

Investing in a Rising Tax Environment: The Roth Conversion Opportunity

Andrew H. Friedman
July 2009

The President's budget proposal, released earlier this year, confirms what we predicted and most people expected: A tax increase in future years will be needed to contend with an unprecedented budget deficit swollen by economic stimulus measures, financial bail-outs, wars, and the escalating costs of Social Security and Medicare. The President is proposing tax increases to take effect in 2011 on families with income over \$250,000.

Our prior white papers outline some strategies higher-income investors can consider to ameliorate the consequences of looming tax increases. Converting traditional retirement accounts to Roth IRAs is one such strategy.

Beginning in 2010, all investors will be able to convert their traditional retirement accounts to Roth IRAs. By making this conversion and holding assets in the Roth account for a prescribed period, investors can withdraw their retirement funds *entirely tax free*. Moreover, because lifetime distributions are not required from Roth IRAs, an investor can choose *not* to withdraw funds. In that case, the entire account passes to the investor's heirs, who may similarly withdraw the funds income tax-free. (The inherited account may be subject to estate tax.)

In a rising tax environment, establishing a Roth IRA to produce future tax-free income can provide significant tax savings.

1. Roth IRA overview

In 2009 (and prior years), only families with adjusted gross income under \$100,000 are permitted to convert a Traditional IRA to a Roth IRA. Beginning in 2010, however, *all* individuals are eligible to make this conversion.

If the investor has held a Roth IRA account for at least five years and is at least age 59½ (or has died, is disabled, or is purchasing a first home), then all amounts withdrawn from the Roth IRA -- including earnings -- are received entirely tax-free.¹ Moreover, while assets held in a Traditional IRA must begin to be distributed when the holder turns age 70½, no such lifetime distribution rules apply to a Roth IRA. Instead, a Roth IRA holder may choose to retain assets in the Roth, where they can continue to accumulate tax-free.

And finally, because Roth IRA distributions are not subject to tax, they are not included in "modified adjusted gross income" for purposes of determining the portion of Social Security benefits subject to income tax. Thus, conversion to a Roth IRA can reduce the tax imposed on Social Security benefits in later years.

There are some instances though where distributions from a Roth IRA account can result in a tax. First, if the investor is under age 59½ (and does not meet another exception), then withdrawals of earnings, and of amounts converted from a Traditional IRA within the prior five years, are subject to a 10% penalty tax.

Second, if amounts are withdrawn before the investor has held at least one Roth IRA account for five years, then withdrawals of earnings from the Roth IRA are subject to income tax. This result is mitigated by an ordering rule, however. Withdrawals made during the first five years the investor holds a Roth IRA account are treated as coming first from non-taxable contributions and previously taxed amounts. Only after those amounts are withdrawn is tax imposed.

For instance, suppose an investor who has never contributed to a Roth IRA converts a Traditional IRA with a value of \$100,000 (all from pre-tax contributions). As discussed below, the investor must pay tax on this \$100,000 upon the conversion. The investor thus can withdraw up to \$100,000 from the Roth IRA during the initial five years without tax, as those amounts are treated as coming from previously taxed income. However, if the investor withdraws more than \$100,000 during the five-year period, then any amount over \$100,000 will be taxed. (This example assumes the investor is over age 59½. If younger, the \$100,000 withdrawal within five years of the conversion will in all cases be subject to a 10% penalty.)

Post-death distribution rules apply to a Roth IRA in the same manner as to Traditional IRAs. Thus, at death the Roth IRA balance must be distributed to a named beneficiary within five years or over the beneficiary's lifetime. Spousal beneficiaries are exempt from this requirement and may continue their deceased spouse's Roth IRA intact. All distributions made to the beneficiary from the Roth IRA retain their tax-free character, so that the beneficiary, like the original Roth IRA holder, receives the assets entirely tax-free.

2. Taxable income recognized on conversion

When the holder of a Traditional IRA converts to a Roth IRA, he recognizes taxable income on the previously untaxed value of the converted IRA. To the extent the conversion occurs in 2010, the holder can choose to include the conversion amount in taxable income in two phases: half in 2011 (*i.e.*, with the return due April 15, 2012) and half in 2012 (*i.e.*, with the return due April 15, 2013). In this case, the income will be taxed at the holder's tax rates prevailing in 2011 and 2012. Alternatively, the holder can choose to include the 2010 conversion amount fully in 2010 income and pay tax at 2010 rates. Because a holder should know the 2011 rates when he files his 2010 return in April 2011, he will know which option is more advantageous.

