CONVERTING TO A ROTH IRA

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This article quantifies the tax costs and benefits of a Roth IRA conversion under different investment scenarios.

High-net-worth clients are generally precluded from annually contributing to a Roth Individual Retirement Account (R-IRA) due to Modified Adjusted Gross Income (MAGI) limitations. However, taxpayers can convert a traditional IRA (T-IRA), as well as other retirement accounts, into an R-IRA regardless of their income. This comes with a significant cost because the conversion is generally fully taxable as ordinary income in the year of conversion at the federal, state, and local levels.

This favorable tax provision is a "conversion contribution"[1] when a T-IRA is transferred to an R-IRA. Under the right circumstances, this tax maneuver is an excellent opportunity for high-net-worth taxpayers to create a financial asset that can grow and eventually be distributed income tax free to the taxpayer, one's spouse, and descendants including great-grandchildren. A taxpayer and his or her spouse are currently not subject to the minimum required distributions (MRDs) from an R-IRA and future named beneficiaries generally have the option, if planned for correctly, to take MRDs over their future life expectancy. In contrast, a T-IRA requires the taxpayer to receive MRDs after reaching age $70^1/_2$. Further annual contributions can be made into an R-IRA, unlike a T-IRA, after this age. If tax rates are lowered in the current push for tax reform by the Trump Administration and congressional Republicans, the conversion costs could be materially lower for taxpayers. However, the risk exists that Congress could change or disallow current favorable R-IRA conversion rules. (As of the end of 2017, both the House and the Senate tax bills/proposals call for the repeal of recharacterization.)

This article quantifies the tax costs and benefits of R-IRA conversion under different investment scenarios. To focus the analysis, the article assumes the taxpayer is in the highest marginal tax bracket and that the conversion tax cost can be funded with nonretirement funds. The article also provides guidance on when to make the conversion and the current ability to reverse a conversion to an R-IRA. Major factors at play when making a conversion to an R-IRA are the account(s) value, funding of the resulting tax, the ability to re-

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verse the conversion, and the multitude of often tricky IRA rules with failure to comply penalties of 6%, 10%, and even a draconian 50% for failure to take an MRD from a T-IRA. Exhibit 1 summarizes major points about conversions to R-IRAs.

Tax practitioner tips.

- If a high-net-worth taxpayer in the 39.6% marginal tax rate converts a $100,000 T-IRA (where all contributions were deductible) into an R-IRA, this will result in federal taxes of $39,600 and could trigger AGI limitations on certain tax benefits. Additionally, state and local taxes could be incurred.
- If in future tax reform the top ordinary tax rate decreases to 35% from 39.6% for most taxpayers, the tax cost of a $100,000 R-IRA conversion would decrease by $4,600 or over 11% for taxpayers in the highest marginal tax rate (MTR) bracket.
- IRAs and qualified retirement accounts are subjected to a wide variety of provisions, rules, restrictions, limitations, and penalties. Reflective of this is that IRS Pub. 590 on IRAs was split into two parts in 2014. IRS Pub. 590-A deals with contributions and 590-B covers distributions. The 2016 editions of these annual publications are a primary source for this article.[2]
- MRDs and required minimum distributions (RMD) are used interchangeably in practice and in IRS Pubs. 590-A and 590-B. A careful reading of line 52, of Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, refers to them as a "minimum required distribution" (see Exhibit 4).
- Technically, if a qualified retirement plan (such as a 401k) is switched to an R-IRA, this is a rollover (not a conversion).
- During any tax reform, an area that may have less favorable taxpayer provisions is retirement planning. The Wall Street Journal reported in April 2017 that one means to offset revenue losses from lower tax rates is to "reduce the benefits of contributing to a 401k and similar retirement plans."[3] Hopefully, favorable R-IRA attributes, such as no MRDs, will be grandfathered in for existing R-IRAs.

