010, the resulting gross income will be recognized in two equal parts in the tax years 2011 and 2012—unless the taxpayer opts out of this deferral.

Immediate Action Needed in Anticipation of 2010

If one arrives in 2010 with no non–Roth IRAs, a substantial tax planning opportunity will have been missed. Accordingly, beginning with the 2006 tax year,[26] one should commence making contributions to a traditional IRA—presumably, nondeductible contributions. The ideal situation in which to find oneself in 2010 is to hold only non–Roth IRAs with high tax basis—*i.e.,* little gross income to be recognized upon conversion to Roth. Many, if not most, middle- to high-income taxpayers have probably not been using IRAs of any kind in their retirement planning. As discussed above, the gross income that results from a Roth conversion is based on the overall ratio of tax basis to the value of all non–Roth IRAs. Thus, with no older, low- or no-tax-basis IRAs owned, the gross income resulting from a Roth conversion in 2010 is limited to the return generated during somewhat less than three years, beginning with the first contribution in 2007 and ending with the last contribution in 2010. This fact pattern is clean, and the gross income to be recognized in 2010 is minimal.

> Moderate- to high-income taxpayers who have been unable to include Roth IRAs in their retirement planning can now take advantage of the Roth IRA.

We will now put numbers in this retirement plan. The limits on contributions to IRAs for tax years between 2006 and 2010 are presented in Table 1.

Table 1. IRA Contribution Limits, 2006–2010

Tax Year	Contribution Limits	
	Age < 50	Age > 49
2006	$4,000	$5,000
2007	$4,000	$5,000
2008	$5,000	$6,000
2009	$5,000	$6,000
2010	$5,000	$6,000

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Contributions to one's IRA must be made by the due date for each year's return. Thus, at the time this article was written, there was still a little time left to make IRA contributions for the 2006 tax year.[27] Beginning with a double contribution in 2007 (one for the 2006 tax year and the second for the 2007 tax year), contributions should be made as soon as possible after January 1 of each tax year, 2008 through 2010. After the fifth contribution, a total of $23,000 will have been contributed ($28,000 if the taxpayer is at least 50 years of age throughout). Assuming an eight-percent annual return (prorated for 2007) and contributions being made on April 1, 2007, and January 1 of each subsequent year, immediately after the 2010 contribution the account balance would be $25,843 ($31,492 if at least 50 years of age). If the account is immediately converted to a Roth IRA, the gross income that results would be $2,843 if the taxpayer is under 50 years of age or $3,492 if the taxpayer is at least 50.

As discussed previously, the potential for gross income recognition increases significantly if, in addition to the newly created nondeductible IRA, the taxpayer also holds other IRAs with low or no tax basis. In the previous paragraph, a scenario was presented in which a newly funded traditional, but nondeductible, IRA was converted to a Roth IRA in 2010 with very little gross income resulting. These results change substantially when low- or no-tax-basis IRAs are added to the mix. Consider the taxpayer above who is under 50 years of age and between the years of 2007 and 2010 contributed a total of $23,000 to a nondeductible traditional IRA. Assuming an eight-percent return, this IRA would have a value of $25,843 after the January 1, 2010, contribution. Assume that, in addition to this newly funded nondeductible IRA, the taxpayer also held an older traditional IRA with a value of $204,157 and no tax basis (*i.e.,* all contributions were fully deductible). The total value of all non–Roth IRAs held would be $230,000 (*i.e.,* $204,157 plus $25,843), and the tax basis would be the $23,000, the nondeductible contributions made between 2007 and 2010. The $23,000 tax basis of the newly funded IRA represents 10 percent of the total value of all IRAs. If just the newly funded IRA ($25,843) was converted in 2010, only 10 percent of the conversion amount ($2,584) would be treated as tax-free recovery of tax basis. Consequently, gross income of $23,259 ($25,843 less $2,584) would have to be recognized. The remaining $20,416 tax basis ($23,000 less $2,584) is reallocated to the IRA(s) not converted.

