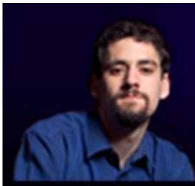
The Kitces Report
Advancing knowledge in financial planning... June 2009

Evaluating Strategies for Roth Conversions

In last month's newsletter, we evaluated the decision between a Roth and traditional IRA, and in what situations each type of account would be favored. As a follow-up in this month's newsletter, we will look at numerous strategies and techniques that are often "pitched" as planning opportunities associated with Roth conversions. Sometimes the strategy sounds good at face value, but does it really "work" the way its stated?

Of course, this is by no means the comprehensive list of Roth conversion strategies, but many are commonly proposed planning ideas and tips that can be evaluated to determine whether they are or are not good strategies, and in what situations they should and should not be applied. At the end, you will hopefully have a better perspective on what does, and does not, create value when applying Roth conversion strategies for your clients.

Roth Conversion Strategies

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What Contribution Income Limit?

The Pitch

The first strategy to be analyzed is typically presented as follows:

> *Married client couple has over $200,000 of income, which renders them ineligible to contribute to a Roth IRA. In addition, they already have a retirement plan at work, and are therefore ineligible for pre-tax traditional IRA contributions due to their active participant status (given their high level of income). However, the couple will contribute to a traditional IRA anyway - on an after-tax basis - with the goal of converting the traditional IRA to a Roth IRA in 2010 (which should be "mostly" tax free since the account was funded with after-tax dollars). This approach effectively allows the client to still make Roth IRA contributions indirectly, by contributing to the non-deductible IRA now and doing the conversion later. And after 2010, we can continue the strategy, allowing the client to make an indirect Roth IRA contribution every year, by making the non-deductible IRA contribution year by year and then converting that new IRA to a Roth IRA shortly thereafter.*

At face value, this sounds like a pretty appealing strategy - it essentially allows all clients to get their annual IRA contributions into a Roth IRA, either immediately or in just a few years, circumventing the Roth IRA contribution income limits.

But does the strategy really work? The brief answer is that the strategy works - sort of, and with caveats. To understand, it is necessary to take a step back and look at how Roth conversions really operate.

Technical Rules

The general rules for Roth IRAs prevent a married couple with Adjusted Gross Income (AGI) in excess of $176,000 from making any contribution to a Roth IRA

(for singles, the upper end of the phase-out limit is $120,000). On the other hand, any couple can contribute to a traditional IRA, regardless of how high their income is, as long as they have the minimum amount of qualifying (earned) income. At worst, if one or both members of the couple is an active participant in an employer retirement plan, the contribution will no longer be deductible once income exceeds the specified limits (see the May 2009 issue of The Kitces Report for a more in-depth discussion of the applicable rules for the deductibility of IRA contributions and the determination of active participant status). For a single individual, the upper AGI limit is $65,000 if the taxpayer is an active participant; for a married couple, the upper AGI limit is $109,000. If the individual is married and is not an active participant but the spouse is, the upper limit is raised to $169,000 for the non-active-participant spouse. When income exceeds these thresholds, the taxpayer may only make non-deductible IRA contributions.

In order to complete a Roth conversion, the taxpayer's AGI must be below $100,000 (the same limit applies for both single and joint filers); however, this income limit is removed in 2010, allowing any taxpayer to complete a Roth conversion regardless of how high their income is.

When a Roth conversion is completed from a traditional IRA, the tax code requires that any distributions from the IRA (that were converted to the Roth IRA) must be reported in income to the extent that they are *not* attributable to non-deductible contributions. Allocating the taxable versus non-taxable amounts for the conversion distribution follow the normal rules that are applicable to all traditional IRA distributions - the non-taxable amount is determined by a fraction, where the numerator is the total amount of non-deductible contributions, and the denominator is the total value of the IRA. However, it is important to bear in mind that this so-called "pro-rata rule" requires *all* IRAs to be aggregated together to calculate the denominator of this fraction. This requirement to aggregate IRAs for the pro-rata rule applies when determining the income tax consequences of any taxable distribution from the IRA (including a Roth conversion).

The Reality

As the technical rules above indicate, it is certainly true that for higher income taxpayers, there is a point where a Roth IRA contribution is no longer an option, while a traditional IRA contribution is *always* available as an option. Given that most higher income individuals are active participants in an employer retirement plan, the traditional IRA contribution will most frequently be non-deductible (due to the separate income limits on deductibility for active participants), but nonetheless a non-deductible contribution is always an option. And although a non-deductible contribution itself may not always be desirable (as it provides tax-deferral on growth, but also can "convert" growth that may have been eligible for preferential long-term capital gains and qualified dividend rates into ordinary income IRA withdrawals in the future), the opportunity to make a non-deductible contribution in anticipation of a Roth conversion is more appealing. After all, if the taxpayer makes a non-deductible contribution to a traditional IRA, and then converts the traditional IRA to a Roth IRA (ostensibly not taxable to the extent of the non-deductible contribution), then the end result is as desired - the taxpayer made a non-deductible contribution and ended out with money in a Roth IRA, the equivalent to having made a Roth IRA contribution in the first place.

