

Who Benefits the Most from a Roth Conversion?

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Summary

A traditional IRA¹ can be considered as a partnership between the participant and the federal and state governments. The participant's share of the interest, dividends and gains are essentially tax-free.

A participant can buy out the governments' share by converting to a Roth IRA and paying the tax liability from other funds. In effect, a conversion moves funds from a taxable environment to a tax-free environment. Conversion therefore increases a participant's overall after-tax return.

Conversion generally requires paying a premium. The amount of the premium equals the difference between the rate of tax paid at the time of conversion and the rate of tax that would have been paid on distributions in retirement. The participant can usually reduce the premium by converting over several years and by converting in years when other income is low.

The deficit between spending and income is the cash flow that must be supplied from IRAs and other investments. The amount of IRAs and other investments needed to support this cash flow is approximately twenty-five times the annual deficit. The value of IRAs and taxable investments in excess of this amount are surplus to the participant's needs.

Conversion is problematic if none of the IRA is surplus. Conversion is generally unwise if the participant's heir is a charity.

If a participant finds that required minimum distributions exceed their retirement needs, it is generally advantageous to take extra annual distributions and to convert the extra distributions to a Roth IRA.

Investment return and tax policy are major uncertainties affecting the conversion decision and sensitivities should be run to confirm that the conversion is profitable for a plausible range of these variables.

Equity prices are currently depressed and a change in administration may lead to higher federal tax rates. For these reasons, it may be advantageous to initiate a conversion in 2008. If modified AGI exceeds \$100,000, it will be necessary to delay conversion until 2010 or later.

Additional detail is available at www.lingane.com/tax.

¹ References to traditional IRAs apply equally to 457 plans, to traditional-type 401(k) and 403(b) plans and to SEP and SIMPLE pensions.

Introduction. Planners are trained to approach customer inquiries comprehensively and to inquire broadly as to the customer's situation.

- Do you have unresolved issues with your family, your friends, or your God?
- Have you made adequate financial provision for yourself, for your spouse and for others who are dependent upon you?
- Have you authorized someone to make health care decisions on your behalf?

Are the necessary documents available to your health care agent?

- How do you intend to dispose of your assets at your death?

Are your will and living trust and the beneficiary designations of insurance, IRAs and pensions consistent with these intentions?

- Have you have taken steps to avoid unnecessary tax upon your death and the death of your spouse?

Have you confirmed that your estate plan will achieve the desired tax savings if your assets are dominated by a home and a large IRA?

If you are deficient in these areas, corrective action should take priority.

My topic today is identifying those who will most likely benefit financially from converting a traditional IRA to a Roth IRA. I'm going to suggest that the best candidates are those in comfortable circumstances with noncharitable heirs.

Along the way, I'm going to suggest that the traditional IRA should be thought of as a partnership with the federal and state governments rather than as the participant's exclusive asset, and I'll show how to estimate the governments' share. I'm also going to suggest that a Roth conversion should be thought of as the process of buying out the governments' share of a traditional IRA. In general, buyouts require a premium. I'll show how to estimate the premium and whether the premium is affordable.

The typical financial forecast requires year-by-year assumptions as to living expenses, inflation, income, tax policy and the date of death. While most forecasts assume a constant investment return, we know from the historical record that the variation in return is also a very important parameter.

Forecasts can be modified to incorporate the variation in return and potential tax policy and to address death as a probability rather than as a discrete event. We are now talking about thousands of simulations and a broad range of quantitative outcomes. That is, quantitative financial forecasting is inherently uncertain.

It is therefore important to seek the correct qualitative result even if there is considerable uncertainty as to the quantitative result. My focus today is on

whether there is a financial benefit from converting your traditional IRA rather than on trying to quantify the magnitude of the benefit.

Focusing on the qualitative results allows me to simplify the analysis. Hopefully, this also makes for a less confusing presentation.

I'll be using balloons to illustrate the analysis. Since balloons cannot perform complex mathematics, my use of balloons should reinforce my comment that I'm focusing on the essential issues.

For those interested in comprehensive analyses, I recommend my article "Should You Convert to a Roth IRA? It Depends on Your Circumstances²" and the working paper on my website. Keebler and Bigge illustrate a variety of conversion scenarios³.

Earnings Within a Traditional IRA are Tax-free. The combined federal and California marginal income tax is about one third of salaries and other ordinary income⁴.

Let's assume that you have three balloons to save or invest.

Hold out two green and one white balloon

One third is tax – represented by the white balloon – and your share is represented by the two green balloons. If you invest in a taxable account, the account would have been valued at two balloons after paying the tax.

Remove the white balloon

A taxable account grows more slowly than the market because of the tax on the interest, dividends and gains. If the market doubles in real terms, a taxable account might grow to three balloons, or a bit more.

Two green balloons grow to three green balloons.

The tax must be paid before contributing to a Roth IRA and distributions are generally tax-free⁵. In contrast, you do not pay the tax before contributing to a traditional IRA but the distributions are taxed.

² *AAll Journal*, November 1997; available at www.aaii.org.

³ "To Convert or Not to Convert, That is the Question" by Robert S. Keebler and Stephen J. Bigge, *Journal of Retirement Planning*, May – June 2007. Available at www.ataxplan.com.

⁴ The average tax rate is the combined federal and state tax divided by total income while the marginal tax rate reflects the tax paid on incremental income in excess of a base income. The marginal tax rate is generally more appropriate for planning purposes.

Married taxpayers resident in California with taxable incomes between \$60,000 and \$130,000 pay a 32% marginal tax rate under current law. Married taxpayers with taxable incomes between \$130,000 and \$200,000 have a 35% combined rate.

Conversion can involve large changes in taxable income and marginal tax rates are not accurate when the incremental income is large. In such situations, it is best to calculate the incremental tax explicitly.

⁵ This assumes that the distribution is a “qualified distribution.”

A qualified distribution occurs on or after the participant achieves age 59.5 (or made because the participant is disabled or to your heirs or to fund certain first home purchases) and after the Roth IRA, or any Roth IRA of the participant, has been in existence for at least five tax years. The first tax year is the year of the first contribution and the interval ends on December 31 of the fifth year. Since contributions can be made as late as April 15th of the following year, the five year interval for a contribution on April 15, 2009 for tax year 2008 begins January 1, 2008 and concludes December 31, 2012. For a complete explanation, see IRS Publication 590 “Individual Retirement Arrangements.”

A penalty is assessed on nonqualified distributions before age 59.5.

A separate five year period applies for distributions from a “designated Roth account” such as a Roth 401(k). Distributions from a Roth IRA following a trustee-to-trustee rollover from a designated Roth account into a Roth IRA which has existed for at least five years are tax free. See the examples in Reg. 1.408A-10, Q-4.

Still another separate five-year period applies – for purposes of the premature distribution penalty only - for conversions from a traditional IRA or pension to a Roth IRA. The 5-year interval begins on January 1 of the year in which the conversion occurs. If there are multiple conversions, there are multiple 5-year intervals.

Qualified distributions are free of tax and penalties.

If a distribution is nonqualified, the distribution is considered to be taken first from contributions, then from conversions, then from the earnings on conversions and finally from the earnings on contributions. The distribution of contributions and conversions are tax-free. The distribution of earnings on contributions are penalized if distributed before age 59.5. (A distribution after age 59.5 is nonqualified if it occurs with 5-years of the initial contribution; there is no penalty on such nonqualified distributions.)

The distribution of earnings on conversions are penalized if distributed before age 59.5 and within 5 years of the conversion but are not penalized on or after age 59.5.

