

Roth Immersion

*Everything the professional advisor
needs to know to help clients
with their Roth retirement plans*

by

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This Special Report is the entire Chapter 5 of the 7th edition (2011) of the author's book *Life and Death Planning for Retirement Benefits* (Ataxplan Publications; www.ataxplan.com). This seminar handout includes material that was cut from 7th edition for reasons of space and also includes selected sections of other Chapters.

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Abbreviations, Symbols, and Defined Terms Used in this Report

§ Section references refer to sections of the Code unless otherwise indicated.
¶ Paragraph references refer to sections of the author's book *Life and Death Planning for Retirement Benefits*. If the referenced section begins with "¶ 5", or is followed by the statement [see Appendix A] the section can be found elsewhere in this Report. Otherwise the cross referenced section is NOT reproduced in this Report. The book can be purchased for \$89.95 plus shipping through www.ataxplan.com, through Amazon.com, or by calling 800-247-6553.

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| AMT | Alternative minimum tax. § 55. |
| Code | Internal Revenue Code of 1986, as amended through August 2012. |
| DRAC | Designated Roth account. See ¶ 5.7.01. |
| Five-Year Period. | See ¶ 5.2.05. |
| HEART Act | The "Heroes Earning Assistance and Relief Tax Act" of 2008 (Pub. L. 110-245). |
| IRA | Individual retirement account or individual retirement trust under § 408. |
| IRD | Income in respect of a decedent. § 691. |
| IRS | Internal Revenue Service. |
| MRD | Minimum required distribution under § 401(a)(9). |
| NUA | Net unrealized appreciation. See ¶ 5.4.04(A). |
| PPA '06 | The Pension Protection Act of 2006 (Pub. L. 109-280). |
| QRP | Qualified retirement plan under § 401(a). |
| Reg. | Treasury Regulation. |
| RBD | Required beginning date. See ¶ 5.2.02(A). |
| Regular contribution. | See ¶ 5.3.02. |
| TAPRA | The Taxpayer Relief Act of 1997 (Pub. L. 105-34). |
| Traditional IRA or plan. | An IRA or retirement plan that is not a Roth IRA or Roth plan. |
| WRERA | The Worker, Retiree, and Employer Recovery Act of 2008 (Pub. L. 110-458). |

Roth Retirement Plans

Roth retirement plans offer the possibility of tax-free distributions to those who are eligible (and can afford) to adopt them.

This Chapter covers everything the advisor needs to know about “Roth” retirement plans except the following matters that are covered in other Chapters: Roth conversions by the participant’s surviving spouse (see ¶ 3.2.04 [see Appendix A]) or nonspouse beneficiary (¶ 4.2.05) [see Appendix A]; the executor’s responsibilities with respect to a deceased participant’s Roth plan or Roth conversion (¶ 4.1.02); and tax treatment of investment losses (¶ 2.2.11) and management fees (¶ 8.1.04) [see Appendix A] with respect to a Roth IRA.

5.1 Roth Plans: Introduction & Miscellaneous

“Tax-free compounding is the best thing in the world.” –Jonathan G. Blattmachr, Esq.

5.1.01 Introduction to Roth retirement plans

Prior to the debut of the Roth IRA in 1998, all retirement plans had the same basic tax structure: Contributions to the plan might or might not be tax deductible; and all distributions from the plan in excess of the participant’s after-tax contributions would be includible in the recipient’s gross income.

§ 408A established a new kind of IRA, called a Roth IRA, effective in 1998. Roth IRA contributions are never deductible, but distributions are normally tax-free. Thus, income tax on the plan’s investment returns is not merely deferred, it is eliminated—at the cost of payment of income tax up front on the plan contributions. In addition to tax-free distributions, the Roth IRA offers two other advantages over traditional IRAs: no minimum required distributions during the participant’s life (¶ 5.2.02(A)); and no maximum age for making contributions (¶ 5.3.04(A)). Congress later added another type of Roth plan (the “designated Roth account” or “DRAC”; ¶ 5.7) and expanded the number of ways to acquire a Roth plan (¶ 5.3.01).