However, the strategy is not without its complications. Most significantly, the tax rules applicable to the conversion itself can present less-than-desirable results in many situations, specifically as a result of the requirement that *all* traditional IRAs be aggregated for determining the tax consequences of a distribution (or a Roth conversion). Some examples will help to illustrate the problem:

> *Example 1.* John makes a $5,000 non-deductible contribution to a traditional IRA in 2008, and makes another $5,000 non-deductible contribution in 2009 (he is an active participant in an employer plan, and his income is too high to allow for a deductible IRA contribution or any Roth IRA contribution). By the end of 2009, the account has grown to $11,500. In early 2010, John converts the entire $11,500 IRA to a Roth IRA. His total non-deductible contributions are $10,000, and his total account balance is $11,500; thus, $10,000 / $11,500 = 86.96% of the conversion is treated as a non-taxable distribution of after-tax contributions. As a result, John is not taxed 86.96% of his $11,500 conversion (which comes out to the $10,000 he originally contributed, since he converted the entire account), and John is only taxed on $1,500 of the conversion distribution (equal to the growth in the account). In the end, John ends out with an $11,500 Roth IRA, comprised of two years of $5,000 contributions plus some growth, despite the fact that his income was too high in 2008 and 2009 to ever be eligible for a Roth IRA contribution.

Example 2. John makes the same contributions as above. However, he also has an existing $55,000 IRA that includes his deductible contributions and growth from many years ago. John makes his new non-deductible IRA contributions to a separate, new IRA account, so that he can easily track the growth associated with the non-deductible contributions, and because he intends to convert only the account with non-deductible contributions. By the end of 2009, his IRA with non-deductible contributions has again grown to $11,500, and his traditional IRA has growth to $66,000. In early 2010, John converts his IRA with non-deductible contributions to a Roth IRA, and takes no withdrawals from his other $66,000 IRA. However, when John calculates the amount of his Roth conversion that is non-taxable, the ratio is calculated as $10,000 / $77,500 (the denominator including the aggregation of *all* of his IRAs, including the $11,500 account and the $66,000 account). Thus, the non-taxable amount of John's Roth conversion is only 12.9%, or about $1,484. The other $10,016 of John's Roth conversion is taxable to him, even though he converted a separate standalone account with only non-deductible contributions in it!.

As a result of the separate, outside IRA that John had, the conversion of his $11,500 resulted in $10,016 in example 2, as contrasted with only $1,500 of taxable income in example 1. In both cases, John contributed $5,000/year of non-deductible contributions to a single account, invested them the same, and converted the same entire standalone account ($11,500) to a Roth IRA. However, due to the IRA aggregation rules, the tax consequences were significantly different, and John was unable to harvest a Roth conversion using only the non-deductible IRA and its associated contributions. As a result, the entire transaction was less desirable; John's conversion caused over $10,000 of taxable income instead of only $1,500, and now he has a remaining $8,516 of non-deductible contributions still associated with the remaining $66,000 IRA, even though the non-deductible contributions never went into the account! And if the outside IRA was $660,000, instead of "only" $66,000, then John's conversion of the $11,500 account would have resulted in $11,329 of income (over 98.5% taxable!).

Thus, the presence of outside IRA money causes a significant complication for the general strategy of making non-deductible contributions to an IRA with the intention of completing a Roth conversion in the future. Notably, the aggregation rule applies at the time of conversion, which also means that the strategy could be less effective if a client, who contributed to a non-deductible IRA for several years in anticipation of the conversion, separately received IRA dollars at any time before the conversion. For example, if the client rolled over a $200,000 401(k) plan to an IRA sometime in 2009, then when it came time for the Roth conversion in 2010, the new IRA would have to be aggregated for tax purposes, even though it wasn't present for most of the years that the non-deductible IRA was receiving contributions.

The aggregation rules also present a problem for those who wish to use a non-deductible contribution followed by a Roth conversion to circumvent the Roth IRA income limits in 2010. If the client has no other IRAs, the strategy can still work effectively, with a contribution followed by a conversion. However, if the client has any other IRAs, once again the Roth conversion step will require aggregation of all the IRAs for tax purposes, and consequently a $5,000 non-deductible contribution cannot be fully converted tax-free in the presence of other pre-tax IRA accounts.

In addition, it is notable that Congress may in some way alter the Roth contribution income limit rules in 2010 and beyond, in light of the fact that Roth conversions do effectively render the income limits moot for a large number of taxpayers anyway (who can make non-deductible contributions and convert, regardless of the original Roth contribution income limits).