- The first contribution to a Roth IRA was made more than five years previously and the conversion of the traditional IRA occurs on or after age 59.5.

Distributions are free of tax because they are qualified distributions.

- The distribution from the Roth IRA occurs more than five years after the conversion. The first contribution date is therefore at least five years previously.

If the participant is age 59.5 or older on the date of the distribution, distributions are qualified and there is no tax or penalty.

If the participant is less than age 59.5 on the date of the distribution, the distribution is nonqualified and is taxable to the extent that the distribution exceeds the sum of contributions and conversions. The taxable portion, if any, is subject to the premature distribution penalty unless an exception exists.

- The distribution was made within five years of the conversion and the first Roth contribution date is at least five years previously.

If the participant is age 59.5 or older on the date of the distribution, the distributions are qualified and there is no tax or penalty.

If the participant is less than age 59.5, the distribution is not qualified and taxed to the extent that the distribution exceeds contributions and conversions. Any distribution in excess of contributions is subject to the premature distribution penalty unless an exception exists.

When contributing to a Roth IRA, the first step is to pay the tax.

Hold out two green and one white balloon; remove the white balloon.

The green balloons are contributed to the Roth IRA and the bank or brokerage statement reports the account value as equal to two balloons.

A Roth IRA is a special environment because there is no tax on the interest, dividends and gains. To indicate this preferential tax status, let's exchange out the green balloons for red ones. Green balloons will represent taxable investments without preferential tax treatment.

Exchange two green balloons for two red balloons.

You manage the Roth IRA. If the market doubles in real terms, the account balance doubles because there is no tax drag.

Add two red balloons.

You have four balloons to spend free of tax. If you die, your heirs receive four balloons free of tax⁶.

Now imagine a contribution to a traditional IRA. Since the tax is not paid before contributing to a traditional IRA, the bank statement reports the account value as three balloons. This is deceptive because the account value includes the unpaid tax liability.

Hold out two red and one white balloon.

While you manage all of the balloons, you own only the red balloons. (I'm again using red balloons because of the preferential tax treatment of traditional IRAs.) The government owns the white balloons⁷.

The converted amount is penalized but not taxed because the distribution occurs before age 59.5 and within five years of the conversion. The purpose of this rule is to make it impossible to avoid the premature distribution penalty by converting a traditional IRA to a Roth IRA.

The exceptions to the premature distribution penalty are death, disability, substantially equal payments, distributions to pay certain medical, educational or first home purchase expenses, IRS levies and qualified reservist distributions. These exceptions are different than the exceptions to the taxation of distributions before age 59.5.

⁶ Your heirs may also, and probably should, invest the four balloons in an inherited Roth IRA with continued preferential tax treatment.

⁷ This is how the Congress views things. Consider the following excerpt from a staff report to the Joint Committee on Taxation (JCS-3-01, Vol II, pp. 158-160).

The deductible IRA investment can be viewed as an investment that is jointly shared by the government and the taxpayer. The government's share is equal to the tax rate (28 percent in the above example). When the IRA funds are withdrawn, the government receives its share of the funds.

...

The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free rate of return on the investment. ...

I suggest that you should think of a traditional pension or traditional IRA as a partnership with the state and federal governments. You are the managing partner. You make the decisions but the state and federal governments share in the interest, dividends and gains.

If the market doubles in real terms, your share doubles and the governments' share also doubles.

Add two red and one white balloons.

A second advantage of deductible IRA contributions arises if the taxpayer's marginal tax rate in the year the funds are withdrawn is lower than the marginal tax rate in the year of the contribution. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the funds are withdrawn, the lower the tax rate prevailing at that time, the smaller the government's share. In the example above, for instance, if the tax rate when the funds are withdrawn is 15 percent, then the tax paid after one year would be \$165. Not only does the taxpayer receive a tax-free rate of return on the taxpayer's share of the investment, but the taxpayer's share of the investment is 85 percent rather than 72 percent.

Tax rates might be lower at the time the funds are withdrawn because the IRA owner may be receiving untaxed Social Security benefits and reduced taxable income from other sources. However, the marginal tax rate could be lower or higher because tax rate schedules may change over time.

From an economic perspective, contributions to Roth IRAs are similar to deductible IRA contributions. With a Roth IRA, the taxpayer does not deduct the contribution from income, but pays no tax when the funds are withdrawn assuming applicable requirements are satisfied. In other words, the government takes its share before the funds are invested. The taxpayer is never taxed on the interest earned on the investment, and thus earns a tax-free rate of return on the IRA investment. This is the same tax benefit provided to deductible IRAs.

However, in the case of a Roth IRA, the tax is paid on the initial contribution at the time of contribution, and in the case of deductible IRA contributions, the tax is paid on the initial contribution at the time of withdrawal. In effect, the government's share of the Roth IRA is equal to the taxpayer's marginal tax rate at the time the funds are contributed, whereas the government's share of the deductible IRA is equal to the taxpayer's marginal tax rate at the time the funds are withdrawn. Whether the deductible IRA and Roth IRA are economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year the contribution is made and the taxpayer's marginal tax rate in the year the IRA funds are withdrawn.

If these two marginal tax rates are equal, then the Roth IRA provides the same overall benefits as deductible IRA contributions. ... If the tax rate in the year the contribution is made is different from the tax rate in the year the funds are withdrawn, then the deductible IRA contribution and the Roth IRA are no longer equivalent. When tax rates decrease over time (either because tax rates change or taxpayers fall into lower tax brackets), deductible IRA contributions are more advantageous, because taxpayers defer payment of tax until tax rates are lower. When tax rates increase over time, a Roth IRA is more tax favored.

One source of difference between the deductible IRA and the Roth IRA arises from the imposition of a common annual limitation on contributions. Under present law, the contribution limit applied to Roth IRAs is the same as that currently applicable to deductible IRAs, \$2,000.

Contributions to a deductible IRA are limited to \$2,000 of pre-tax income, whereas contributions to a Roth IRA are limited to \$2,000 of after-tax income. The \$2,000 Roth IRA contribution limit effectively increases the amount of tax-free saving that can be invested in the Roth IRA relative to the deductible IRA. The difference in the limits is only valuable to taxpayers who want to invest more than \$2,000 of pre-tax income in an IRA.

When the traditional IRA is distributed, you receive your share – the red balloons – and the governments receive their shares. If you die and the account is distributed, your heirs are only entitled to the red balloons⁸.

It made no difference whether the tax was paid first, as with the Roth IRA, or last, as with the traditional IRA. You or your heirs received the same amount, after-tax.

We have been conditioned to think of a traditional IRA as fundamentally different from a Roth IRA. Earnings on a Roth IRA are tax-free while earnings on a traditional IRA are tax-deferred. These statements are accurate. I want you to consider a traditional IRA in a different light, that the earnings on your share of a traditional IRA are tax-free. In other words, your share of a traditional IRA performs as if it were a Roth IRA.

Understood in this manner, there is no fundamental difference in the after-tax returns within a traditional or Roth IRA. What is different is that the nominal value of the traditional IRA is larger. The larger size of the traditional IRA provides an opportunity to increase the after-tax return of your entire portfolio, both IRAs and taxable investments, by using taxable funds to buy out the governments' share.

A pension partnership forces the state and federal governments to invest rather than spend current tax revenues, which has the effect of increasing the present value of future tax revenues. Thus governments would have more resources if they encouraged savings through traditional pensions and IRAs rather than through Roth-type pensions and IRAs.