Roth retirement plans offer the possibility of tax-free investment growth to those who are eligible (and can afford) to adopt them. Through 2009, to be “eligible” to convert an existing traditional plan to a Roth IRA meant having “modified adjusted gross income” of \$100,000 or less, and not using married-filing-separately filing status. Starting in 2010, everyone who owns a traditional retirement plan or IRA is eligible to convert to a Roth IRA, regardless of income or filing status. ¶ 5.4.02.

5.1.02 What practitioners must know

Advisors need to know:

- ✓ The differences between Roth IRAs and traditional IRAs. ¶ 5.2.01.
- ✓ How the minimum distribution rules apply to Roth IRAs. ¶ 5.2.02.
- ✓ The income tax treatment of qualified and nonqualified Roth IRA distributions. ¶ 5.2.03–¶ 5.2.07.
- ✓ The eight ways to fund a Roth IRA. ¶ 5.3.01.
- ✓ How to fund a Roth IRA with “regular” (annual-type) contributions from compensation income. ¶ 5.3.02–¶ 5.3.04.
- ✓ The rules for “conversion” of a traditional plan or IRA to a Roth IRA. ¶ 5.4.
- ✓ How the 10 percent penalty on pre-age 59½ distributions applies to Roth conversions and distributions. ¶ 5.5.
- ✓ How to undo (recharacterize) a Roth conversion or other contribution to a Roth or traditional IRA. ¶ 5.6.
- ✓ What a “designated Roth account” (DRAC) is, the tax rules for DRAC contributions and distributions, and how DRACs differ from Roth IRAs. ¶ 5.7.
- ✓ Which clients should consider or avoid Roth IRAs and DRACs. ¶ 5.8.01–¶ 5.8.05.
- ✓ How to prepare for and execute a Roth conversion. ¶ 5.8.06.
- ✓ Which Roth planning ideas do not work. ¶ 5.8.07.
- ✓ How to handle Roth benefits in a client’s estate plan. ¶ 5.8.08.
- ✓ Which Roth IRA transactions are abusive. ¶ 5.1.03.
- ✓ How to handle investment losses (¶ 2.2.11) and investment management fees (¶ 8.1.04) [see Appendix A] with respect to a Roth IRA.

5.1.03 Roth retirement plan abuses

In a blatant abuse of the Roth IRA retirement savings vehicle, some individuals have attempted to shift income into their Roth IRAs by such means as having the Roth IRA form a wholly-owned entity (such as an LLC), then shifting value into that entity by (for example) selling property to it at bargain prices. The goal of these schemes is to shelter income in the tax-free Roth.

In Notice 2004-8, 2004-4 IRB 333, the IRS declared war on these devices, attacking them: as disguised IRA contributions in violation of the limits on annual IRA contributions and the requirement that only cash may be contributed to an IRA (¶ 5.3.02); as listed transactions for

purposes of the anti-tax-shelter regulations (see Reg. § 54.6011-4); and possibly as prohibited transactions under § 4975 (which would disqualify the IRA; § 408(e)(2)). The IRS will dismantle the transactions through denial of deductions (for, *e.g.*, excessive payments from a business to the IRA-owned entity) or re-allocation of income, deductions, etc., among the persons and entities involved pursuant to § 482; see CCA 2009-17030 in which this principle was applied. This development was predicted in Choate, N., “Retirement Benefits: Unexpected Drama,” 143 *Trusts & Estates* 1 (Jan. 2004), p. 40.