Investment scenarios

Critical to quantifying the potential benefits of an R-IRA conversion is the expected investment returns after a conversion. Investors have two initial basic investment parameters when modeling potential future returns. One is essentially risk free and the other entails taking significant equity-market-based risks. This article uses two proxies to model these two choices:

1. U.S. Treasury ten-year Note rate of interest as of the end of August 2017.
2. Vanguard's historical returns for its S&P 500 index-based funds as of the end of August 2017.

Exhibit 2 contains the return data on the ten-year U.S. Treasury Note and Vanguard's S&P 500 annualized returns for Investor Shares (since 1979) and Admiral Shares (since 2001). Using these benchmarks, the article models non-compounded returns of 2.5%, 5%, and 10% in the projections of possible long-term future outcomes. Modeling these return alternatives reveals historical returns and plausible equity return scenarios. If one invests in a ten-year Treasury Note and holds it to maturity, one knows what the investment results will be (other than reinvested interest rates on interest payments). See Exhibit 3 for simplified return projections based on non-compounded returns.

[A conversion] is an excellent opportunity for high-net-worth taxpayers to create a financial asset that can grow and eventually be distributed income tax free to the taxpayer, one's spouse, and descendants including great-grandchildren.

Exhibit 3 reveals that an R-IRA has higher return potential over time due to future tax savings even with highly conservative assumptions. While these projections do not account for compounded annualized returns or for fluctuations in returns, and are for a relatively short ten-year time horizon, they clearly show the higher return potential for an R-IRA conversion. Longer time horizons would generally increase the return projections assuming tax rates do not go down dramatically after the conversion is made.

[1] IRS Pub. 590-A, Contributions to Individual Retirement Arrangements (IRAs).

[2] www.irs.gov/pub/irs-pdf/p590a.pdf and https://www.irs.gov/pub/irs-pdf/p590b.pdf.

[3] Zweig, "Grab Your Pitchforks, Your 401(k) May Need Defending From Congress," *The Wall Street Journal* 4/21/17, www.wsj.com/articles/grab-your-pitchforks-your-401-k-may-need-defending-from-congress-1492804191.

EXHIBIT 1 Roth Conversion Pointers

Funding of taxes	Funds should come from a non-IRA source to maintain the ability to maximize tax-free growth and to avoid ordinary income recognition and a possible 10% early withdrawal penalty.
Timing of conversion	A market correction of 20% would likely be an ideal time to consider a conversion.
Estate benefits	The paying of income taxes lowers the taxable estate. For high-net-worth taxpayers with applicable 40% federal transfer tax rate, this results in every $1 million converted to an R-IRA potentially saving $400,000 in future estate taxes under the current Code.
Minimum required distributions (MRDs)	MRDs are not currently applicable to an R-IRA; a taxpayer and spouse can elect to never take a distribution thus allowing for maximum growth. Subsequent named heir(s) must distribute the account over their life expectancy per IRS tables or over five years.
Failure to name IRA beneficiary or make needed updates	Failure to have a valid named beneficiary of an IRA account is costly as it will require that the IRA be paid out by the end of the 5th calendar year after death. Additionally, all too often clients do not get around to this and also fail to even update the beneficiary form due to life changes (death, divorce, etc.)
R-IRA distributions	Distributions are tax free once the original owner reaches age 59.5 and the R-IRA is aged five years. Heirs distributions are completely tax-free once the R-IRA conversion has aged five years.
Sources of funds for R-IRA conversion	Taxpayers can move funds into an R-IRA from a traditional, Simplified Employee Pension (SEP), and a simple IRA. Other qualified retirement plans, such 401k can be converted (technically a rollover).
Only utilize a trustee to trustee transfer	As with any IRA transfers, a trustee to trustee transfer is the greatly preferred method to avoid the 60-day transfer limitation. Unfortunately, it is not uncommon for some trustees to automatically issue a check.