Conclusion

For the client situation where there really are no other IRAs, and income is too high to otherwise contribute to a Roth IRA, this strategy can be an effective means to indirectly increase the client's Roth IRA holdings. By contributing to a non-deductible IRA currently, in anticipation of a Roth IRA conversion in 2010, the client can ultimately achieve the equivalent of a Roth IRA contribution at a very similar tax cost to an outright Roth IRA contribution in the first place. In 2010, clients may be able to use the strategy to circumvent the Roth IRA contribution income limits as well - again, if there are no other traditional IRAs around to adversely trigger the IRA aggregation rule.

Fortunately, the IRA aggregation rules do only apply to other IRAs, and not other types of non-IRA qualified plan retirement accounts. Thus, clients who hold money in a 401(k), 403(b), defined benefit plan, etc,. can retain assets in those accounts and not need to deal with the aggregation rules. In point of fact, for clients who anticipate Roth conversions in 2010, avoiding the

aggregation rule may even be an incentive to choose to retain assets in such plans.

Nonetheless, the presence of virtually any other outside IRA money makes the strategy of non-deductible contributions followed by Roth conversions radically less desirable and tax-favored (as seen in example 2), due to the fact that the non-deductible contributions alone cannot be converted without incorporating the tax impact of all other pre-tax funds.

However, for clients where the income level is too high for Roth IRA contributions, and there are no other IRAs present (or anticipated to be present by the time of conversion), the non-deductible contribution followed by a Roth conversion can be a desirable strategy to maximize tax-preferred wealth accumulation, especially where the client is an active participant in an employer retirement plan as well and may only make non-deductible contributions. On the other hand, if the client is able to make a pre-tax IRA contribution, the Roth conversion must be evaluated separately as a comparison of traditional to Roth IRA dollars, based on the client's current and anticipated future tax rates.

Harvesting Old 401(k) After-Tax Contributions

The Pitch

The next strategy to be analyzed is typically presented as follows:

> *Daniel has $150,000 in his 401(k), which includes $25,000 of non-deductible after-tax contributions from prior years. Since non-deductible contributions are not taxable when they are withdrawn, they are also not taxable when converted to a Roth IRA. Consequently, Daniel would like to liquidate his IRA by rolling over the $125,000 of pre-tax money to a traditional IRA, and move the remaining $25,000 to a Roth IRA as a tax free Roth conversion. This will allow Daniel to enjoy tax-free future growth on his $25,000 of after-tax contributions, instead of creating taxable growth within the traditional IRA/401(k), and can be accomplished at no current tax cost since the Roth will be funded entirely with after-tax dollars.*

As with the prior strategy, this sounds very appealing at first. Convert after-tax dollars in a retirement plan to a Roth IRA without any tax cost, and then be allowed to enjoy future tax-free growth! Who wouldn't want to do it!?

Does this strategy actually work? The answer is yes, but the rules and proper methodology to accomplish it are a little more ambiguous than might first appear.

Technical Rules

When amounts are converted from a traditional retirement account to a Roth, only the portion that would have been taxed as a distribution must be reported in income. Thus, to the extent that a retirement account conversion includes both after-tax amounts and various taxable amounts (either pre-tax contributions, or any growth in the account), a portion of the conversion (attributable to after-tax contributions) can be converted tax free.

Under the standard rules for IRAs, any distribution from the account (including for a Roth conversion) is treated as a pro-rata distribution of after-tax and taxable amounts. Thus, for example, if the cited earlier pertained to a traditional IRA, 16.67% of any distribution (including the Roth conversion) of the $150,000 IRA would be treated as a non-taxable distribution of after-tax monies, and the remainder would be treated as taxable.

In addition, under new rules established from the Pension Protection Act of 2006, it is also true that a client can complete a direct conversion from an employer retirement plan to a Roth IRA in a single conversion transaction. (By completing the conversion in a single-step transaction, the taxpayer avoids the requirement to aggregate with other IRAs, since the

Out and About

- Michael will be presenting on "Roth Conversions and Tax Loss Harvesting" at the NAPFA Washington DC Study Group on July 22nd

- Michael will also be presenting an "Income Tax Planning Update" at the WealthCounsel "Planning for the Generations" Conference on August 6th

- Michael will be speaking on income tax and retirement income planning topics at the Garrett Planning Network Retreat conference on August 7th

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conversion comes directly from an employer retirement plan and not a traditional IRA.)

Unfortunately, though, additional complications arise in the case where the pre-tax and after-tax amounts are held in an employer retirement plan account. In the case of an employer retirement plan like a 401(k), this general rule still applies - a taxable distribution from a 401(k) plan is treated in the same manner, as a pro-rata distribution of non-taxable and taxable amounts. There would apparently be no way to extract "just" the after-tax amounts. *However*, under IRC Section 402(c), an apparent exception to the "normal" pro-rata rule applies in the case of rollovers from employer retirement plans 401(k)s to other retirement accounts. Instead, the rules stipulate that where a distribution is rolled over, the amount transferred is treated as coming first from any taxable amounts in the account, and only then from any remaining portions of the account allocable to cost basis.