The gross income resulting from the $25,843 Roth conversion described above could be as much as $23,259. There is a moral to be learned from this example. Before pulling the trigger on a Roth conversion, the taxpayer should understand clearly how much gross income will result and the additional tax liability that will have to be paid. Failure to heed this advice may result in the Roth conversion being even more expensive than necessary. Specifically, if the taxpayer has to cannibalize the converted IRA to pay the tax liability on the conversion, the 10-percent penalty on early distributions will be due on that portion of the traditional IRA that was not converted to a Roth IRA—unless the taxpayer was older than 59 1/2.[28]

No Required Minimum Distributions on Roth IRAs

Unlike traditional IRAs, Roth IRAs are not subject to the required minimum distribution (RMD) rules.[29] Accordingly, funds in a Roth can be held indefinitely—or bequeathed upon death while retaining their tax-free status.[30] Further, contributions to Roth IRAs may continue after the age of 70 1/2,[31] so long as the taxpayer has sufficient earned income[32] (*i.e.,* compensation for services). Referring to the Roth conversions described above, the IRAs converted to Roth status could be kept in reserve indefinitely. Table 2 presents the account value to which the Roth IRAs described above would compound in five-year intervals.

Table 2. Compound Future Value of IRA No Contributions After 2010 (8% annual return)

Account Value	Age < 50	Age > 50
January 1, 2010	$25,843	$31,492
After 5 years	$37,972	$46,272
After 10 years	$55,793	$67,989
After 15 years	$81,978	$99,898
After 20 years	$120,453	$146,783
After 25 years	$176,985	$215,672

The repeal of the AGI limit for Roth conversions creates another unexpected result. Although direct contributions to a Roth IRA would still be subject to AGI limits in 2010, the repeal of the AGI limit on

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Roth conversions allows the AGI limits for contributions to Roth IRA to be sidestepped. Assuming the tax law remains unchanged, contributions to a Roth IRA can be made, regardless of one's AGI, by first contributing to a traditional, but nondeductible, IRA, followed immediately by a Roth conversion.

The potential for setting aside a tax-free "rainy day fund" is enhanced substantially if contributions continue after 2010. Again assuming an eight-percent return, Table 2 is reworked under the assumption that contributions to the Roth IRA continue each year after 2010. The resulting account values are presented in Table 3.

Table 3. Compound Future Value of IRA Contributions Continue After 2010 (8% annual return)

Account Value	Age < 50	Age > 50
January 1, 2010	$25,843	$31,492
After 5 years	$62,305	$70,605
After 10 years	$123,226	$135,422
After 15 years	$212,739	$230,659
After 20 years	$344,263	$370,593
After 25 years	$537,515	n/a*

* Contributions to non–Roth IRAs cannot be made after reaching the age of 70 1/2. So, the ability to sidestep the AGI limits on Roth contributions ceases at that age.

The balances that can be attained are impressive. A new and substantial dimension of flexibility is added to one's retirement planning—a contingency fund that can be accumulated or added to for as long as one wishes and that can be bequeathed tax-free if not needed. Excuse the colloquialism, but this is sweet! Of course, once the taxpayer retires, he or she may no longer have any earned income (*i.e.,* compensation for services), in which case contributions to any IRA would have to cease.

That the effective repeal of both the AGI limit on Roth conversions and the AGI limit on Roth contributions was intended is unlikely. What is more likely is that this result is due to hasty, sloppy drafting of TIPRA. Accordingly, we will have to wait and see whether this planning opportunity still exists when 2010 arrives.