EXHIBIT 2 Investment return benchmarks as of the end of August 2017

Essentially risk free	**Yield**			
10-year U.S. Treasury Note	2.119%			
Risk-based returns	**Symbol**	**10 years**	**Avg. annual returns since inception**	**Fund inception date**
Vanguard's				
S&P 500 Index Fund Admiral Shares	VFIAX	7.60%	5.71%	11/13/00
S&P 500 Index Fund Investor Shares	VFINX	7.49%	10.98%	8/31/76

Tax practitioner tips.

- Exhibit 3 reveals that converting from a tax-deferred retirement plan into an R-IRA can result in higher returns than maintaining funds in a tax-deferred retirement plan. Key assumptions in the models are that taxes incurred on conversions are funded with nonretirement funds and that both investment return rates and tax rates remain constant over the ten-year period.
- If tax rates are lowered in 2017 or 2018, this would decrease the cost of a conversion. If tax rates were subsequently raised in later years, then conversion benefits would increase.

Exhibit 3 assumes in non-conversion scenarios a future tax rate of 40% for ordinary in-

EXHIBIT 3 Simplified analysis of $100,000 IRA converted or not converted to R-IRA

Part A Simplified analysis of $100,000 IRA converted or not converted to R-IRA			
R-IRA conversion taxed at 40%, taxes funded from non-IRA source			
Simple return (***not*** compounded)	**2.50%**	**5.00%**	**10.00%**
Initial total investment	$140,000	$140,000	$140,000
Immediate taxation funded with *non*-retirement funds	($40,000)	($40,000)	($40,000)
Earnings over 10 years on $100,000 (not compounded)	$25,000	$50,000	$100,000
Subtotal	$125,000	$150,000	$200,000
Deferred tax	$0	$0	$0
After Tax Value	**$125,000**	**$150,000**	**$200,000**
Part B T-IRA not converted taxed at future 40%/24%			
Simple return (not compounded)	**2.50%**	**5.00%**	**10.00%**
T-IRA value	$100,000	$100,000	$100,000
Immediate taxation	$0	$0	$0
Earnings over 10 years on $100,000 (not compounded)	$25,000	$50,000	$100,000
Subtotal	$125,000	$150,000	$200,000
Deferred tax @40% (assumed ordinary rates)	($50,000)	($60,000)	($80,000)
After tax value	$75,000	$90,000	$120,000
$40,000 initial tax savings (assumed invested and taxed at 24% preferential rate)	$47,600	$55,200	$70,400
Net after tax value	**$122,600**	**$145,200**	**$190,400**

come (R-IRA conversion and distribution) and a 24% preferential rate for the amount of income the $40,000 in taxes *not* incurred without an R-IRA conversion would potentially create. These rates were chosen as the "round ups" of the current highest federal tax rates that investors are subject to (39.6% for ordinary income, capital gain preferential rates of 20%, and net investment income tax (NIIT) of 3.8%). The NIIT is not applicable for IRA distributions. Potential state and local taxation are not considered. If federal tax rates are lowered in future tax legislation, this could lower the actual tax on R-IRA conversions and/or later distributions.

Importantly, Exhibit 3, Part A, assumes that the taxpayer funded the R-IRA conversion tax costs with non-retirement funds. Using a 10% compounded annualized return with a ten-year period would increase ending *pretax* value of either a T-IRA or an R-IRA to over $259,000 in Exhibit 3.[4] Interest and dividends that could be reinvested are not incorporated to simplify and focus the analysis (if incorporated, they would add to the expected return). As discussed below, if one stretches the R-IRA to the maximum by naming a grandchild or great-grandchild as a beneficiary, this would likely dramatically increase after-tax savings.

Tax practitioner tips.

- After-tax values shown in Exhibit 3 for an R-IRA conversion will tend to be on the conservative side. If one assumes a longer investment horizon, compounded annualized returns and/or stable or increasing tax rates, the benefits of an R-IRA conversion would be significantly higher.
- There are readily available R-IRA conversion calculators online that can easily model a variety of anticipated investment compounded returns and tax rates (both Fidelity Investments and Charles Schwab have R-IRA conversion calculators[5]).