Notably, in any case, the distribution from the 401(k) itself can only occur if the distribution is allowed under the plan rules. Depending on the plan, this may require that the plan participant either be separated from service, or reach the specified retirement age, unless the plan otherwise allows for some type of in-service distributions.

The Reality

The special ordering rule for rollover distributions from 401(k) plans ostensibly provides an opportunity to separate the account into a pre-tax distribution and a second after-tax distribution, which could be subsequently be directed to a rollover IRA (for the pre-tax amounts) and a Roth IRA (to convert the after-tax amounts). In essence, this would directly accomplish the proposed strategy.

Unfortunately, though, the exact manner in which the 402(c) rules play out is still a little ambiguous. While the rules seem to indicate an ordering process to distributions, it is a matter of some debate about how exactly they must be accomplished.

The most conservative approach is to have the retirement plan complete an outright distribution to the participant. In this scenario, the plan is fully liquidated in a distribution to the participant, who rolls over an amount equal to the pre-tax value to an IRA, and then subsequently rolls over the remainder of the distribution to a Roth IRA. The amounts that should be allocated to pre-tax money are rolled over first to ensure the proper application of the ordering rules. The remainder, which should be only after-tax funds at that point, simply needs to be rolled over to a Roth IRA (completing the conversion) before the normal 60-day deadline that applies to rollovers. However, a significant caveat to this approach is that if the plan participant receives a full outright distribution, the mandatory 20% withholding rules will apply. Thus, to follow this approach, the client would be need to make up the missing 20% of the distribution out of pocket to complete the pre-tax rollover, then roll over the remaining after-tax funds to the Roth IRA, and finally recover the 20% "excess" withholding when the tax return is filed early in the subsequent year. Depending on the size of the 401(k) account and the client's available liquidity, having funds available for the 20% withholding may be problematic.

The next alternative is to try to accomplish the rollovers as a direct trustee-to-trustee transfer. This avoids the cash flow challenge of 20% withholding, but it is not as clear under the 402(c) rules if the same ordering process applies if the individual takes sequential direct rollover distributions, as opposed to a single outright distribution that is later rolled over in separate transactions. If a client wishes to follow this approach - in the context of our example above, to complete an outright rollover of the first $125,000 (ostensibly all pre-tax) and then later an outright rollover of the remaining $25,000 to a Roth IRA - it is advisable to at least confirm that the 401(k) administrator will report the transaction as desired, as opposed to separately applying the pro-rata rule to each separate distribution (where 16.67% of *each* distribution, for $125,000 and for $25,000, would be tax-free instead of having the first being all taxable and the second all after-tax).

A third approach is to simply complete all of the rollover distributions at once, and have the plan administrator distribute the account in two simultaneous checks: one for $125,000 (which will be send to the rollover IRA), and one for $25,000 representing the after-tax amounts (which will be send to the Roth IRA). Although it remains very ambiguous about whether this approach is entirely supported under the tax code, it appears to be the most common manner that such distributions are actually made from 401(k) plans. Thus, to the extent that the plan administrator is willing to make the distributions under this approach, *and report them accordingly on the Form 1099-R*, many clients may choose to follow this simplest and most direct approach. But clients should be cautious and cognizant that there may be some risk the IRS will challenge whether this was/is a proper manner for the distribution, and thus clients may have some level of audit risk if

they do not follow one of the "safer" approaches detailed earlier.

Conclusion

Although this strategy works, its safest application in the face of somewhat ambiguous technical rules can create a significant cash flow constraint - making up for the 20% withholding on the amount distributed from the plan and waiting until tax season to recover it as a refund. In addition, the strategy is only available for those who are otherwise eligible to take a distribution from an employer retirement plan in the first place. For those who haven't reached their plan retirement age and haven't separated from service, the strategy may not be possible anyway, simply due to the inability to receive a distribution to rollover in the first place. Thus, this strategy is most likely to be implemented with older clients who have reached the plan retirement age and/or have retired and thus have separated from service and are eligible for distributions from the plan.

Nonetheless, confusion about the precise "right" way to complete and codify such distributions extends to many plan administrators as well. In many cases, clients can simply request that the plan administrator cut two checks - one for the pre-tax amounts and one for the after-tax amounts - and send them to the appropriate rollover and Roth IRAs, and the plan administrator will report the rollovers as desired. Although it is possible that this may be challenged by the IRS at some point, the odds of challenge and discovery are fairly low for any individual client if the transaction will be reported as desired on the form 1099-R. Consequently, in many cases, clients will likely choose this route if available, and only very conservative clients (or for those situations where the plan administrator will not cooperate) will opt for the more conservative distribution-and-withholding approach.