Politicians don't see things in the same way as financial planners however. Citing pressing current needs, they opt for strategies which provide the most current revenue. Thus politicians encourage Roth IRAs, Roth-type pensions and the conversion of traditional pensions and IRAs to Roth IRAs!

Determining the Governments' Share. I've probably given the impression that the governments' share of a traditional IRA is determined at the time of contribution. This is not correct. The governments' share is determined at the time of distribution.

Since there is unlikely that the governments' share of the contributions will be exactly the same as the governments' share of the distributions, many commentators have discussed the impact of different tax rates on the decision to contribute to a traditional IRA versus contributing to a Roth IRA.

Be that as it may, the tax rate at the time of contribution has nothing to do with the decision to convert to a Roth IRA. What is important is the rate of tax paid on the conversion as compared to the rate of tax that would be paid

⁸ Alternatively, your heirs can elect to continue the partnership in the form of an inherited traditional IRA. Your heirs would manage all of the balloons for benefit of themselves and of the state and federal governments.

on the distributions if there was no conversion. I discuss the conversion premium in detail later in this working paper. But first let's address the rate of tax paid on the distributions if there were no conversion.

The rate of tax paid on the distributions is influenced by the timing and magnitude of the distributions. If the entire IRA were distributed all at once, there would be an increase in taxable income. Since ours is a progressive tax system, an increase in income likely means more tax than if the IRA were distributed gradually over many years.

If distributions occurred in years when other income is low or when there are large deductions, taxable income might be lower than if the IRA were distributed gradually. Consequently, the rate of tax paid on conversions might be lower in such years.

Because the governments' share – the rate of tax paid on the distributions – depends on how and when you elect distributions, you must decide on a distribution strategy in order to estimate the governments' share.

The distribution strategy will typically require a forecast of your spending and of your Social Security and other income. The difference between spending and income in a given year is the cash flow that you require from your IRA and other investments in that year.

These forecasts involve all of the uncertainties mentioned previously.

The forecasting is simplified if we restrict ourselves to situations in which the IRA is surplus to the participant's needs. The second and more important reason is that having surplus assets avoids putting your financial security at risk if the financial benefits are less than anticipated.

If the IRA under consideration is surplus to your needs, you are not taking distributions for economic reasons. Rather, you are taking distributions because the state and federal governments require minimum distributions. Since the government publishes a required distribution schedule, we know the amount and timing of the distributions without having to forecast spending.⁹

I'll discuss how to estimate how much of an IRA is surplus later in this working paper. For now, let me provide an approximate illustration so that you have some feel of what I'm talking about.

Example. Assume that the deficit between spending and income is \$40,000. If spending and income both increase about in pace with inflation, then your investments must supply \$40,000 in real terms for the rest of your life and for the lives of those who are dependent upon you.

There is a body of research that suggests that a broadly diversified portfolio should be able to sustain inflation-adjusted withdrawals of 4% annually for

⁹ The uncertainties as to tax policy and investment returns remain.

the life of a sixty-five year old with only a small risk of running out of money before death. Since \$40,000 is 4% of a million dollars, you need a million dollar portfolio to support your lifestyle. If the total value of your investments is \$2 million, then a million dollars is surplus to your needs.

It is common to estimate the tax paid on distributions by guessing at the incremental tax rate in retirement and assuming both that the incremental tax rate is the appropriate metric and that the incremental tax rate is constant. I prefer to avoid these assumptions by determining the tax as the difference in the tax liabilities with and without the distributions¹⁰. The sum of the differences in tax divided by the sum of the distributions is the average tax rate paid on IRA distributions in retirement.

The difference calculation provides the correct result when distributions are large – thereby causing the incremental taxable income to span more than one tax bracket – and when other income, deductions or filing status are variable.

For complete accuracy, we should determine the governments' share as the ratio of the present value of the tax differences divided by the present value of the distributions. Discounting generally reduces the governments' share because the largest distributions tend to occur late in life. For example, if the ratio of the incremental tax in constant dollars to the cumulative distribution in constant dollars is 34%, the ratio discounted at 5% real might be 32%.

Failing to discount the year by year data likely overestimates the governments' share slightly and underestimates the conversion premium.

The assumptions needed to forecast the growth of a traditional and Roth IRAs and of taxable accounts and to forecast the tax liabilities on IRA distributions are summarized below.

¹⁰ Taxable income is likely to be relatively low early in retirement because you will be spending taxable investments rather than taking IRA distributions. Taxable income will rise after age seventy because of required minimum distributions and becomes quite large late in life. It is unlikely that the tax rate on distributions will be constant over this range of taxable income, especially with larger IRAs. Figure 1, Lingane 1997, referenced previously, illustrates both income and tax rate changes in retirement.

Forecasting Assumptions	
Equity Return	7% real, constant return.
Tax Rate on Equity Returns	No tax inside an IRA; 30% tax if owned outside an IRA ¹¹ . Alternatively, the tax is 35% of the real return, effective January 2009.
Fixed Income Return	2.5% real, constant return.
Tax Rate on Ordinary Income	No tax inside an IRA; 70% tax if owned outside an IRA ¹² .
Portfolio. If the traditional IRA to be converted is surplus to the participant's needs, it is presumably invested for maximum growth. That is, the traditional IRA, the taxable investments used to pay the tax and the resulting Roth IRA are invested in equities.	100% equities: 7.0% real return before-tax, 4.9% real return after-tax. Alternatively, 60% equities: 5.2% real return before-tax and 3.2% real return after tax.

¹¹ Equity returns are taxed at preferential federal rates if the stock is held for more than one year. Returns are not taxed until the stock is sold and tax on unrealized gains is forgiven at death. The effective tax rate on equity returns could be as high as the marginal ordinary tax rate, say 33%, for an active trader or as low as 5% (23% combined tax on one fifth of the return paid currently and the tax on gains forgiven at death) for the buy and hold investor.

Vanguard's Total US Market (VTSMX) paid an annual dividend of about 1.5% from 2003-2007. If the combined federal and California tax were 23% on the annual dividends and if 8.5% annual gains were realized every ten years and taxed at 23%, the effective after-tax return would be 8.2% annually. The effective tax rate is 18% of the 10% annual return and 26% tax of the real 7% return.

Vanguard's Total International Stock fund (VGTSX) paid an annual dividend of about 2% from 2003-2007. These dividends are not qualified federal dividends and are therefore taxed as ordinary income. If the dividends were taxed at 33% and if 8% annual gains were realized every ten years and taxed at 23%, the effective after-tax return would be 8.0% annually. The effective tax rate is 20% of the nominal 10% return and 29% of the real 7% return..

Vanguard's REIT index fund (VGSIX) paid an annual dividend of about 5% from 2003-2007. These dividends are not qualified federal dividends and are therefore taxed as ordinary income. If the dividend were taxed at 33%, and if 5% annual gains were realized every ten years and taxed at 23%, the effective after-tax return would be 7.4%. The effective tax rate is 26% of the nominal 10% annual return and 37% of the real 7% return..

The effective tax rate for a 40:40:20 portfolio of US and international equities and REITs is about 20% of the nominal return and 30% of the real return.

If the federal LTCG rate were increased from 15 to 20%, as has been proposed by Mr. Obama, the effective tax rate on a 40:40:20 equity portfolio would be about 24% of the nominal return or 35% of the real return. This assumes that tax rate changes do not affect market returns.

¹² 33% federal and California tax reduces the nominal from 5.5 to 3.7%. The same tax liability represents 70% of a 2.5% real return.