To obtain a possible 5% and 10% annualized return, equity market exposure is generally re-

[4] www.bankrate.com/calculators/retirement/roi-calculator.aspx.

[5] calcsuite.fidelity.com/rothconveval/app/launchPage.htm and www.schwab.com/public/schwab/investing/retirement.

quired. Equity markets can and do go down dramatically at times. In 2008 and 2009, equity markets and most bond markets saw significant declines in values. Equity markets at the height of the financial crisis saw around a 50% decline in values. In other words, an S&P 500 index account that was worth $100,000 at the beginning of the year was worth around $50,000 at the height of the financial market collapse.

Tax practitioner tips.

- While equity-market-based returns are anything but assured, they do allow the basis for reasonable discussion of potential outcomes.
- Equity markets have historically been afforded a compounded annualized return of 10% when modeling expected returns. However, if one had made an investment in Vanguard's S&P 500 Index Admiral Fund since its inception in August 2000, the annualized return would be 5.6%, as opposed to an 11% annualized return for the S&P 500 Index Investor Shares Fund (assuming one invested and stayed invested since 1979).
- A market correction is generally defined as an equity market decline of 10%, so such an occurrence would be an ideal time to consider converting retirement funds into an R-IRA. In other words, an index account that was $100,000 would be worth $90,000.

The risk exists that Congress could change or disallow current favorable Roth IRA conversion rules.

- In 2008 and 2009, many 401k investors started calling their accounts "201k's" to reflect the more than 50% decline in values that many accounts suffered. At the time, almost all investors dreaded opening account statements and some even sold in a panic (a classic investment mistake).
- No investment is without risk. The pragmatic reality is that the only assured return in financial markets for U.S. investors is to invest solely in U.S. Treasury securities and hold them until maturity. Even this is considered only "essentially risk-free" as the U.S. Government could conceivably default. For example, delay of interest and principal payments during a U.S. deficit ceiling debate is a possibility that must be recognized.
- Bond markets can offer a potential for higher returns than afforded by U.S. Treasuries. Corporate bonds are, however, far from risk free. As of 9/25/17, U.S. corporate Aaa industrial bonds had a 52-week yield range of between 3.40% and 3.47%.[6]

Funding the tax costs

As observed, Exhibit 3, Part A, assumes that the taxpayer funded the R-IRA conversion tax costs with nonretirement funds, which is almost always the significantly better approach to take when converting to an R-IRA. If a taxpayer pays tax conversion costs with retirement proceeds from a T-IRA or other retirement account, this generally has two material costs:

1. The R-IRA account balance will be materially less (by, potentially, 39.6% plus state and local tax).
2. If the taxpayer is under 59½ years of age, a 10% early distribution penalty would likely apply to amounts not converted from a T-IRA.

The conversion tax cost can be lower if the taxpayer has a basis in a retirement account fund from prior "nondeductible contributions."[7] If this is the case, then portions of the amount contributed would be allocated to the pre-tax contribution resulting in a lower taxable portion. The nontax portion would be based on an IRS worksheet formula of total amount contributed times pre-tax basis divided by total amount of all T-IRA plans.

Modified IRS Pub. 590-B example.

> A taxpayer in 2016 converted his $100,000 T-IRA into an R-IRA. His prior total basis in this IRA was $20,000 (as reflected in Form 8606, Nondeductible IRAs). The taxpayer will have $80,000 ordinary income in 2016 due to this conversion assuming this is his only T-IRA.