For other planning ideas that Congress or the IRS has considered potentially abusive or just plain too good to be allowed, and therefore has addressed with a change in the law or other loophole-closing action, see ¶ 5.4.04(A) (Roth conversion of NUA stock), ¶ 5.4.03(A) (Roth conversion of certain annuity contracts), ¶ 5.5.02 (Roth conversion followed by immediate distribution while under age 59½), ¶ 5.6.07 (immediate reconversion following a recharacterization), ¶ 5.7.10 (shifting value to a DRAC within a plan), and ¶ 5.8.08(C) (lifetime gift of a Roth IRA). See also the IRS website page regarding abusive retirement plan transactions, <http://www.irs.gov/retirement/article/0,,id=118821,00.html>.

The IRS’s next target for anti-abuse rule changes? I would nominate intentional excess Roth IRA contributions; see Ludwig Example at ¶ 2.1.08(H). Perhaps the IRS will classify any distribution of the earnings on an excess Roth IRA as a nonqualified distribution, even if made after the corrective distributions deadline (¶ 2.1.08(A); ¶ 5.6.06), or disqualify altogether a Roth IRA that is intentionally (as opposed to accidentally) funded with an improper contribution, to nullify benefits from this type of abusive transaction.

5.1.04 Unanswered questions regarding Roth plans

¶ 5.2.04: Does the rule that the deemed income resulting from a prohibited transaction cannot be a qualified distribution apply to prohibited transactions with Roth IRAs? Or just to prohibited transactions involving a DRAC?

¶ 5.2.05: How is calculation of the Five-Year Period for a participant’s future Roth IRAs affected if at all by the participant’s closing out of all his Roth IRAs?

¶ 5.4.04(C)(3), ¶ 2.1.13(C): What is the IRS’s statutory basis for the distinction, in Notice 2009-68, 2009-39 IRB 423, 429, between direct and indirect partial rollovers with respect to the allocation of basis between the rolled and nonrolled portions?

¶ 5.4.03(A): A special rule applies to valuation of an IRA-owned annuity contract for purposes of converting that contract to a Roth IRA. Does the same rule apply if an annuity contract owned by a *nonIRA plan* is converted to a Roth?

¶ 5.6.07: If a traditional IRA is converted to a Roth IRA, and then the converter “recharacterizes” some or all of the conversion prior to the applicable deadline (so the money is moved back to the traditional IRA, as if the conversion never happened), the individual who so recharacterized cannot convert “that amount” back to a Roth IRA again until at least 30 days have elapsed, or until the next taxable year after the year of the original conversion, whichever is later.

Does this mean the individual can convert *some other amount* from the same traditional IRA without waiting for the 30 day/next year period to pass?

¶ 5.8.08(B): How does an executor recharacterize an IRA contribution if the beneficiary of the IRA won't cooperate? Who is the beneficiary of the account following the recharacterization?

¶ 5.7.08(D): In case of a rollover from a DRAC to a Roth IRA, where the individual's basis exceeds the value of the account at the time of the rollover, does the excess basis carry over to the new plan if there is a total and/or direct rollover? Or does this rule apply only to partial 60-day rollovers?

5.2 Roth IRAs: Minimum Distribution and Income Tax Aspects

Roth IRAs are just like traditional IRAs except where the Tax Code says they are different. The differences arise in the treatment of distributions (normally tax-free from Roth IRAs), deductibility of contributions, and application of the minimum distribution rules.

5.2.01 *Roth (and deemed Roth) IRAs vs. traditional IRAs*

The Tax Code provides that, for federal income tax purposes, Roth IRAs are treated just like traditional IRAs except where the Code specifies different treatment. § 408A(a); Reg. § 1.408A-1, A-1(b). Thus, if any question about Roth IRAs is not specifically answered in § 408A or the Roth IRA regulations, the answer should be the same as for a traditional IRA.