Account Diversification for Roth Conversions

The Pitch

Under the next strategy, the concept is usually explained in the following manner:

> *Instead of completing a Roth conversion of all your investments from a traditional IRA to a Roth IRA, split your investments into separate Roth conversions. For example, convert all of the stocks in your IRA to Roth IRA #1, and your alternative investments to Roth IRA #2. Next year, you can look back and see which accounts went up and which went down. Any of the accounts that went up you can keep as a Roth IRA, and only pay taxes based on the value at the time of the conversion. Any of the accounts that went down can be recharacterized back to a traditional IRA, so you can avoid the tax consequences completely for the account that declined in value. Then next year you repeat the process, thereby ensuring that you only complete Roth conversions for accounts that increase in value.*

As with the prior two strategies we have examined, this strategy does work, but it's not without its own unique complications.

Technical Rules

As discussed in last month's newsletter, it is certainly possible to recharacterize a Roth conversion back to the traditional IRA from which it originated, and thereby avoid any tax consequences that would have been associated with the original conversion. The deadline for a Roth recharacterization is the tax filing deadline of the taxpayer, plus extensions if filed, which can allow a Roth recharacterization to occur as late as October 15th of the year after the conversion. The amount available to be rolled back to the traditional IRA must be adjusted for any gains or losses during the interim period. I.e., if $100,000 is converted but its value declines to $80,000, only $80,000 of the Roth IRA can be transferred back to the original traditional IRA; nonetheless, because the entire conversion amount (after adjusting for gains and losses) was recharacterized, no tax consequences accrue with respect to the Roth conversion.

If a Roth conversion is recharacterized, those dollars cannot be converted again for the same tax year as the original conversion, but may be in a subsequent tax year. For example, if Daniel converts a $60,000 Roth IRA in January of 2009, and recharacterizes the conversion in June of 2009, he can convert the $60,000 again, but not until 2010 (a later tax year). Notably, if Daniel converts the Roth IRA in January of 2009, and recharacterizes it in February of 2010 (still allowable since it is before the 2009 tax filing deadline), he can convert the $60,000 again in 2010 since the original conversion was still 2009 and it is now a different tax year. Nonetheless, if Daniel wishes to re-convert in

2010, he must still wait at least 30 days from the recharacterization before he converts the same dollars a second time. Thus, the recharacterization rules essentially stipulate that the taxpayer can convert again after the later of 30 days or a subsequent tax year after the year of the original conversion.

The Reality

As indicated above, the basic approach of completing a Roth conversion with the possibility of recharacterizing later is certainly allowed, within the existing deadline requirements. Moreover, it is allowable to convert to a Roth IRA and recharacterize, even with the expectation of re-converting again in the tax year after the conversion (if the account balance has declined).

This planning opportunity led to the initial form of the strategy examined here - which was simply to convert a traditional IRA, wait until the following year to see if it had gone up or down in value, and then either keep the Roth IRA if the investments had a good return (paying conversion taxes on only the original amount), or recharacterizing the conversion if the account was down and then reconverting after 30 days using the new reduced account balance in the new tax year. The approach was essentially to convert and win if the account was up, or reset with a new conversion next year if the account was down. (Note: Under the so-called "anti-cherry-picking" rules of IRS Notice 2000-39, the recharacterization must be for a pro-rata portion of the account or the entire account, but cannot be for specific assets within the account. To recharacterize separate investment assets, they must be held in separate accounts.)

The strategy discussed in this section is really simply a natural extension of the approach. If you can convert a traditional IRA to a Roth IRA and wait to see whether it's up (to keep it) or down (to recharacterize and try to reconvert again next year), why not give yourself more opportunities to create value by doing the strategy several times with different investments. In the context of the original "pitch", if the equities and alternatives were held in a single account and moved in opposite directions, the overall account might simply be flat after a year. However, if the equities were converted to one account and the alternatives to a second account, then if in fact their performance does differ, there is an opportunity to harvest the value by keeping the Roth conversion gains from one account and recharacterizing to reconvert the account with losses.

Notably, the strategy is appropriate primarily because these were investments that the traditional IRA (or converted Roth IRA) was already going to hold anyway. Thus, there is no underlying investment difference in using multiple Roth IRAs to separate the conversions; it's just to separate the tax consequences associated with the conversion.

In theory, to best harvest the value of the strategy, the Roth conversions should be done early in the year, to maximize the amount of time that the client gets a "free look" at whether the account is appreciating, or declining in value, for each of the separate Roth conversion investments. Potentially, a client who converts in January of year #1 could have as much as 22 months to remain invested until October of year #2 before making a final decision about recharacterization. However, this approach leaves very limited time to re-convert in year #2 for any assets that declined in value, to revisit the process in year #3. Thus, optimally, the client would probably want to convert in January of each year, and assess whether there were any investments to recharacterize in December of that year, so that the client could be prepared to re-convert again and repeat the process anew in the following January.