Many practitioners believe that taxpayers should postpone a tax obligation as long as legally possible. An R-IRA conversion does have the potential for significant tax costs and risks (immediate taxation, higher-rate brackets, lost deductions, negative AGI floors implications, lower future tax rates, etc.). However, making an R-IRA conversion over several tax years would mitigate some of these issues and, if a taxpayer has the available cash from nonretirement funds, then conversion can provide additional tax benefits besides creating a tax-free account. For high-net-worth clients, prepaying T-IRA taxes means that their taxable es-

[6] "Key Interest Rates: Weekly Snapshot," *The Wall Street Journals*, www.wsj.com/mdc/public/page/2_3020-keyinrates.html?mod=topnav_2_3020.

[7] IRS Pub. 590-A, note 1, *supra*.

tates decline, which could result in avoiding 40% transfer taxes and creating a multi-generational tax-free account.

Tax practitioner tips.

- Consider converting to an R-IRA over several years to limit the taxable income. Taxpayers can currently elect to convert a portion of a T-IRA (or other retirement accounts) on an annual basis. One risk to this approach is that conversion may be restricted or eliminated with any future tax legislation.
- When calculating immediate tax costs and expected future savings of the R-IRA, one must incorporate the income and estate tax effects.

Estate planning

An R-IRA conversion can be an excellent estate planning tool for high-net-worth clients. Prepaying taxes on a T-IRA means the client's taxable estates decline and this could aid in maximizing the basic exclusion amount ($5.49 million in 2017) and avoiding the 40% transfer tax. This form of estate planning must be conducted with extreme care to avoid beneficiaries having to take a distribution over five years instead of their life expectancy. Ideally, grandchildren and great-grandchildren are named as beneficiaries resulting in maximum longevity of the R-IRA. This potentially stretches the "tax-free growth for 50, 60, or even 70 years," according to Bobbi Bierhals, a partner at the law firm McDermott Will & Emery in Chicago.[8] Using multiple beneficiaries and/or stretching an IRA to later generations is not without complexity as the following IRS example highlights.

IRS Pub. 590-B example.

> When Ms. Hibbard died in 2016, her Roth IRA contained regular contributions of $4,000, a conversion contribution of $10,000 that was made in 2012, and earnings of $2,000. No distributions had been made from her IRA. She had no basis in the conversion contribution in 2012. When she established this Roth IRA (her first) in 2012, she named each of her four children as equal beneficiaries. Each child will receive one-fourth of each type of contribution and one-fourth of the earnings. An immediate distribution of $4,000 to each child will be treated as $1,000 from regular contributions, $2,500 from conversion contributions, and $500 from earnings. In this case, because the distributions are made before the end of the applicable five-year period for a qualified distribution, each beneficiary includes $500 in income for 2016. The 10% additional tax on early distributions does not apply because the distribution was made to the beneficiaries as a result of the death of the IRA owner.

A trust that is funded with R-IRAs is possible but requires extreme care. Multiple beneficiaries can be named for an IRA. Setting up accounts for each beneficiary will stretch out the payments for a longer period. It is critical to correctly title the accounts to preserve beneficiaries' ability to stretch the IRA out over time. Not naming a beneficiary for an IRA is a costly mistake as it will then need to be distributed over five years.

Tax practitioner tips.

- Executors can currently recharacterize an R-IRA conversion.
- The 10% early withdrawal penalty is not applicable if the distribution was due to death.[9]
- Failure to designate a beneficiary with the IRA trustee is a costly omission as the IRA must be paid out in full by the end of the fifth calendar year. In contrast, a designated beneficiary has the option to take the distributions out over his or her life expectancy per IRS tables. If a spouse is a designated beneficiary, then there are no MRDs during the spouse's lifetime.

Conversion rules

Multiple types of retirement accounts mean there are numerous potential rules that are applicable to an R-IRA conversion. Conversely, restrictions that apply, such as R-IRA AGI limitations and "one-rollover-per year" for non-trustee transfers, do not apply at certain times. Some Code provisions and IRS rules that are applicable during R-IRA conversions are:

1. The conversion amount is generally taxable fully as ordinary income.
2. Multiple rollovers within a year can be made into an R-IRA.
3. The same property that is withdrawn from a T-IRA must fund an R-IRA.
4. Conversion to an R-IRA must occur within 60 days.
5. If there is not a direct rollover to a trustee, then a 20% federal withholding is generally applicable. If a 20% withholding is not made up for by another source, then it will be included in the taxpayer's income and a 10% early distribution penalty can apply.