An alternative, for someone who has not considered that some assets could be surplus to their needs, is 60% equities within the IRAs.	
Tax Brackets Regular and AMT Standard Deductions Personal Exemptions	Escalated at the rate of inflation. Escalating these parameters at the rate of inflation and expressing investment returns in real terms allow current tax software to calculate future tax liabilities in current dollars.
Tax Rates	10%, 15%, 25%, 28%, 33% and 35% federal rates, as in 2007. 9.3% California tax rate. California income tax is deductible on the federal return, which effectively reduces the California rate to between 6.5 - 7.5%. Alternatively, the two highest federal tax rates are increased from 33 to 36% and from 35 to 39.6% effective January 2009.
Other Tax Assumptions	\$50,000 other ordinary taxable income, constant in real terms Married filing jointly. There is likely to be an extended period after the death of the first spouse when the filing status is Single. Assuming MFJ forever underestimates tax liabilities.
Annual Distributions, from age seventy until the death of participant	Per Table III, IRS Publication 590. Distributions, net of tax, are deposited in a taxable account.
Distributions after participant's death	Full distribution at participant's age 80; Full distribution at age 90; or RMD after death until participant's imputed age 110.

The value of the traditional IRA has a strong influence on the average tax to be paid as the IRA is distributed. For example, the average tax is about 35% for a million dollar traditional IRA, measured at age 65, but 27% for a \$100,000 IRA.

The participant's age at death and the heirs' intentions are also important. For example, the average tax is about 37% for a million dollar IRA fully

distributed on the participant's death at age 80 and about 32% if the IRA is gradually distributed after the participant's death.

The portfolio composition, which in turn influences the investment return, has a minor influence. For example, the average tax rate decreases from 35% for a million dollar all equity IRA to about 34% for a million dollar IRA of equities and bonds.

Portfolio composition has no effect for a smaller \$100,000 IRA.

These observations are summarized in the following table.

\$1MM IRA, 7.0% return	2007 Tax Policy	Obama Tax Policy	Double RMD, 2007 Policy	Double RMD, Obama Policy
Distribute residual age 80	37%	40%	35%	37%
Distribute residual age 90	35%	37%	33%	33%
Distribute residual age 110	32%	33S%	31%	31%
\$100K IRA, 7.0% return	2007 Tax Policy	Obama Tax Policy	Double RMD, 2007 Policy	Double RMD, Obama Policy
Distribute residual age 80	29%	29%	27%	27%
Distribute residual age 90	27%	27%	24%	24%
Distribute residual age 110	23%	23%	23%	23%

\$1MM IRA, 5.2% return	2007 Tax Policy	Obama Tax Policy	Double RMD, 2007 Policy	Double RMD, Obama Policy
Distribute residual age 80	37%	39%	35%	36%
Distribute residual age 90	34%	36%	32%	32%
Distribute residual age 110	31%	31%	30%	30%
\$100K IRA, 5.2% return	2007 Tax Policy	Obama Tax Policy	Double RMD, 2007 Policy	Double RMD, Obama Policy
Distribute residual age 80	29%	29%	26%	26%
Distribute residual age 90	27%	27%	24%	24%
Distribute residual age 110	23%	23%	23%	23%

The impact of a strategy in which distributions are accelerated by doubling the required minimum distribution will be addressed later.

Estimating Surplus Assets. "Surplus assets" are total assets less what is needed to make up for the difference between spending and income.

I approach retirement spending by asking about current spending. After adding the spending that the customer has forgotten about and eliminating the spending which will disappear in retirement, each spending category is

escalated separately. The change in spending at the first death must also be evaluated and any special spending plans considered.

Example. Health care expenses might increase at twice the rate of inflation; real estate taxes might increase by 1% annually; food, clothing, utilities, automobile and miscellaneous expense might increase at one half the rate of inflation; and discretionary spending might remain constant.

The open circles in Figure 1 illustrate how spending, escalated in this manner, might change over time for a particular customer.

The next step is to estimate current income and to escalate this income into the future. Social Security benefits are adjusted for inflation and the combined benefit likely decreases on the death of the first spouse.

Fixed annuities generally provide a constant benefit for life or for a term certain but some fixed annuities escalate at a constant rate or at a rate to keep pace with inflation. There may be a change in payment on the death of the first spouse and the taxable portion of the annuity payment may increase significantly after basis is recovered.

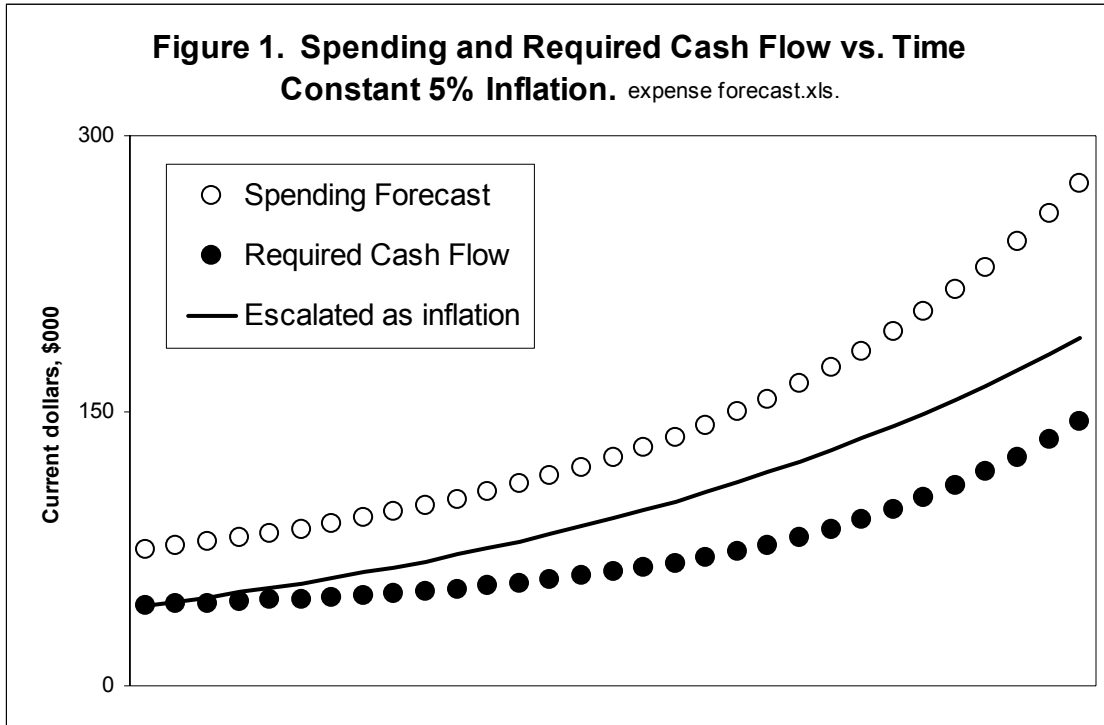
It is rare to find a variable annuities which have been converted to pay status. This is fortunate from a planning perspective since forecasting the payments from a variable annuity requires assumptions about market performance.

Some employer pensions are inflation-adjusted but many are not. Again, be alert to the possibility of a benefit change at the death of the first spouse.

Interest, dividends and required IRA distributions are not considered for purposes of determining other income. Rather, the investments paying the interest and dividends are included with the IRAs as total investable assets.

Income from rental real estate or from a closely held business or a trust must be evaluated on a case by case basis.