On the other hand, clients should also be cautious about unnecessarily over-implementing the strategy. Although theoretically a separate Roth IRA conversion transaction could be done for every single possible investment the client might hold, creating 5, 10, or more different Roth IRAs to convert, track, and potentially recharacterize to reconvert in a subsequent year, the sheer paperwork and tracking requirements for all of the different accounts could become quite burdensome. Thus, it is probably largely sufficient to implement the strategy by separating different asset classes into different Roth IRAs - where there is a lower correlation and a more genuine expectation of a potential material difference in returns that would make the overall strategy worthwhile - rather than creating separate Roth IRAs for each individual investment holding. Over a period of one or several years, eventually the issue will be moot because all of the client's investments will likely eventually experience an "up" year where a recharacterization does not occur; at that point, all

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of the client's traditional IRA funds will be fully converted and there will be no more conversions or recharacterizations to consider.

Nonetheless, implementing a planning approach of this nature should only be done in the context of what would otherwise make good sense for a Roth conversion. As discussed extensively in the May issue of *The Kitces Report*, completing a Roth conversion is most beneficial if tax rates are higher in the future - when withdrawals were going to occur - than the rate in effect now when the conversion occurs. This is true regardless of the associated growth rate; instead, a greater growth rate simply means that more wealth is created if tax rates are favorable, and more wealth is destroyed if tax rates are unfavorable. Thus, to the extent that the multiple-account-Roth-conversion strategy is effective because it isolates the accounts with desirable growth rates (at least in the first year) and excludes accounts or investments with lower or negative growth rates, the approach still will only be effective if the tax rate situation is favorable, all else being equal. (See the May issue of The Kitces Report for a discussion of other factors that may impact the breakeven point for a Roth conversion.) In the end, if the current Roth conversion tax rate is undesirable, no implementation of this account-splitting strategy will make the wealth impact more favorable.

Conclusion

Overall, the multiple account Roth conversion strategy is an effective - arguably, a more effective - means to complete a Roth conversion of a sizable account, especially if the account holds a broad range of asset classes that can be separated. The primary constraints to the strategy are the timing of the implementation (ideally, if it will be recurring for several years, to convert early in each year and re-assess for a recharacterization at the end of each year), and the sheer complexity of paperwork and implementation necessary to manage, invest, track, and properly report multiple Roth conversions, recharacterizations, reconversions, and the associated tax consequences.

Nonetheless, to the extent these hurdles can be managed, the strategy provides clients the opportunity to get a "sneak peek" at the first year's worth of growth (or lack thereof) on a Roth conversion before deciding whether to keep the conversion. Although ultimately, tax rates are still the dominant controlling factor in the value of a Roth conversion, the benefit gleaned from a favorable tax rate change between the time of conversion and the time of withdrawal is only enhanced by better growth rates on the underlying investments. With this strategy, you can at least ensure a good head start in the first year.

Roth Conversions using Annuities to Reduce Taxation

The Pitch

This strategy seeks to mitigate the tax impact of a Roth conversion through the purchase of annuities within an IRA, and typically is presented as follows:

> *Daniel has a $200,000 IRA and is considering a Roth conversion of the IRA. Under the normal rules, converting a Roth IRA worth $200,000 would require him to report $200,000 in income. Instead, Daniel will purchase a variable annuity with a steep up-front contingent surrender charge of 10% in the first few years. With the annuity, Daniel's liquid net surrender value is only $180,000, and therefore he would only be required to report $180,000 of income on his tax return, effectively avoiding taxes on the last $20,000, and saving $6,000 assuming a 30% effective tax rate. Since Daniel doesn't need to use the money anytime soon, he can simply continue holding the annuity after the conversion and wait for the surrender charges to expire and then reinvest elsewhere.*

Unfortunately, as we will see in the technical explanation below, this strategy is no longer effective, due to changes in the tax law over the past several years.

Technical Rules

(Publisher's note: Because of the rapidly changing rules in this area of the tax code, I have included detailed tax citations for those planners who may find themselves in a situation where they need to direct a client's other advisor to specific concrete references.)

Prior to August 19, 2005, there was no special methodology for valuing an annuity held inside of an IRA for Roth conversion purposes, and consequently most clients did in fact simply report the cash surrender value.

However, this changed when the IRS issued new Proposed and Temporary Regulations 1.408A-4T in August of 2005, and followed it up with further clarification in Rev. Proc. 2006-13 in the following

year. Under the new rules for converting deferred annuities that had not yet been annuitized, it was restated that the fair market value must *fully* reflect all of the contract's benefits and features.