If a taxpayer pays tax conversion costs with retirement proceeds from a traditional IRA or other retirement account, this generally has two material costs.

[8] Prior, "Be Careful When Passing Down a Roth IRA," *The Wall Street Journal*, 10/23/16, www.wsj.com/articles/be-careful-when-passing-down-a-roth-ira-1477275060.

[9] www.irs.gov/pub/irs-pdf/p590b.pdf.

6. When a T-IRA that has a basis (prior nondeductible converted amount) is converted to an R-IRA, the amount that is taxable is based on a formula that aggregates all the taxpayer's T-IRAs into a single deemed T-IRA.

The actual mechanics of transferring funds from a T-IRA to an R-IRA need to be coordinated and planned with extreme care. A trustee-to-trustee transfer is the best approach, but IRA transfers are unfortunately often made by check and a 60-day conversion limitation is easily missed. Fortunately, the IRS has released an easy method to self-certify abatement of penalties for eligible taxpayers if the 60-day deadline is missed but the funds are eventually placed in an IRA.[10] If a taxpayer converts from a T-IRA to an R-IRA, this is reported on Form 8606.

Critical to quantifying the potential benefits of an R-IRA conversion is the expected investment returns after a conversion.

Tax practitioner tips.

- While a taxpayer is allowed only "one-rollover-per-year," this does not apply to a conversion to an R-IRA.
- Clients should only have IRA transfers done "trustee to trustee" to avoid any potential of not complying with the 60-day deadline for a conversion to occur. All too often, clients run afoul of this time requirement.

Undoing a conversion to an R-IRA

A desirable feature of a conversion to an R-IRA is that, once it occurs, a taxpayer can change funds back to a T-IRA, essentially undoing the original transfer and eliminating its taxation. This is known as a recharacterization. This can occur up to October 15 of the year following conversion. The actual mechanics of recharacterization requires several steps as IRS Pub. 590A highlights.

IRS Pub. 590-A example.

> On June 1, 2016, Christine properly and timely converted her traditional IRA to a Roth IRA. In December, Christine decided to recharacterize the conversion and move the funds to a traditional IRA. In January 2017, to make the necessary adjustment to remove the conversion, Christine opened a traditional IRA with the same trustee. Also in January 2017, she instructed the trustee of the Roth IRA to make a trustee-to-trustee transfer of the conversion contribution made to the Roth IRA (including net income allocable to it since the conversion) to the new traditional IRA. She also notified the trustee that she was electing to recharacterize the contribution to the Roth IRA and treat it as if it had been contributed to the new traditional IRA. Because of the recharacterization, Christine has no taxable income from the conversion to report for 2016, and the resulting rollover to a traditional IRA is not treated as a rollover for purposes of the one-rollover-per-year rule.

Recharacterization cannot occur until after 30 days of the initial conversion. If the recharacterization occurs in the same year as the original conversion to an R-IRA, the taxpayer also must wait until the next tax year to convert back into an R-IRA. IRS Pub. 590-A gives two examples highlighting the interplay of these rules.[11]

IRS Pub. 590-A example (same tax year).

> On June 2, 2016, Darron converts an amount from his traditional IRA to a Roth IRA. In October 1, 2016, he decides to transfer back (recharacterize) that amount from the Roth IRA to a traditional IRA. He will not be able to move (reconvert) that amount from the traditional IRA to a Roth IRA until January 1, 2017.

IRS Pub. 590-A example (30-day rule).