Deferral of Recognition of Gross Income on Roth Conversion–Opting out May Be Appropriate

Any gross income resulting from a Roth conversion in 2010 will be recognized in equal parts in 2011 and 2012, unless the taxpayer opts out of the deferral. All things being equal, deferral of gross income, and the tax cost associated therewith, is a good thing. However, the moderate tax rates we now enjoy under EGTRRA[33] are scheduled to sunset after 2010. With no Congressional action, tax rates will revert to their pre-EGTRRA levels. However, with the mounting budget pressure associated with the war in Iraq and fixing (or at least patching) Social Security, to name but two issues, the political reality may prove to be that taxes will have to move beyond pre-EGTRRA rates. What is fairly certain is that our current low tax rates are unlikely to be extended beyond 2010.

We now consider the consequences of deferring or not deferring the gross income from a Roth conversion in 2010. Assume that $100,000 gross income results from a 2010 Roth conversion. The gross income will be recognized in 2010 only if the taxpayer opts out of deferral. Otherwise, $50,000 will be recognized in each of the two following tax years—2011 and 2012. We will examine the tax consequences associated with the timing of the gross income from the Roth conversion on a married filing jointly tax return under each of the following alternative post-2010 tax rate assumptions:

- EGTRRA tax rates are extended at least through 2012
- Pre-EGTRRA tax rates return when EGTRRA sunsets after 2010

Table 4. Tax Liabilities Computed

Moderate AGI Level			No Roth Conversion	High AGI Level		
2010	2011	2012		2010	2011	2012
$185,000	$185,000	$185,000	Adjusted Gross Income	$500,000	$500,000	$500,000
($30,000)	($29,480)	($29,588)	Itemized Deductions	($80,000)	($70,030)	($70,138)
($7,200)	($7,350)	($7,500)	2 Exemptions	($7,200)	$0	$0
$147,800	$148,170	$147,912	Taxable Income	$412,800	$429,970	$429,862
			Tax Liability			
$29,834	$29,684	$29,357	CPI-Adjusted 2006 Rates after 2010	$115,323	$120,691	$120,011
n/a	$34,319	$33,989	CPI-Adjusted 2001 Rates after 2010	n/a	$134,510	$133,696
n/a	$46,123	$45,426	CPI-Adjusted 1980 Rates after 2010	n/a	$213,974	$212,586

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- The even higher tax structure in force in 1980 applies (*i.e.,* prior to the enactment of ERTA)

The tax rate schedules for 2006, 2001 (pre-EGTRRA) and 1980 (pre-ERTA) will be adjusted for changes in the Consumer Price Index.[34] We assume that the tax structure now in effect under EGTRRA will still be in effect in 2010, adjusted for projected changes in CPI.

We will consider two different levels of AGI: (1) $185,000, an AGI level at which a Roth IRA would not be allowed in any year through 2010[35]; and (2) $500,000, a figure that will emphasize the potentially substantial impact of higher tax rates after 2010. At the $185,000 AGI level, itemized deductions are set at $30,000. At the $500,000 AGI level, itemized deductions are increased proportionately to $80,000. In all cases, we assume two exemptions, adjusted for projected changes in CPI. Applicable phase-outs of itemized deductions and exemptions are applied based on CPI-adjusted thresholds. Without the Roth conversion, the determination of the tax resulting at each of the two AGI levels is presented in Table 4. The left hand side of the table presents the $185,000 AGI level, and the right hand side presents the $500,000 AGI level.

As the result of the Roth conversion, $100,000 of additional gross income is recognized, either in two equal parts in 2011 and 2012 (GI deferred) or all of it in 2010 (no deferral). We will first consider the consequences of deferral. An extra $50,000 of gross income will be recognized in 2011 and 2012. The determination of the revised tax liability for 2011 and 2012 is presented in Table 5.

By comparing the revised tax liabilities in Table 5 to the tax liabilities in Table 4 (the base line), we can determine the additional tax resulting from the Roth conversion. Referring to the left hand side of the table (AGI $185,000), we can see that, if the EGTRRA tax structure continues after 2010, the tax liability in 2011 and 2012 is increased by $14,420 in each year, for a total tax on the $100,000 gross income of $28,840. The same comparison for the right hand side of the table (AGI $500,000) results in a tax increase of $36,050 ($18,025 additional tax each year). Under each of the other two possible tax structures, the additional tax resulting from the Roth conversion is greater still. The additional tax from the deferral of the income from the Roth conversion under each of the three tax structures is presented in Table 6.