Amounts converted after 2010 are subject to tax fully in the year of conversion. Keep in mind though that a holder is not required to convert his IRA all at once. If the tax cost of a single conversion is too high, a holder can choose to convert a portion of the Traditional IRA each year (and stop converting at any time) to manage the tax burden.

If a holder chooses to convert only a portion of his IRA, any after-tax contributions are taken into account ratably. For instance, suppose a holder has two IRA accounts, each with a value of \$10,000. Account X is comprised totally of all after-tax contributions and thus has no unrealized gain. Account Y has all pre-tax contributions, and thus has \$10,000 of unrealized gain. The holder converts account X to a Roth. Although he might think he owes no tax on the conversion because there is no gain in account X, in fact because he has converted half of his IRA value (\$10,000 out of \$20,000 total value), he will get credit for half of his after-tax contributions ($1/2$ of \$10,000 = \$5,000). Thus, he will recognize \$5,000 taxable income on the conversion of account X, and an additional \$5,000 of taxable income if and when he later converts account Y.

If possible, the holder should pay the tax on conversion with non-IRA funds. Doing so in effect provides an additional contribution to the Roth IRA, as the assets in the IRA account remain the same but now all future taxes on those assets have been paid. Although the future benefits will be greatest if the holder uses non-IRA funds, holders over age 59½ may choose to withdraw funds from the IRA to pay the tax on conversion. If the holder is under age 59½, however, funds withdrawn from the IRA to pay the tax will be subject to a 10% penalty unless another exception applies.

Investors who in recent years have incurred non-passive ordinary losses that they reported on their individual returns (*e.g.*, losses flowing through from a partnership or S corporation), may be able to convert their IRA to a Roth IRA without *any* tax cost by offsetting the loss carryforwards against the income recognized on the conversion.

3. *Who should consider converting?*

As a general rule, an investor will benefit from converting his IRA to a Roth *as long as the tax rate he is paying in the year of conversion is not higher than the rate he will pay when he pulls money from his IRA*. This rule assumes that the investor earns at least the rate of inflation on his invested assets.

Thus, a retired investor is likely to benefit from the conversion, as he is already in his retirement tax bracket and may be subject to higher tax if rates rise in the future. In addition, by converting, the investor can avoid having to begin taking required minimum distributions (RMDs) at age 70½. (Future RMDs are avoided even if the investor is over age 70½ at the time of conversion.)

Similarly, an investor who is currently working but expects to remain in the highest tax bracket after retirement likely will benefit from converting, given the expected increase in tax rates.

Conversely, investors who are working and expect their tax rate to drop during retirement likely will not benefit from converting before retiring.

4. Reversing the conversion

An investor who converts to a Roth IRA can choose to reverse the conversion (and avoid the accompanying tax) at any time up until the October 15 following the year in which the conversion occurred. If an investor reverses the conversion, the funds will be treated as remaining in a Traditional IRA.

An investor who reverts to a Traditional IRA and then desires to once again convert his traditional IRA to a Roth cannot do so in the same year in which the original conversion to the Roth occurred. If the investor reverses the conversion in the year after the Roth IRA conversion occurred (before October 16), then the investor must wait 30 days to reconvert to a Roth.

5. Rolling 401(k) funds into a Roth IRA

The lifting of the income limitation on Roth IRA conversions in 2010 also applies to transfers from a traditional 401(k) account to a Roth IRA. Thus, beginning next year, 401(k) participants can roll 401(k) assets into a Roth IRA, provided the plan permits them to withdraw the assets at that time (*i.e.*, they have separated from service or are eligible for in-service distributions under the terms of their plan). The investor will recognize tax on the rollover in the same manner as tax is paid on amounts converted from a Traditional IRA.

Alternatively, if the plan permits, a 401(k) participant can roll his account this year to a traditional IRA and then convert the Traditional IRA next year to a Roth IRA. This route may provide a smoother transition to a Roth early in 2010, as the holder will not have to wait for his 401(k) administrator to process his request next year and release the funds.