> Same facts as in (prior) Example above except Darron transfers back that amount from the Roth IRA to a traditional IRA on March 2, 2017 for tax year 2016 . . . . He will not be able to move (reconvert) that amount from the traditional IRA to a Roth IRA until April 1, 2017.

When recharacterizing an R-IRA, the trustee (or trustees) must be notified as to applicable dates, the amount originally converted, and "any net income (loss) allocable" contributed to an R-IRA. This process is simplified if the same trustee was used for the T-IRA and the R-IRA. IRS Pub. 590-A gives an example of when an R-IRA is recharacterized when a net loss has occurred.

IRS Pub. 590-A example.

> On April 1, 2017, when her Roth IRA is worth $80,000, Allison makes a $160,000 conversion contribution to the Roth IRA. Subsequently, Allison requests that the $160,000 be recharacterized to a traditional IRA. Pursuant to this request, on April 1, 2018, when the IRA is worth $225,000, the Roth IRA trustee transfers to a traditional IRA the $160,000 plus allocable net income. No other contributions have been made to the Roth IRA and no distributions have been made.

[10] Rev. Proc. 2016-47, 2016-37 IRB 346.

[11] www.irs.gov/publications/p590a/ch01.html#en_US_2016_publink1000230671.

EXHIBIT 4 IRS Form 5329—50% penalty for failure to take MRD from T-IRA

Part IX **Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs).** Complete this part if you did not receive the minimum required distribution from your qualified retirement plan.

52	Minimum required distribution for 2016 (see instructions)	52	
53	Amount actually distributed to you in 2016	53	
54	Subtract line 53 from line 52. If zero or less, enter -0-	54	
55	**Additional tax.** Enter 50% (0.50) of line 54. Include this amount on Form 1040, line 59, or Form 1040NR, line 57	55	

The adjusted opening balance is $240,000 ($80,000 + $160,000) and the adjusted closing balance is $225,000. Therefore, in order to recharacterize the April 1, 2017, $160,000 conversion contribution on April 1, 2018, the Roth IRA trustee must transfer from Allison's Roth IRA to her traditional IRA $150,000 ($160,000 – $10,000).

Recharacterizations are reported on Form 8606. If a taxpayer has multiple IRAs, only an R-IRA that is recharacterized is used to figure the applicable amount.

If markets decline in value after a conversion, taxpayers will often be tempted to recharacterize immediately. However, given that there is an extended period to undo the conversion, a taxpayer would be wise to wait to see if markets recover as a taxpayer would have to wait until the next year following the action to convert back into an R-IRA (if reversion is done in year one).

Tax practitioner tips.

- When filing an amended return to report recharacterization, one should write, "Filed pursuant to section 301.8100-2" on the return.
- If lower tax rates occur in 2018 or if markets decline materially after a conversion to an R-IRA, a taxpayer has, as of early December 2017, a highly favorable ability to undo the original conversion, thus avoiding taxes (or filing an amended return for a refund of taxes). However, if the original conversion to an R-IRA is undone in the first year, the taxpayer must wait to the next year to convert back into an R-IRA. This means that late December of the current year or October of the following year are ideal times to assess whether to undo a conversion to an R-IRA.
- Taxpayers can recharacterize an IRA contribution from an IRA account to a different type of IRA up to the due date of the tax return (including an extension). When the taxpayer undoes an R-IRA conversion this is only one type of recharacterization.
- Warning: as of the final version of this article, potential tax legislation calls for repeal of recharacterization.

Strict adherence to IRS rules

When dealing with IRAs and other qualified retirement plans, taxpayers can be subject to a variety of penalties. Penalties of 6%, 10%, or even 50% are possible. Taxpayers who violate the rules are required to file Form 5329. Penalties that are assessed on Form 5329 are:

1. A 6% penalty for: "Additional Tax on Excess Contributions to Traditional IRAs;" "Additional Tax on Excess Contributions to Roth IRAs;" "Additional Tax on Excess Contributions to Coverdell ESAs;" "Additional Tax on Excess Contributions to Archer MSAs;" "Additional Tax on Excess Contributions to Health Savings Accounts (HSAs);" and "Additional Tax on Excess Contributions to an ABLE Account."
2. A 10% penalty for: "Additional Tax on Early Distributions" and for "Additional Tax on Certain Distributions from Education Accounts and ABLE Accounts."
3. A 50% penalty for: "Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs)."