So, how do the tax consequences of deferring the gross income from the Roth conversion compare to the consequences if the taxpayer opts out of deferral and reports the entire $100,000 gross income in 2010? Table 7 presents the determination of the revised tax liability in 2010, assuming the taxpayer opts out of deferral. Again, the tax structure under EGTRRA is assumed to be applicable in 2010.

Comparing Table 7 to Table 4 (the base line), we determine that in the moderate AGI case (left side), the additional tax is $30,119 ($59,954 tax from Table 7 versus $29,834 tax from Table 4). In the high AGI case (right side), the additional tax is $35,000 ($150,323 tax from Table 7 versus $115,323 tax from Table 4). Not surprisingly, if the tax structure reverts to a more severe, pre-EGTRRA regime for 2011 and 2012, opting out of the two-year deferral provides better results at both AGI levels.

We would expect, however, that if the EGTRRA tax structure is extended to 2011 and 2012, deferring the gross income from the Roth conversion would be the right decision. This expectation is

Table 5. Roth Conversion in 2010

Moderate AGI Level		Gross Income Deferred to 2011 & 2012	High AGI Level	
2011	2012		2011	2012
$235,000	$235,000	Adjusted Gross Income	$550,000	$550,000
($27,980)	($28,088)	Itemized Deductions	($68,530)	($68,638)
($7,350)	($7,500)	2 Exemptions	$0	$0
$199,670	$199,412	Taxable Income	$481,470	$481,362
		Tax Liability		
$44,104	$43,777	CPI-Adjusted 2006 Rates after 2010	$138,716	$138,036
$50,284	$49,954	CPI-Adjusted 2001 Rates after 2010	$154,904	$154,090
$73,171	$72,285	CPI-Adjusted 1980 Rates after 2010	$248,499	$246,726

Table 6. Roth Conversion in 2010

Moderate AGI Level			Additional Tax with Deferral of GI	High AGI Level		
Total Tax	2011	2012		2011	2012	Total Tax
$28,840	$14,420	$14,420	CPI-Adjusted 2006 Rates after 2010	$18,025	$18,025	$36,050
$31,930	$15,965	$15,965	CPI-Adjusted 2001 Rates after 2010	$20,394	$20,394	$40,788
$53,906	$27,047	$26,858	CPI-Adjusted 1980 Rates after 2010	$34,526	$34,140	$68,666

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supported at the lower AGI level, where the additional tax is $28,840 with deferral compared to $30,119 without deferral. However, at the higher AGI level, the reverse is found. The additional tax with deferral actually increases to $36,050, compared to $35,000 without deferral.

What we see is that the decision to defer or not is AGI-sensitive when the tax structure remains stable. How can this be so? Common sense suggests that with stable tax rates,[36] deferral should result in either no change in the tax or a modest decrease in tax because higher marginal tax rates are avoided by splitting the gross income between two years. What is driving this AGI-sensitive result is a provision of EGTRRA that repeals the phase-out of itemized deductions and exemptions in 2010, but only for one year. When EGTRRA sunsets after 2010, the phase-outs return. The return of these phase-out provisions effectively increases the marginal tax rate for higher-income taxpayers. At the $185,000 AGI level, the phase-outs have no impact on exemptions and only minor impact on itemized deductions. However, the $500,000 AGI level scenario is more severely impacted by both phase-out provisions, which results in the AGI sensitivity mentioned above.