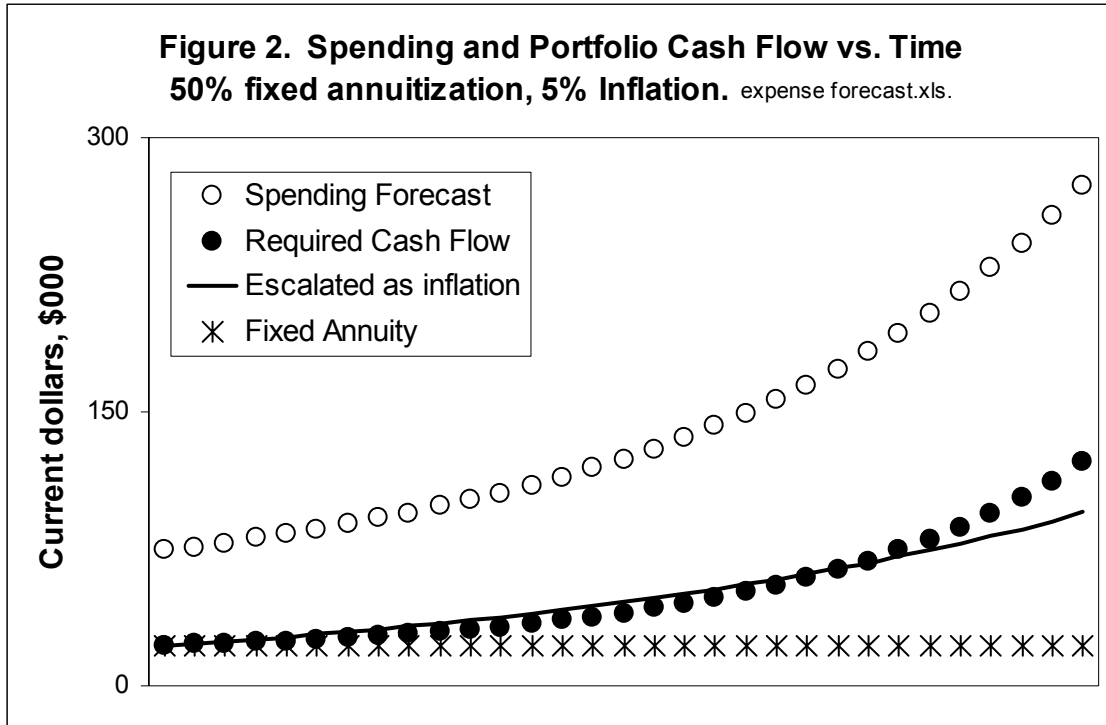
The difference between spending and income is the cash flow that must be supplied from IRAs and other investments. The solid circles in Figure 1 illustrate the required cash flow for a situation in which the only other income is from Social Security. The point of this figure is to illustrate that the required cash flow may escalate less rapidly than the rate of inflation in some situations.



The rate of escalation of required cash flow could equal or be larger than the rate of inflation. This situation is likely if the customer owns a fixed annuity with constant payments. The required cash flow escalates more rapidly because costs are rising while the annuity payments are constant.

Such a situation is illustrated in Figure 2. Spending and Social Security benefits are unchanged from Figure 1; the difference is that one half of the investment portfolio has been annuitized. The required cash flow from the remaining half of the portfolio must now increase about as fast as inflation.

Taxes need to be included in the spending forecast. While it is convenient to assume that taxes will represent a fixed fraction of income, the variation in taxable income is likely to be too large to allow this approximation. Taxable income changes on ceasing employment, on beginning required IRA distributions, after the basis in a pension or annuity is recovered and at the first death if income or filing status changes.



The quantitative year by year analysis that I've just described allows a planner to precisely determine what assets are required to supply your needs in retirement and, by difference, the amount of your current assets that are surplus to your retirement needs.

This analysis involves many assumptions and thus the forecast involves considerable uncertainty. It is likely biased low if a constant investment return and constant inflation rate were assumed. While apparently comprehensive and precise, this analysis almost certainly seriously underestimates what it will take to supply your needs in retirement.

Nonetheless, a year by year analysis is generally worth doing because of the insights gained into how income and spending change at the first death and about the size of the estate at the second death. It may also be comforting to learn that rapidly medical expenses are not a serious concern for those with Medicare coverage if you have been frightened by the popular press.

Because the results of a quantitative analysis are uncertain and probably biased, it is useful to also estimate what it will take to supply your needs in retirement using a simpler approach.

- Determine current spending, net of income taxes. Adjust for changes in retirement if you are not currently retired.
- Determine retirement income net of investment income and IRA distributions.

- Estimate the income tax liability assuming that gross income equals spending and that income, less the appropriate deductions for charity and taxes and the like, is taxed as ordinary income.
- Spending plus income tax less income is the cash flow that must be supplied by your investments and IRAs.
- Assume that the cash flow from investments and IRAs must increase at the rate of inflation.
- Assume that you will be able to manage your IRAs and other investments to supply a 4% cash flow, adjusted annually for inflation¹³. The minimum value of your investments and IRAs are therefore twenty-five times the cash flow required from your investments.

Extension of Prior Example. After reviewing your current spending and subtracting Social Security and other guaranteed income, you find that you need \$40,000 annually from your investments and IRAs. This equates to a million dollar investment portfolio ($\$40,000 / 0.04$). If you have \$500,000 in taxable investments and a \$1,500,000 IRA, \$1,000,000 of your traditional IRA is surplus to your needs.

We will see that the tax on a million dollar IRA is about \$460,000 and that this tax must be paid from taxable investments rather than from the IRA itself for clear financial benefit. Thus there is a planning difficulty: you have a million dollar surplus IRA but no surplus taxable investments with which to pay the tax.

You could reserve more the IRA to supply the deficit between income and spending and thereby free up taxable funds to pay the tax. I have not investigated how this plays out, but I will!

An advantage of assuming that an investment portfolio will sustain only a 4% cash flow is that you need not worry (or need worry less) about the variation in market returns. The historical evidence is that there has been only a small risk, historically, of outliving a portfolio when distributions were limited to 4%.

Terminating the partnership. When a partnership does well, some partners may want to buyout the others so that they can own more of a good investment.

¹³ There is considerable evidence that a portfolio can sustain a 4% withdrawal rate until the death of a sixty-five year old individual. The sustainable rate might be 5% if the portfolio is broadly diversified and investment expenses are low and even a bit more than 5% if spending increases less rapidly than inflation. See "Sustainable Withdrawal Rates in Retirement, and how alternative strategies affect the heirs" at www.lingane.com/tax.

See also *Conserving Client Portfolios During Retirement* by William P. Bengen, FPA Press, 2006 and *The Calculus of Retirement Income* by Moshe A. Milevsky, Cambridge University Press, 2006.

A traditional IRA is a very good investment because it provides tax-free interest, dividends and gains. IRA owners should therefore want to buyout the governments' share.

Investors may buyout the governments' share if their modified AGI – generally the AGI shown on their tax return less the income generated by the conversion and less any required IRA distributions¹⁴ - is \$100,000 or less and additional considerations are satisfied. IRS Publication 590 includes a thirteen line worksheet for calculating modified AGI.

This ceiling is not affected by marital status but married couples who file separately are generally precluded from converting whatever their MAGI¹⁵. Beginning in 2010, the modified AGI ceiling and the exclusion of married filing separately filers are repealed.

The process whereby a taxpayer buys out the governments' share of a traditional IRA is called a "Roth conversion." Formally speaking, conversion involves three steps.

1. The taxpayer authorizes a distribution from a traditional IRA. This can be a full or partial distribution.
2. The taxpayer makes a "qualified rollover contribution" to a Roth IRA. This contribution must be equal to or smaller than the distribution¹⁶.
3. The taxpayer files a tax return and pays the tax on the distributed income.