Here are the ways in which a Roth IRA is NOT the same as a traditional IRA:

- ✓ The minimum distribution rules apply differently to the two types of IRAs. See ¶ 5.2.02(A).
- ✓ “Qualified” distributions from a Roth IRA are income tax-free, whereas traditional IRA distributions are generally taxable. See ¶ 5.2.03–¶ 5.2.05.
- ✓ As with a traditional IRA, the participant's own (already-taxed) contributions to a Roth IRA are not taxed again when they are withdrawn from the account; but there is a big difference between Roth and traditional IRAs in how you determine whether a particular distribution consists of the participant's own contributions. See ¶ 5.2.06–¶ 5.2.07.
- ✓ There are different eligibility requirements for making contributions to a Roth versus a traditional IRA. See ¶ 5.3.04, ¶ 5.4.02.

Deemed IRAs: An employer who maintains a qualified retirement plan may permit employees to make voluntary contributions to “a separate account or annuity established under the plan.” § 408(q)(1)(A); Reg. § 1.408(q)-1. The separate account must meet the requirements of § 408 (traditional IRA) or § 408A (Roth IRA). The separate account (called a **deemed traditional IRA** or **deemed Roth IRA**) is then treated in all respects the same as a “regular” traditional or Roth IRA and is generally not subject to the qualified plan requirements.

Since a deemed Roth IRA is treated in all respects the same as a “real” Roth IRA, all discussion in this book about Roth IRAs applies equally to deemed Roth IRAs. Deemed IRAs seem to be rare (nonexistent?); at least, this author has never encountered one. Marcia Chadwick Holt, Esq., author of *Estate Planning for Retirement* (see Bibliography), points out that one deterrent to plans’ allowing deemed IRAs is that qualified plans often have one or more individual trustees, which are not allowed for IRA assets.

5.2.02 *Roth IRAs and the minimum distribution rules*

For explanation of the minimum distribution rules, see Chapter 1 of *Life and Death Planning for Retirement Benefits*.

The minimum distribution rules do not apply to a Roth IRA until after the participant dies. Thus, withdrawals beginning at age 70½ that are mandated for traditional IRAs simply do not apply to Roth IRAs. After the participant’s death, the minimum distribution rules *do* apply to the Roth IRA beneficiary, with distributions being computed as if the participant died “before his required beginning date.”

- A. **No lifetime required distributions.** The lifetime minimum required distribution (MRD) rules generally require that a participant must take annual distributions from an IRA beginning at approximately age 70½, using a distribution schedule designed to assure that the projected death benefits to the participant’s beneficiary will be no more than “incidental benefits” compared with the value of the projected distributions to the participant. See ¶ 1.3. These “lifetime MRD rules” do not apply to Roth IRAs. § 408A(c)(5) provides that § 401(a)(9)(A) (which contains the lifetime minimum distribution rules) and the “incidental death benefits” rule do not apply to Roth IRAs. Accordingly, there is no “required beginning date” (RBD; ¶ 1.4) for a Roth IRA. A person who reaches age 70½ does not have to start taking distributions from his Roth IRA as he does from his traditional IRA. For how to do a Roth conversion in a year in which the participant is required to take an MRD from the plan or IRA being converted, see ¶ 5.2.02(E).
- B. **Post-death MRD rules DO apply.** Once death occurs, the minimum distribution rules *do* apply to Roth IRAs. The Roth IRA is not exempted from any minimum distribution rules other than § 401(a)(9)(A) and the incidental death benefits rule, both of which apply only during the participant’s life, so distributions must begin coming out of the Roth IRA after his death. Since there is no RBD for a Roth IRA, the post-death minimum distribution rules will *always* be applied “as though the Roth IRA owner died before his” RBD, regardless of when he dies. Reg. § 1.408A-6, A-14(b).

For how to compute MRDs from a Roth IRA after the participant’s death, see ¶ 1.5.02–¶ 1.5.03. If the participant’s surviving spouse inherits the Roth IRA, see ¶ 1.5.03(B) for how to compute MRDs to her so long as she holds the account as beneficiary. If she rolls the account over to her own Roth IRA (¶ 3.2.03(B) [see Appendix A]), it then becomes “her” Roth IRA, and there are no further distributions required until after her death (see “A” above).