The safe harbor approach provided in the 2006 Revenue Procedure stipulated that valuation rules would be the same as those using for valuing certain gifts under Treas. Reg. 1.401(a)(9)-6, Q&A-12, with additional special modifications. In the end, the new safe harbor rules indicated that the proper valuation of a deferred annuity (separate rules apply for other types of annuities) for Roth conversion purposes would be:

> - The dollar amount credited to the annuity owner under the contract [i.e., the gross cash value], *not reduced by any surrender charges under the contract*; PLUS
>
> - The actuarial present value of any additional benefits, regardless of [how small] their value.
>
> - Furthermore, all front-end loads and other non-recurring charges assessed in the twelve months immediately preceding the conversion must also be added to the account value. In addition, future distributions are not to be assumed in the determination of the actuarial present value of additional benefits.

The final version of the Treasury Regulations 1.408A-4, Q&A-14 (TD 9418), effective on July 29, 2008, continued the above rules, with the revision that if an annuity is fully surrendered as a part of the Roth conversion process and no benefits of the annuity contract extend after the conversion, the net cash surrender value may be used for the valuation. In addition, the final rules stipulate that if for some reason the above approaches still fail to properly reflect the full fair market value of the annuity, those valuation methods cannot be used and the annuity must still be valued at the full "fair market value."

The Reality

The rules for valuing an annuity for Roth conversion purposes were changed, initially in 2005, with follow-up guidance in 2006, followed by a final version of the new rules in 2008. The reason for the change, in point of fact, was to stop the very kind of strategy explained in "The Pitch" above, as it was viewed by tax officials to be an abusive use of ambiguous rules and not a genuine reflection of the actual economics of the transaction. By indicating under the new rules that the conversion value must be the full cash value of the contract, *without reduction by any surrender charges*, the approach of buying an annuity with a contingent surrender charge to temporarily depress the valuation was rendered dead.

In point of fact, the requirement that the valuation of an annuity for Roth conversion purposes include the actuarial present value of *any* additional benefits also eliminates several other similar Roth conversion strategies with annuities. For example, if a variable annuity was purchased for $300,000, and the value dropped to $150,000, but the death benefit remained at $300,000, some clients might be encouraged to convert to a Roth IRA, so that the entire $300,000 death benefit will accrue to the heirs tax-free (in a Roth account) at "only" a tax cost for $150,000 of income. However, under the new rules, the actuarial present value of the extra $150,000 death benefit must still be included; this will result in a value that is still less than $300,000, but will be higher (potentially much higher) than "just" the $150,000 cash value.

The additional requirements that front-end loads and non-recurring charges in the preceding 12 months must be ignored for Roth conversion valuation purposes, and that all of the above rules may be ignored if the valuation still does not fully reflect fair market value, are additional steps taken by the Treasury and IRS to ensure that valuation-related abuses do not occur as a part of the Roth conversion process.

In addition, it's also notable that annuities do not come at a "free" cost. They include expenses for the contract itself and the various guarantees that it provides. Although such guarantees may be a good value for many clients, if the *sole* purpose of purchasing the annuity is to alter its valuation without any other need for the contract's benefits and guarantees, those costs simply represent an additional economic drag on the overall value of the transaction. In many cases, this will at best reduce the tax value of the strategy (if it could even be completed without running afoul of the new tax rules), if not outright eliminate the value completely over several years of additional expense costs.

Conclusion

Although once a semi-effective strategy - if an annuity could be obtained at a reasonable cost that didn't erode the tax value created - the use of annuities within IRAs to depress the value for Roth conversion purposes is no longer a viable strategy. After being deemed abusive by the Treasury and the IRS, new rules over the past four years have eliminated the valuation loopholes. Any advisors and clients still seeking to apply these rules in

today's environment run the risk of IRS penalties for a potentially significant misstatement of income.

Thus, although annuities may still have many valid uses within an IRA for risk management purposes in certain client situations, their use as a tool to adjust and manipulate the account value for tax purposes is over.

Lowering Future Tax Rates through the Roth Conversion Itself

Beyond the four strategies outlined above, many strategies put forth for Roth conversions essentially boil down to "if you complete a Roth conversion, you'll won't face future taxation on your IRA withdrawals (or will have less IRA money to be taxed), and therefore _____ will be taxed at a lower rate." This may apply in a number of contexts, whether to reduce the tax burden on pensions, the taxation of Social Security benefits, or converting part of the traditional IRA to a Roth to reduce the taxation on the remainder of the IRA.

Although it is true that reducing IRA assets by a Roth conversion means there is less future IRA money that will be subject to taxation, it is not entirely correct to suggest that converting to a Roth IRA will reduce the future tax burden on something like a pension. The reality is that a pension represents a fixed stream of income that will occur already; in other words, it is essentially the "base case" on top of which you stack an IRA withdrawal. Thus, it would be more accurate to say that the Roth conversion avoids whatever tax rate would have applied to the IRA on top of the pension; not that the Roth conversion itself reduces the tax rate on the pension. Is such a conversion still a good deal? In the end, it comes back to the same factors as always; what would the tax rate have been on the IRA withdrawal in the future (after accounting for the pension and other income), and how does that compare to the tax rate on the Roth conversion now.