The conversion can be effected in two fundamental ways. One strategy is to pay the tax with the governments' share of the traditional IRA. This produces a Roth IRA equal to the participant's share of the traditional IRA.

Start with two red and one white balloon. Pay the tax with the white balloon and reinvest the red balloons in a Roth IRA.

¹⁴ Choate (*Life and Death Planning for Retirement Benefits*, 6th Ed., p. 244), citing legislative history, says that only RMDs from IRAs, including inherited IRAs, are excluded. Publication 590 for 2005 had said that RMDs from qualified plans were also excluded but the 2007 version of this publication no longer excludes RMDs from qualified plans.

¹⁵ Both MAGI and filing status are determined in the year of distribution. This proviso is needed because it is possible to take a distribution from a traditional IRA in one tax year and to complete the conversion by contributing to a Roth IRA in the following tax year.

A married person who files separately and who lives apart from their spouse for the entire tax year may convert a traditional IRA if their separate MAGI is less than the ceiling amount.

¹⁶ Generally, the distributed funds are used to fund the contribution, in which case the first two steps occur simultaneously in a trustee-to-trustee transfer. . The funds could be paid to the taxpayer who must then make the contribution to the Roth IRA within sixty days, but this approach is not recommended because of the potential for error. The taxpayer might be injured in a traffic accident on the way to the bank, for example, thereby voiding the conversion.

Generally speaking, little is gained with this strategy¹⁷. Before the conversion you owned two thirds of a traditional IRA and your two thirds share of the interest, dividends and gains was tax-free. After the conversion, all of the interest, dividends and gains are tax-free but the interest, dividends and gains are only two thirds as large.

The better strategy is to use taxable investments to pay the tax.

Start with two red and one white balloon in the traditional IRA and a green balloon in a taxable account. Reinvest the red and white balloons in a Roth IRA and pay the tax with the green balloon.

Before the conversion you owned two balloons within a traditional IRA and you had one balloon invested in a taxable account. You received interest, dividends and gains from three balloons; your share of the interest, dividends and gains from the IRA was tax-free and you paid tax on the interest, dividends and gains in the taxable account. After the conversion, you receive interest, dividends and gains from three balloons, as before, but now all of this income is tax-exempt. It is as if you had moved the green balloon from a taxable to a tax-exempt environment.

Start with two red and one white balloon. Pay the white balloon to the government, add the green balloon to the two red balloons and then exchange the green balloon for a red balloon.

At death, your heirs receive the value of your Roth IRA or, absent a conversion, your share of the traditional IRA plus the investments that you would have used to pay the tax. That is, your heirs receive three balloons.

A charity, which does not pay income tax, receives the full value of the traditional IRA at death plus the investments that would have been used to pay the tax.

Charity receives two red balloons plus one white and one green balloon.

If you convert, the charity receives the value of the Roth IRA, which is less than the value of your traditional IRA and taxable account. Therefore, it is generally unwise to convert assets which are intended for charity.

A business partner is unlikely to accept a buyout at par. They will likely demand a premium. If the buyer considers the premium to be reasonable, the deal will go through. If the seller demands too high a premium, the buyer will walk away.

¹⁷ If dissolving the traditional IRA means paying less than the average rate of tax in retirement, dissolution is always financially attractive.

Participants should be willing to pay a reasonable premium on converting a traditional IRA and, if the premium is too high, to walk away from the conversion.

The Conversion Premium. I recommend that you determine the tax due to conversion using tax software; the rules are too complex for approximate calculations. Use the software to determine the tax liabilities with and without the conversion income. The difference is the incremental tax due to the conversion and the ratio of the incremental tax to the amount converted is the rate of tax paid.

Include the tax on any gain (or loss) from the sale of investments to pay the tax in the conversion premium. Since gains are often an acceleration of tax rather than an addition to tax, including these gains may overstate the conversion premium.

Beginning in 2007, individuals with modified AGIs of more than about \$80,000 (\$160,000 married filing jointly) pay higher Medicare B premiums. The maximum additional premium is about \$1,700 per person per year for modified AGIs exceeding \$200,000 (\$400,000 married filing jointly.) Include any extra Medicare costs in the conversion premium

Example. Bill and Jane, aged 65, live comfortably. They own their home in the East Bay, a million dollar traditional IRA and a million dollars of taxable investments. They receive \$30,000 in annual Social Security benefits.

Bill and Jane are considering converting all of their traditional IRA in 2008. Absent the conversion, their taxable income would be \$50,000 and their combined federal and California tax liability would be about \$7,000. (Since 2008 tax software is not yet available, tax liabilities were determined with 2007 software.)

With the conversion, their combined tax liabilities are \$465,000. This includes an extra Medicare B premium in 2010 and the tax on \$230,000 of long terms gains that were realized to pay the tax.

	<u>2008 Rules</u>	<u>Possible Future Rules</u>
Tax on Conversion Income(WKS, I. 16)	310,500	343,500
Tax on Gains (WKS, I. 15)	34,500	46,000
California Income Tax	116,600	116,583
Extra Medicare Premium	3,400	3,400
Total with Conversion	465,000	509,500
Tax without Conversion	<7,000>	<7,000>
Incremental Cost of Conversion	458,000	502,200

The incremental cost of this million dollar conversion is therefore \$458,000 or about 46%. If Bill and Jane would have paid 33% tax had they taken on distributions over their retirement years, they pay a 13% premium if they convert everything in 2008.

Since Bill and Jane are considering increasing their tax liability by nearly half a million dollars, I recommend that they include a tax professional on their planning team.

Thirteen percent extra tax, \$130,000, would seriously dent Bill's and Janes financial ledger should something go awry. This potential hit does not affect their financial security since the converted IRA is surplus to their needs. If Bill and Jane had converted necessary assets, a potential hit of this magnitude could threaten their financial security. Hence the wisdom of not converting necessary assets, even though it is often possible to show – on paper – that there is a benefit from converting necessary assets.

I doubt that converting everything in 2008 is the best strategy and I suspect that the conversion could be effected with less than a 13% premium. However, the increased after-tax return on the investments that they move into the Roth IRA by virtue of the conversion should repay a 13% premium before their life expectancy. This conversion – although not optimized – probably increases their after-tax wealth at death.

Assessing the Breakeven Time. Breakeven is the time when the real value of the Roth IRA created by the conversion exceeds the combined real values of the traditional IRA which was converted and of the taxable account which was used to pay the taxes.

Example. *The taxes associated with converting a million dollar traditional IRA to a Roth IRA in 2008 is about \$460,000. This is about \$130,000 more than the taxes that would be paid if the IRA were gradually distributed in retirement. This premium effectively decreases net worth by \$130,000.*

The million dollar Roth IRA provides a higher after-tax return than you would have earned on your share of the million dollar traditional IRA plus the \$460,000 used to fund the conversion. If the real return is 7%, both the Roth IRA and your share of the traditional IRA plus the taxable account grow to nearly \$3 million (\$2008) in year sixteen. The breakeven time is therefore sixteen years.

If the real return were 5.2%, the breakeven time is about fourteen years.

If the unrealized gain within the taxable account would have been realized on the conversion date whether or not there was a conversion, the breakeven is about ?? years.

Since there is considerable variation in the breakeven time, the quantitative benefits of conversion are uncertain. My focus, however, is not on the quantitative benefit but on whether it is likely that conversion will increase the wealth that passes to the heirs. Since Bill and Jane are likely to outlive the breakeven time – whatever it is – I conclude that their heirs will likely benefit from converting everything in 2008.