6. Additional Roth IRA contributions

Although the income limitation is removed from conversions in 2010, the limitation on making contributions to a Roth is not. Thus, a single taxpayer with adjusted gross income (AGI) over \$116,000 cannot make direct contributions to a Roth account in any year. Married individuals filing a joint return cannot contribute if their AGI is over \$169,000.

There is, however, a workaround. Each year an investor can make a non-deductible contribution to an IRA and then immediately roll that amount into a Roth. Because he made the contribution with after-tax income, there is no gain recognized on the roll-over. (assuming the investor converted all pre-tax IRA amounts to a Roth in earlier years).

7. Using annuities in a Roth IRA

Choosing the proper investment for a Roth IRA can enhance its value for either income or Roth transfer purposes. For instance, an investor may consider purchasing a variable annuity in a Roth IRA to assist in retirement income planning, legacy and spousal protection upon death, and the benefit of possibly “stretching” tax-free income to the next generation.

A. Retirement Income Planning

A holder may consider purchasing a variable annuity in a Roth IRA to provide downside protection, potential equity upside, and a guaranteed tax-free lifetime income stream. A variable annuity with an optional income benefit rider, purchased for an additional cost, can provide guaranteed lifetime income that increases as investment assets increase but does not decline if asset values go down (provided no excess withdrawals are taken). Although the cash value of a variable annuity may decline based on market performance, the benefit base on which distributions are based will not, so that annual distributions will never decrease.² Thus, in essence, the annuity is providing a defined benefit arrangement, under which the holder receives guaranteed income for life regardless of longevity or market performance.

When an annuity is held in a Roth, the guaranteed income stream provided by his personal defined benefit arrangement is *entirely tax-free*. When the Roth IRA holder dies, the annuity death benefit is available to the IRA beneficiary, and that death benefit, too, is *entirely tax-free*. The holder may choose to enhance this death benefit through the purchase of a rider at an additional cost.

B. Spousal Protection

When the Roth IRA holder dies, the annuity death benefit is available to the Roth IRA designated beneficiary, and that death benefit, too, is entirely income tax-free. If the spouse is the sole beneficiary, the spouse can treat the Roth IRA as her own with no IRS required minimum distribution requirements. Along with continued favorable tax treatment, spouse generally has the flexibility to continue the annuity contract's rider and features of the original owner.

C. Potential Tax-free Income to the Next Generation

Any Roth annuity death benefit paid will be distributed income tax-free to the designated non-spouse individual beneficiaries. Each beneficiary has the choice to end Roth income tax-free treatment within five years of death by electing a lump sum distribution or extend aka "stretch" the Roth income tax-free treatment.

What is “Stretch”?

You have worked hard to save money throughout your lifetime and you want to ensure your remaining Roth assets pass to the next generation upon your death.

By naming your heir(s) as designated beneficiary of your Roth IRA, they can each elect to continue the Roth tax treatment through a stretch distribution or a lump-sum distribution.

The advantage to stretching is:

- *Structure an income stream over their life expectancy*
- *Extend the tax-free earning power of assets in the Roth IRA beyond 5 years*

The beneficiary can extend the Roth status by either receiving IRS minimum annual withdrawals within the diversified sub-account options or electing one of the base contract's annuity options (e.g. single life annuity or period certain) to receive level income. The beneficiary must elect to extend the Roth status by September 30th of year and receive the first annual distribution by December 31 of the same calendar year. If this IRS time requirement is not met, the Roth must be fully distributed within five years of the owner's death.

Death benefit proceeds from an insurance policy or annuity contract are generally income tax free and if properly structured, may also be free from estate tax.

D. Planning for 2010

As discussed earlier, some high-income earners are not eligible for a Roth conversion until 2010. By funding a traditional IRA with a variable annuity prior to a 2010 Roth conversion through an IRA transfer or eligible rollover from an employer-sponsored qualified plan, will allow the retiree or near retiree flexibility to align the annuity features and options with their retirement income needs.³

The full conversion to a Roth IRA of a traditional IRA holding an annuity does not require surrender of the contract. Instead, the contract is transferred "in-kind" from a traditional IRA to a Roth IRA; no policy benefits are lost and no surrender charges are imposed. The annuity valuation for tax purposes in the converted IRA may be greater than the contract's sub-account value when taking into the annuity's additional riders and benefits. An investor should consult with his financial professional or the insurance company that issued the annuity to determine the annuity valuation before undertaking the Roth conversion with an in force IRA annuity contract.