On the other hand, the impact of Social Security taxation represents a slightly different dynamic, although it still falls broadly into the category of "higher future tax rates favor the Roth IRA." Under the Social Security rules, as little as 0% or as much as 85% of an individual's Social Security benefits may be subject to taxation (at whatever tax rates otherwise apply). While the amount of Social Security that will be taxed is phased in, though, significantly higher marginal tax rates may occur on additional income. For instance, at the margin, adding another $10,000 of income (e.g., from an IRA withdrawal), may also cause an additional $8,500 (85%) of Social Security benefits to become taxable. If the individual is subject to a 25% tax rate, this results in a total of $4,625 in additional taxes ($2,500 on the original $10,000 of income, and another $2,125 on the extra Social Security benefits that are taxed). Thus, at the margin, an additional $10,000 of IRA income causes $4,625 of additional taxes, for a marginal tax rate of 46.25% on that $10,000 of income! Surely, almost any current tax rate on a Roth conversion would be favored over such a high future tax rate! However, the reality is that once the maximum 85% of Social Security benefits are taxed, additional income is simply taxed once again at the individual's marginal tax bracket (e.g., 25%), so while the tax rate due to Social Security benefits taxation is high, it is also over a very limited scope. So while the next $10,000 of the individual's income might face a 46+% tax rate, the next $30,000 of income thereafter might only face 25%. Furthermore, many individuals are only subject to the 15% tax rate while phasing in the taxability of Social Security benefits, while may result in marginal tax rates of "only" about 28% and not 46+%.

So it is certainly true that a client who is in the midst of causing Social Security benefits to be taxed can "think" they're in the 15% bracket, but actually be taxed at the margin at nearly 28%, and clients who think they're in the 25% bracket can sometimes have a portion of income taxed at upwards of 46% marginal rates - at least until all of the Social Security benefits have been fully included in income. And to the extent that this causes higher tax rates in the future, it can make a Roth conversion (or Roth contributions) more worthwhile now. However, unless the receipt of Social Security benefits is really just a few years away, or the situation is extremely isolated (e.g., if Social Security and the IRA are the only two assets/income streams in the client's entire plan), it may not necessarily be desirable to complete a full Roth conversion just to avoid Social Security benefits taxation. The reason is simply that there are so many factors for most clients from year to year that impact Social Security taxation if the client is close to the margin - most significantly, the income from taxable accounts - that it is difficult to anticipate far in advance. If the client's income is merely slightly higher than expected, all of the Social Security benefits may already be fully included in income due to other factors, and the future tax rate on the IRA withdrawal may be significantly lower than originally anticipated.

Beyond Social Security benefits, it is certainly true that converting IRA money can reduce the amount of taxable funds that will be withdrawn in the future, which can in turn help to reduce the future tax bracket those remaining funds may face. For example, the likely taxation that $1,000,000 of IRA funds will face in the future is often higher than what only $400,000 of IRA funds will face, simply because there are likely to be less aggregate IRA withdrawals over time (thanks to a $600,000 Roth conversion). However, one must be cautious, since converting "too much" of an IRA could actually cause future tax rates to become so low that the Roth conversion is no longer beneficial! For instance, if the client with a $1,000,000 IRA converted all but $100,000, it is likely that the last $100,000 could actually be harvested out of the IRA in the future at extremely low tax rates (since there is little else taxable for the client), making a Roth conversion for the last $100,000 far less desirable. Consequently, it may mean that the best course of action is often a blend, converting enough money to keep some IRA withdrawals out of the highest brackets, but retaining some IRA money for future withdrawal because the tax rate on that portion of the money will not be as high. Especially if the availability of a Roth and traditional IRA together gives the individual more flexibility to time the taxability of withdrawals to favorable tax years.

In the end, though, there is no substitute for a thorough, individual analysis of potential future tax rates for a client's individual situation. Such an analysis should take into account all of the likely income factors in the future, ranging from pensions to portfolio income to Social Security taxation to phaseouts of deductions and changing AGI thresholds. Only by accounting for the client's full situation can the planner get a clear picture of what the actual tax rate would likely be on future IRA withdrawals, to properly assess whether a Roth conversion is desirable or not for an individual client situation.

Summary

There are many strategies often associated with Roth conversions. Some are nothing more than a different way to frame the transaction, but in many cases the strategies are bona fide ways to apply Roth conversions strategically to enhance wealth, in full compliance with existing tax rules. Unfortunately, some of the tax law surrounding certain aspects of Roth transactions is still a little gray, and other parts have been changed in recent years to restrict perceived tax abuses.

Nonetheless, at a fundamental level the opportunity for a Roth conversion still allows taxpayers to make active decisions about the timing of recognizing income on retirement savings, and to the extent that tax rates and a client's income do vary from year to year, opportunities to create wealth will continue to arise for clients and their planners who are prepared to take advantage of it.

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