My advice to Bill and Jane is to assume that conversion will provide a financial benefit and to put their energy, with professional assistance, into defining a strategy which reduces the conversion premium.

For example, the premium might be lower by converting over several years. Converting \$150,000 annually might reduce the premium to 43%

Conversion Income	\$150,000	\$300,000	\$1,000,000
Taxable Income	227,461	411,000	1,196,488
Tax on Conversion Income(WKS, l. 16)	42,882	88,558	310,477
Tax on Gains (WKS, l. 15)	5,250	11,250	34,500
AMT	4,753	12,130	
California Income Tax	15,844	34,300	116,600
Extra Medicare Premium	3,400	3,400	3,400
Total with Conversion	72,129	149,638	464,977
Tax without Conversion	<7,000>	<7,000>	<7,000>
Incremental Cost of Conversion	65,129 43%	143,900 48%	457,977 46%

Conversions over many years are undesirable. To cite only one negative consideration, Medicare premiums would be elevated for a long period. Thus Bill and Sue should consider converting over a shorter interval.

It turns out that, due to AMT, converting \$300,000 a year has a higher premium than converting \$150,000 or a million dollars. I did not anticipate this result, which illustrates the importance of using tax software.

Required Minimum Distributions. Participants must take minimum distributions from traditional IRAs after age seventy and a half but they need take nothing from Roth IRAs before death. Distributions are required from both traditional and Roth IRAs after death¹⁸.

Required minimum distributions remove assets from the tax-exempt environment, meaning that your share of a traditional IRA provides a somewhat lower after-tax return than a Roth IRA after age seventy. I don't

¹⁸ If you are the surviving spouse, you can elect to retitle the IRA in your name. This delays distributions until the surviving spouse attains age seventy and can accelerate distributions if the surviving spouse is older than the decedent.

If you are not the surviving spouse, the inherited IRA must be titled in the name of the decedent with you as beneficiary. Distributions from traditional and Roth IRAs are generally based on your life expectancy. The exceptions are when the beneficiary is an estate or trust, when there are multiple beneficiaries and traditional IRAs when the beneficiary is older than the decedent. See IRS Publication 590 for details.

generally consider required minimum distributions in the analysis because the effect on wealth accumulation is small.

Example. Assume a million dollar Roth IRA at age 65. By age eighty, the Roth IRA grows to \$2.8 million (\$2008) assuming a 7% real return and no distributions. In contrast, your share of a 1.5 million dollar traditional IRA, with the required distributions paid into a taxable account, would be \$2.7 million, only 3% less.

Even though required distributions have only a modest impact on wealth at death, they change the composition of the wealth that your heirs receive. All of the wealth is received in tax-advantaged form with a Roth IRA while less wealth is received in a tax-advantaged form with a traditional IRA.

Roth: Two red balloons grow to four red. Traditional: Two red and one white balloons grow to two red, one white and two green.

Even though required distributions have only a modest impact on wealth at death, they change the composition of the wealth that your heirs receive. All of the wealth is received in tax-advantaged form with a Roth IRA while less wealth is received in a tax-advantaged form with a traditional IRA.

Conversion May Reduce Estate Tax. Estate tax is levied on the nominal value of a decedent's estate. Consider, for example, the prior example where the value of the Roth IRA was only slight more, at age eighty, than the value of the participant's share of the traditional IRA plus taxable account. The nominal value of the traditional IRA is larger, however, and the estate tax could therefore be larger.

In principle, any extra estate tax is recovered through an income tax deduction. In practice, the recovery under Section 691(c) is imperfect.

Possible Tax Changes. The Democrats hope for political victory in November 2008 and they promise tax increases if they are elected.

Obama's apparent plan is to increase the federal capital gains rate from 15 to perhaps 20% and to increase the two highest federal tax rates, those that affect joint filers with taxable incomes in excess of \$250,000, by three or four percentage points¹⁹.

The effect of these changes, which are at this point only proposals, is to increase the tax on converting a million dollar traditional IRA from 46% to 51%, an increase of about \$50,000. Consequently, there is an incentive to consider converting in the waning days of 2008.

¹⁹ *An Updated Analysis of the 2008 Presidential Candidates Tax Plans* by the Tax Policy Center of the Urban Institute and the Brookings Institution, revised July 23, 2008. This report, which is based on the candidates' statements supplemented by assumptions about essential elements unspecified by the campaigns, is updated periodically..

A Democratic victory might increase the average tax rate in retirement by two or three percentage points for larger traditional IRAs. This prospect may further reduce the premium if large IRAs are converted in 2008.

The Joint Committee on Taxation report, referenced previously, recommended changes to the required minimum distribution rules (see p. 196). The staff recommended eliminating required minimum distributions from traditional IRAs and traditional-type pensions prior to the participant's death. This change would slightly disadvantage Roth conversions in terms of the wealth differences at the participant's death; the effect was 3% in the prior example. More significantly, this change would eliminate differences in the compositions of the portfolios received by the heirs.

The staff recommended continuing to allow a surviving spouse to rollover the participant's account into an account in her own name but other inherited IRAs would have to be distributed within five years of death.

While simplification was the primary intent of these recommendations, the report also mentions that eliminating the potential for stretch-outs after death would reduce the value of IRAs for estate planning purposes. The staff apparently considered this to be a valuable objective.

I worry that politicians will figure out that someone with a million dollar Roth IRA has more financial resources than someone with a million dollar traditional IRA and that this realization will prompt them to move from an income based definition of "rich" to a wealth based definition for purposes of means testing programs like Social Security and Medicare.

While it is unlikely, the U.S. might scrap the income tax entirely in favor of an European style VAT. Such a change would be unfortunate from the perspective of someone who has paid their income taxes in advance by converting traditional pensions to Roth IRAs.

What If I Convert Too Little? My preference is to err on the side of converting less than the amount that provides the maximum financial benefits. Thus you may find, five or ten years after the conversion, that you are not spending all of your required distributions. That is, part of your remaining traditional IRA is surplus to your needs.

In such situations, I recommend taking more than the required distribution and converting the excess distribution to a Roth IRA. A gradual conversion during retirement reduces the traditional IRA reduces the risk of large income tax liabilities at about the time of death. Conversion in such circumstances can have a negative premium, meaning that it is beneficial to convert even if the tax is paid from the converted funds.

Thus the downside risk of converting too little is small.

What If I Convert Too Much? I don't think that this is likely because I've only suggested converting assets which are surplus to your needs. I've also

not considered the small increase in wealth and the vary large benefits for your heirs if there are no required distributions.

Nonetheless, a conversion could produces a financial loss. You and your spouse might die prematurely, for example. The good news is that a financial loss is not likely to affect your financial security because you have the Roth IRA in reserve.

Financial security could be at risk if you convert assets which were necessary for your lifestyle. If the future turns out to be different than forecast, you may have less to fall back upon.

How Do I Correct Mistakes? Conversions can be “recharacterized.” Thus if tax rates do not increase in 2009, or if the market tanks, an investor may be able to back out of a 2008 conversion.

The date for recharacterizing a Roth conversion is generally October 15 of the following year. If the tax return is not filed by April 15 and if no extension was obtained to extend the filing deadline, the tax return is late and the time limit for recharacterization reverts to April 15th.

Following a recharacterization, one may not make another conversion until the later of thirty-one days or the next taxable year. Thus a recharacterization on October 15, 2009 would preclude subsequent conversions until January 1, 2010 while a recharacterization on December 15, 2008 would preclude subsequent conversions until January 15, 2009.