Even though the nominal tax increases with deferral in the high AGI case, if we consider the time value of money, our decisions will shift back somewhat in favor of deferral. In this scenario, there is additional tax of $18,025 in each year ($36,050 total additional tax). Discounting these amounts using a six-percent discount rate results in a present value of $33,047, nearly $2,000 less tax than the $35,000 additional tax with no deferral. Even if tax rates revert to higher pre-EGTRRA levels, the present value of the additional tax at the $185,000 AGI level with deferral is somewhat less than with no deferral (present value of $29,270 compared with additional tax of $30,119 without deferral). If post-2010 tax rates increase more severely than the pre-EGTRRA tax structure, the no-deferral option quickly becomes the better choice at both AGI levels. Table 8 summarizes the additional tax that results either with deferral or without deferral of gross income. For the "with deferral" option, the additional tax is presented both in nominal terms and as a present value (discounted using a six-percent discount rate).

Table 7. Roth Conversion in 2010

Moderate AGI Level	No Deferral of GI	AGI Level
2010		**2010**
$285,000	Adjusted Gross Income	$600,000
($30,000)	Itemized Deductions	($80,000)
($7,200)	2 Exemptions	($7,200)
$247,800	Taxable Income	$512,800
	Tax Liability	
$59,954	CPI-Adjusted 2006 Rates in 2010	$150,323

Concluding Comments

Moderate- to high-income taxpayers, who have been unable to include Roth IRAs in their retirement planning, can now take advantage of the Roth IRA. Although direct contributions to a Roth IRA are still barred, contributions can be made to a traditional, but nondeductible, IRA each year. Such nondeductible contributions can be made for each tax year, beginning with 2006. Effective with the 2010 tax year, traditional IRAs may be converted to a Roth IRA, regardless of income level. Thus, beginning in early 2010, traditional IRAs held at that time can be converted to a Roth IRA. Each year thereafter, contributions can be made to a traditional nondeductible IRA followed immediately by a Roth conversion. This indirect Roth contribution can continue so long as the taxpayer has sufficient earned income and has not reached the age of 70

Table 8. Summary of Additional Tax Due to Roth Conversion, with Present Values (with and without deferral of gross income)

	AGI Level, in 2006 $'s	
	$185,000	$500,000
Gross Income from Conversion Recognized in 2010, No Deferral		
➤ Additional Tax Liability in 2010, CPI-Adjusted 2006 tax rates used	$30,119	$35,000
Gross Income from Conversion Deferred until 2011 & 2012		
➤ Additional Tax Liability in 2011 & 2012, CPI-Adjusted 2006 tax rates used	$28,840	$36,050
↳ PV, discounted to 2010 at 6%—	$26,438	$33,047
➤ Additional Tax Liability in 2011 & 2012, CPI-Adjusted 2001 tax rates used	$31,930	$40,788
↳ PV, discounted to 2010 at 6%—	$29,270	$37,390
➤ Additional Tax Liability in 2011 & 2012, CPI-Adjusted 1980 tax rates used	$53,906	$68,666
↳ PV, discounted to 2010 at 6%—	$49,420	$62,956

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1/2. The value of traditional IRAs that are converted will be reported as gross income to the extent such value exceeds the tax basis of the converted IRAs. If a taxpayer owns traditional IRAs with little or no tax basis, the gross income that results from a Roth conversion can be a substantial portion of the value converted, even if the low-tax-basis IRAs are not converted.

For Roth conversions undertaken in 2010, the taxpayer is allowed to defer the gross income that results until 2011 and 2012. However, the relatively low tax rates that we enjoy under EGTRRA sunset after 2010. Therefore, it is important to consider carefully whether deferral of gross income is the prudent choice. Deferring the recognition of gross income to a higher-tax-rate year is not good tax planning. Presumably, as 2010 draws to a close, we will know what the tax rates will look like in 2011 and later. Accordingly, the deferal/no-deferal decision must be made at that time.

Endnotes

[*] This article is reprinted from TAXES—The Tax Magazine, July 2007, at 47.

[1] Section 302 of the Taxpayer Relief Act of 1997 (P.L. 105-34) (TRA 97), Aug. 8, 1997.

