

## Not So Fast

*Now is the time to convert to Roth IRAs-so long as your clients don't fall into these tax traps.*

The Roth IRA conversion floodgates are open. But while the attraction of "tax-free forever" can be powerful, Roth conversions can trigger unintended tax traps and financial problems that are often not addressed until it's too late. Here are five of the most common traps:

### NEW FORMS

The beneficiary form is the single most important estate planning document when it comes to IRAs and Roth IRAs. While every custodian will have its own procedures for a conversion, a new account is generally established. As with any other new retirement account, the new Roth IRA must have beneficiary forms submitted with it. What's more, not having beneficiary forms for a Roth IRA is even worse than not having them for a traditional IRA.

Why? Absent favorable default provisions in the custodial agreement, an individual who inherits an IRA without being named on the beneficiary form will not be considered a designated beneficiary. In such a case, if the IRA owner died before the required beginning date (RBD), the account must be emptied within five years. If the IRA owner died after the RBD, then the distributions may be stretched over the IRA owner's remaining single life expectancy, had he or she lived.

But a Roth IRA has no required distributions. So if there is no designated beneficiary, the account must always be emptied within five years after death.

### PARTIAL CONVERSIONS

By now, most financial advisors know that when you have after-tax money in an IRA, you can't just convert those funds and pay no tax on the conversion. Instead, when there is a partial conversion of IRA assets, a pro-rated amount of after-tax money-or basis-is included with each dollar converted. The formula for calculating this amount is [(total basis in all IRAs/total value of all IRAs) x amount converted].

So where is the tax trap? Unless you wait until the last second and do a conversion on Dec. 31, you won't be able to do an exact calculation. Why? Because the total value of all IRAs (including SEP and SIMPLE IRA balances) used for the denominator in the pro-rata calculation comes from the balances on Dec. 31 of the year of conversion. That could leave some clients paying a little more (or less) in taxes than they originally planned.

For example, assume Sally did a Roth conversion on Jan. 4. On the date of conversion, the total value of all her IRAs is \$50,000, of which \$20,000 is aftertax contributions and \$30,000 is pretax

contributions and/or earnings. The tax-free percentage at this point is 40% ( $\$20,000/\$50,000 = 40\%$ ), and the remaining 60% is taxable. Sally decides she would like to convert half the value of her accounts to a Roth. This might lead you to believe that she will only have \$15,000 of taxable income from the conversion ( $\$25,000 \times 60\% = \$15,000$ ).

But the total value of Sally's IRAs (the denominator) isn't determined until year-end. So, let's say Sally makes some great investments and, by the end of the year, the \$25,000 that was left in the traditional IRA has grown to \$75,000. Now, the denominator, which includes the converted amount, is increased by the \$50,000 growth in account value, so the new tax-free percentage is 20% ( $\$20,000 \text{ basis}/\$100,000 \text{ total value of all IRAs at year-end}$ ). That means the taxable percentage is 80%. Instead of \$15,000 of taxable income generated from the \$25,000 conversion, Sally now has \$20,000 of taxable income. If you have clients who try to calculate their conversions to the penny, this is certainly something you should share with them.

## LATER ROLLOVERS

Another big tax trap can occur when clients change the equation by rolling plan money into an IRA in the same year that they make a Roth conversion. When an IRA is converted, only IRA assets fall under the pro-rata rule. Plan assets have no effect.

For example, let's say Allen has a \$50,000 IRA, \$25,000 of which is non-deductible contributions and \$25,000 earnings. He also has a 401(k) worth \$450,000 (all pretax). If he converts the entire IRA, he will only owe tax on \$25,000, since the plan assets are excluded from the pro-rata formula.

But let's say Allen changes jobs mid-year. Knowing that IRAs are generally better for clients than company plans, you advise him to roll his 401(k) to an IRA. Like a good client, he listens to your advice and rolls the money right away. You just cost Allen thousands in taxes. Why? Remember, it's the end-of-year IRA balance that determines the denominator for the pro-rata calculation, not the balance on the date the IRA is converted.

Since the 401(k) funds are not excluded from the calculation, the pro-rata calculation changes dramatically. Instead of only owing tax on \$25,000, Allen will now owe tax on \$47,500. The new balance in the IRA at year-end is \$500,000 (the \$50,000 of IRA funds plus the \$450,000 of 401(k) funds rolled into the IRA).

The denominator for calculating the pro-rata rule now changes from \$50,000 to \$500,000, making the \$25,000 of non-deductible IRA contributions a much lower percentage of the total IRA balance. That results in the tax-free percentage of the \$50,000 conversion going from 50% to only 5% ( $\$25,000/\$500,000 = 5\%$ ), which significantly increases the taxable amount of the conversion. Now the tax-free part of the conversion is only \$2,500 (5% of \$50,000) as opposed to the \$25,000 (50% of \$50,000) that would have been tax-free without the later 401(k) rollover.

How can Allen avoid this mistake? He can simply wait until Jan. 1 of the following year to roll over the funds. That way, he will have a \$0 year-end IRA balance. Of course, if Allen wants to convert his 401(k) to a Roth IRA, this would be a non-issue, and both conversions could be done in the same year without any adverse effect on the calculation of the tax-free portion of the conversion.

## **RMDS FIRST**

Many high-income retirees were counting down the days until 2010, so they could convert to a Roth IRA and no longer have to deal with required minimum distributions (RMDs). But now that the time has arrived, they must be careful not to act too quickly. In their haste to convert, some IRA owners might convert their entire account balance, not knowing that their RMDs can't be converted to a Roth IRA. Individuals who are 70½ or older in 2010 must first take their 2010 RMDs if they plan to convert all their IRAs to Roth IRAs. The first dollars withdrawn from the IRA are deemed to be the RMD until that amount is satisfied. Once the RMD is withdrawn, the remaining IRA balance can be converted.

Mistakenly converting an RMD could result in an excess contribution to the Roth and would result in a 6% excise penalty for each year it remained in the account. The RMD funds withdrawn can be contributed to a Roth IRA if the IRA owner qualifies to make a contribution. That contribution is limited to \$6,000, however. Clients can also use the RMD to help pay the tax on the conversion of the remainder of the IRA accounts.

Another word of warning: Be careful with older clients who may be converting from multiple company plans. While the RMD for all IRAs can be taken from any combination of IRAs (including just one if there are adequate funds), each company plan has its own RMD. Each company plan RMD must be taken before the remaining funds in that plan can be converted.

## **INELIGIBLE CONVERSIONS**

Unfortunately, many individuals are getting confused. They think that just because anyone can convert in 2010, it means that anyone can convert anything. Not so. The tax code allows only eligible rollover distributions to be converted to Roth IRAs. That means that in addition to RMDs, there are a number of other items that can't be converted.

These include 72(t) payments, hardship distributions, corrective distributions of excess deferrals, deemed distributions (i.e., defaulted plan loans, but not plan loan offsets) and dividends from employer securities. In addition, funds in an inherited IRA are not eligible for a Roth conversion. Regardless of where they come from, if excess or ineligible amounts end up in a Roth IRA, they will be subject to the 6% excise tax for excess contributions for each year they remain there.

Given all the hype, it's important to monitor all of your clients' Roth conversions. Make sure the converted funds make it into a Roth account. Recharacterize the conversion if an unexpected trap appears or if the account value declines after conversion. The account can later be reconverted to a Roth IRA after 30 days or in the calendar year after the year of the initial conversion, whichever is longer.

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