When a conversion is recharacterized, the Roth IRA – and all earnings – are reconstituted *pro rata* as a traditional IRA. If the tax return was filed before the recharacterization date, an amended return to recover the tax paid.

Keebler and Bigge suggest converting a traditional IRA in stages for maximum flexibility, creating a separate Roth IRA for each investment in the portfolio. Thus if international stocks tank, and if they had been converted and segregated in a Roth IRA, it would be possible to recharacterize the international stocks.

Whereas, if the entire traditional IRA had been converted to a single Roth IRA, some of this Roth IRA could be recharacterized but it would not be possible to recharacterize only the international stocks.

Who Benefits from a Roth Conversion? In general,

- Participants with surplus assets and with noncharitable beneficiaries who have a life expectancy of ten years or more and who have the ability to pay the tax from taxable assets.

It may be advantageous to convert or to begin to convert in 2008 and thus lessen the impact of increased tax rates should the Democrats be successful in the fall elections.

- Participants without surplus assets may achieve a small financial gain but conversion without surplus assets puts the participant's financial security at risk of market underperformance or premature death.
- Participants who are experiencing a temporary period of low taxable income benefit from a conversion so long as their taxable income with the conversion does not exceed normal levels.
- Retirees who find that they are saving, rather than spending, some or all of their required distributions benefit from modest annual conversions, even if they are unable to pay the tax from other assets.
- Participants who intend to leave their assets to charity should not convert.

Disclaimer. This paper contains unintentional errors. For this reason, I encourage you to confirm my conclusions with a planning professional. I would appreciate it if you would advise me of errors and misinterpretations.

Props: six red, two white and three green balloons.

Appendix A. Taxation of Distributions from Roth IRAs and Roth-type Pensions

Income taxes and penalties on distributions from a Roth IRA are addressed in Reg. §1.408A-6. Income taxes and penalties on distributions from Roth-type 401(k) or 403(b) pensions are addressed in Reg. §1.408A-10.

For the purposes of the ordering rules for distributions from Roth IRAs, distributions from any of the participant's Roth IRAs, excluding inherited Roth IRAs not retitled in the name of the surviving spouse, are treated as a single distribution. Regular contributions to any of the participant's Roth IRAs in a given year are aggregated and conversions of any of the participant's traditional IRAs are aggregated.

Rollovers among Roth IRAs, conversions followed by recharacterizations and withdrawals of excess contributions are disregarded to avoid double counting.

The amounts of regular contributions and conversions are reduced by prior distributions in accordance with the ordering rules in effect at the time of the prior distributions.

Distributions from a Roth IRA are ordered as follows.

1. Contributions and rollovers from Roth-type pensions
2. Conversions (oldest conversion first, if more than one)
 - Taxable portion of the amount converted first, followed by
 - Nontaxable portion (basis) of the amount converted
3. Earnings on contributions and conversions

Income Taxation of Distributions from Roth IRA

	<u>Before Age 59.5 w/o an Exemption for Death, Disability or First Home</u>	<u>On or after Age 59.5 or due to Death, Disability or First Home</u>
At least 5 years from the first contribution or conversion to any Roth IRA	Not a qualified distribution; earnings are taxed	This is a qualified distribution. The entire distribution is tax exempt
Five years or less from the first contribution or conversion to any Roth IRA	Not a qualified distribution; earnings are taxed	Not a qualified distribution; earnings are taxed

Notes:

Disability is defined in IRA §72(m)(7).

Death does not satisfy or redetermine the 5-yr. period. This if a participant dies before the end of the fifth tax year and the heirs immediately distribute the Roth IRA, the earnings will be taxed to the heirs. If, however, the heirs distribute the account gradually, distributions after the end of the 5-year period are tax exempt.

If the participant dies three years after the first contribution, for example, and if the heirs begin distributions over their life expectancy in the year after death (in order to opt out of the 5-year rule), part of the distributions in the first and second years after death are potentially taxable.

Assessing Penalties on Distributions from Roth IRAs

	<u>Before Age 59.5 and Not Otherwise Excepted by 72(t)</u>	<u>On or after Age 59.5 or First Home or Otherwise Excepted by 72(t)</u>
At least 5 years after the first contribution was made to any Roth IRA	Penalty assessed on earnings and on the taxable portions of any amounts converted less than five years previously	No penalty or tax
Five years or less from the first contribution to any Roth IRA	Penalty assessed on earnings and on the taxable portions of any amounts converted less than five years previously	No penalty; earnings are taxed however.

Notes:

The penalty exceptions under 72(t) include more than the death, disability and first home exceptions that apply for income tax purposes.

The premature distribution penalty applies to the distribution of conversion contributions if less than five years have elapsed and the 72(t) penalty exemptions do not apply. The purpose of this rule is to make it impossible to evade the penalty on premature distributions from a traditional IRA by converting it to a Roth IRA immediately before the distribution.

The 5-year period for premature conversion distributions is measured from the beginning of the tax year of the conversion and different 5-year periods apply if conversions occurred in different tax years. The 5-year period for income taxation generally lapses before the 5-year penalty period.

Distributions from Roth-type pensions are tax-free beginning with the sixth year after the first contribution to any Roth-type pension established for the participant under the same applicable plan, or after the first contribution to another Roth-type pension which is rolled over into the present plan if earlier, so long as the participant has attained age 59.5 or become disabled or dies. There is no exemption for funds used to purchase a first home.

If the distribution is rolled over to a Roth IRA, the five year interval is measured from the date of the first contribution to any Roth IRA. The holding period of the Roth-type pension does not carry over, which is potentially advantageous if the Roth IRA is long standing (see Example 1 below) but disadvantageous if the participant did not have a Roth IRA previously (Example 3.).

Example 1. Employee D began making designated Roth contributions under his employer's 401(k) plan in 2006. Employee D, who is over age 59½, takes a distribution from D's designated Roth account in 2008, prior to the end of the 5-taxable-year period of participation used to determine qualified distributions from a designated Roth account. The distribution is an eligible rollover distribution and D rolls it over in accordance with sections 402(c) and 402A(c)(3) to D's Roth IRA, which was established in 2003. Any subsequent distribution from the Roth IRA of the amount rolled in, plus earnings thereon, would not be includible in gross income (because it would be a qualified distribution within the meaning of section 408A(d)(2)).

Example 2. The facts are the same as in Example 1, except that the Roth IRA is D's first Roth IRA and is established with the rollover in 2008, which is the only contribution made to the Roth IRA. If a distribution is made from the Roth IRA prior to the end of the 5-taxable-year period used to determine qualified distributions from a Roth IRA (which begins in 2008, the year of the rollover which established the Roth IRA) the distribution would not be a qualified distribution within the meaning of section 408A(d)(2), and any amount of the distribution that exceeded the portion of the rollover contribution that consisted of investment in the contract is includible in D's gross income.

Example 3. The facts are the same as in Example 2, except that the distribution from the designated Roth account and the rollover to the Roth IRA occur in 2011 (after the end of the 5-taxable-year period of participation used to determine qualified distributions from a designated Roth account). If a distribution is made from the Roth IRA prior to the expiration of the 5-taxable-year period used to determine qualified distributions from a Roth IRA, the distribution would not be a qualified distribution within the meaning of section 408A(d)(2), and any amount of the distribution that exceeded the amount rolled in is includible in D's gross income.

If the distribution from the Roth-type pension is taxable, the taxable portion is determined as for other pension distributions; that is, approximately *pro rata*. The ordering rules for Roth IRAs DO NOT apply; see TD9324 for an explanation.