Meet with your financial professional to discuss and understand the primary and fundamental retirement income risks in conjunction with your retirement income needs and objectives. Fully and clearly understanding how the variable annuity features, optional rider benefits, risks and costs align with your retirement needs and objectives will enable you and your financial professional to make an informed decision.

¹ If the five year tax holding period is not met, then withdrawals of earnings from the Roth IRA are subject to tax. However, in that case, withdrawals are treated as coming first from non-taxable contributions and previously taxed amounts; only after those amounts are withdrawn is tax imposed. If the holder is not over age 59½ (and does not meet one of the other exceptions), then withdrawals of earnings, and of amounts converted from a Traditional IRA within the prior five years, also are subject to a 10% penalty tax.

² All guarantees are based on the financial strength and claims paying ability of the issuing insurance company, which is solely responsible for all obligations under its policies. If an IRA holder cashes in a variable annuity or takes withdrawals in excess of the guaranteed annual amount, a surrender charge may apply.

³ IRAs and other qualified plans already provide tax deferral like that provided by the annuity. For an additional cost, the annuity provides additional features and benefits, including death benefits and the ability to receive a lifetime income. If other options are available, you should not purchase a qualified annuity unless you want these additional features and benefits, taking into account their cost

This material must be preceded or accompanied by the variable annuity product prospectus and the variable annuity product guide, which explains the variable annuity features, fees and charges.

You should consider the investment objectives, risks and charges, and expenses of the variable annuity and its underlying variable annuity investment options carefully before investing. The prospectuses for the variable annuity and underlying variable annuity investment options contain this and other information. You may obtain free prospectuses by calling your financial professional or 800-366-0066. Read the prospectuses carefully before investing.

Annuity products are issued by ING USA Annuity and Life Insurance Company (Des Moines, IA) and ReliaStar Life Insurance Company of New York (Woodbury, NY) and distributed by Directed Services LLC (West Chester, PA). Both companies are members of the ING family of companies. Only ReliaStar Life Insurance Company of New York is admitted, and its products issued, within the state of New York. All guarantees are based on the financial strength and claims paying ability for ING USA Annuity and Life Insurance Company, who is solely responsible for all obligations under its policies. This material was written to support the promotion or marketing of the transaction or matters addressed herein. It was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under the U.S. federal tax laws. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

ING Annuities is the marketing name for the issuing insurance company. Variable annuities are long-term investments designed for retirement planning. They are a contract between you and an insurance company, under which the insurer agrees to make periodic payments to you. Additionally, variable annuities offer the opportunity to allocate premiums among fixed and variable investment options that have the potential to grow income tax-deferred, until an income stream begins. These payments, called annuity income, will begin either immediately or at a future date and a part of which may be the return of your premium or principal. This income is guaranteed by the issuing insurance company for a specified period of time or for the life of the annuitant. Optional benefits and riders are available for an additional cost.

Variable insurance products are subject to investment risk, are not guaranteed and will fluctuate in value. In addition, there is no guarantee that any variable investment option will meet its stated objective.

Andrew H. Friedman is a former senior partner in a Washington, D.C. law firm. He speaks regularly on legislative and regulatory developments and trends affecting investment, insurance and retirement products. He may be reached at afriedman@cov.com.

Neither the author of this paper, nor any law firm with which the author is associated, is providing legal or tax advice as to the matters discussed herein. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. It is not intended as legal or tax advice and individuals may not rely upon it (including for purposes of avoiding tax penalties imposed by the IRS or state and local tax authorities). Individuals should consult their own legal and tax counsel as to matters discussed herein and before entering into any estate planning, trust, investment, or insurance arrangement.

June 2009. Copyright Andrew H. Friedman 2009. Reprinted by permission. All rights reserved.

154079
cn63612072010
09-5018A
SBA090867
08/17/2009