[2] Unless indicated otherwise, all statutory references are to the current Internal Revenue Code.

[3] Section 512 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) (P.L. 109-222), May 18, 2006.

[4] IRA contributions for tax year 2006 could be made up to April 17, 2007, the due date for the 2006 income tax return.

[5] Economic Recovery Tax Act of 1981 (ERTA) (P.L. 97-34), Aug. 13, 1981.

[6] Code Sec. 408A(c)(3)(A) and Code Sec. 408A(c)(3)(C). Through 2006, the AGI limit for Roth IRAs was $160,000 for a joint return and $110,000 for a single or head of household return. Beginning after 2006, the phase-out thresholds for Roth eligibility are indexed for inflation (Pension Protection Act of 2006 (P.L. 109-280), Aug. 19, 2006). The AGI at which the Roth IRA is no longer allowed increases to $166,000 in 2007 ($114,000 for single or head of household returns) (Rev. Proc. 2006-53, IRB 2006-48, Nov. 9, 2006).

[7] Code Sec. 219(g)(2) and (3) and Rev. Proc. 2006-53, IRB 2006-48, Nov. 9, 2006.

[8] Code Sec. 219(g)(7) and Rev. Proc. 2006-53, IRB 2006-48, Nov. 9, 2006.

[9] For example, distributions from an IRA (Roth or traditional) taken before one reaches the age of 59 1/2 are subject to a 10-percent penalty, in addition to income taxes (Code Sec. 72(t) and *see* discussion below). Also, tax-preferred returns (*e.g.,* long-term capital gains) in a traditional IRA are taxed as ordinary income when distributed.

[10] Code Sec. 408(d)(2) with reference to Code Sec. 72.

[11] Code Sec. 408(d)(2)(A).

[12] Code Sec. 72(t).

[13] Code Sec. 72(t)(2)(A)(ii).

[14] Code Sec. 72(t)(2)(A)(iii).

[15] Code Sec. 72(t)(2)(B).

[16] Code Sec. 72(t)(2)(A)(iv).

[17] The treatment of nonqualified distributions from a Roth IRA is beyond the scope of this article.

[18] Code Sec. 408A(d)(2)(B).

[19] Reg. §1.408A-6, Q&A 2.

[20] Reg. §1.408A-6, Q&A 7(a).

[21] Reg. §1.408A-6, Q&A 7(b).

[22] Code Sec. 408A(c)(3)(B).

[23] Code Sec. 408A(c)(3)(C).

[24] Code Sec. 408(d)(2).

[25] Section 512 of the Tax Increase Protection and Reconciliation Act of 2005 (TIPRA) (P.L. 109-222), May 18, 2006.

[26] This article was written prior to the April 17, 2007, due date for 2006 income tax returns. At that time, therefore, a contribution to an IRA applicable to the 2006 tax year was feasible. As of the date of publication, the opportunity to make an IRA contribution for the 2006 tax year has passed.

[27] The due date for 2006 returns is April 17, 2007—Monday, April 16 is a government holiday in the District of Columbia.

[28] Code Sec. 72(t).

[29] Code Sec. 408A(d)(5).

[30] The five-year holding period of an inherited Roth IRA is determined with reference to when the deceased created the account. Code Sec. 408A(d)(2). So, if the deceased has satisfied the five-year holding period requirement, the account can be bequeathed tax-free.

[31] Code Sec. 408A(c)(4).

[32] Code Sec. 219(b)(1).

[33] Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16).

[34] CPI data source: *http://oregonstate.edu/cla/polisci/faculty/sahr/infcf16652007.xls,* accessed February 8, 2007.

[35] Using the CPI projections from the Oregon State Web site, the $166,000 AGI at which 2007 contributions to a Roth IRA are no longer allowed was compounded five additional years. The $185,023 figure that resulted for 2012 was rounded down to $185,000.

[36] Effective tax rates would actually decrease slightly due to each year's inflation adjustments.

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