Failure to take an MRD from a T-IRA or a qualified retirement plan results in a 50% draconian penalty for the amount not withdrawn (see Exhibit 4). Taxpayers who fail to take an MRD should immediately withdraw the correct amount, file Form 5329, and attach a statement that requests abatement of penalty.

A taxpayer's MRDs must start by April 1 the year after the taxpayer turns age 70$^{1}/_{2}$ as highlighted in the following IRS example.

IRS Pub. 590-B example.

You reach age 70.5 on August 20, 2016. For 2016, you must receive the required minimum distribution from your IRA by April 1, 2017. You must receive the required minimum distribution for 2017 by December 31, 2017.

Tax practitioner tips.

- Ed Slott, an IRA expert, observed in the Wall Street Journal that the IRS often grants abatement of penalties when a taxpayer makes a late

EXHIBIT 5 R-IRA Facts from Investment Company Institute

R-IRAs have been part of the Code since the Taxpayer Relief Act of 1997. As of the end of 2016, there was $7.9 trillion invested in IRAs with the R-IRA making up $660 billion of the total. A July 2017 Investment Company Institute report on the R-IRA presented the following points:

1. In 2015, 9% of R-IRAs were opened in a conversion.
2. An R-IRA tends to be opened with annual contributions whereas a T-IRA is often funded with rollovers.
3. Over 66% of R-IRAs were invested in equities and equity funds, 7% bonds and bonds funds, and 7% in money market funds. Target date funds, balanced funds, and other investments made up the rest.
4. R-IRA holders tend not to take distributions. Over 80% of T-IRA holders age 70 and over took distributions compared with just 5.7% of R-IRA holders.
5. As of the end of 2015, three out of 10 Roth holders were under the age of 40.
6. As of 2015, R-IRAs make up 34% of IRA accounts and held 12% of all IRAs' value. The T-IRA makes up 69% of the IRA accounts and held 81% of all IRAs' value.
7. Over 70% of R-IRA owners reported that they managed retirement accounts based on financial factors such as emergency funds, retirement income, asset allocations, retirement expenses, insurance policies, and when to tap Social Security benefits.
8. About 50% of R-IRA holders employed multiple sources when planning for retirement and 68% consulted financial advisers.

https://www.ici.org/pdf/ten_facts_roth_iras.pdf

withdrawal of the MRD and files Form 5329 with a short statement explaining the failure to take a timely distribution.[12] Slott observed, "I've seen this work in virtually every case."

- Failure to correct an R-IRA annual contribution when a taxpayer's MAGI exceeds limitations ($150,000) results in 6% penalties. Excess amounts can be withdrawn or transferred to a T-IRA as a nondeductible contribution to avoid penalty.
- One manipulation of an R-IRA conversion entails a high-income taxpayer funding a T-IRA (where a nondeductible contribution can be made without regard to MAGI) and immediately converting it to an R-IRA. This is referred to as a "backdoor Roth." This is a high-risk maneuver as the IRS could assert the "step transaction doctrine"[13] and could consider it a disallowed annual contribution to an R-IRA, subjecting a high MAGI taxpayer to a 6% penalty (Additional Tax on Excess Contributions to Roth IRAs).
- A taxpayer is allowed only one indirect rollover per year from a T-IRA. However, the "once-per-year" limitation does not apply to direct rollovers (i.e., trustee-to-trustee transfers), to T-IRAs, or to conversions to R-IRAs. Conversions to R-IRAs should be made "trustee to trustee" to avoid any potential of not complying with the 60-day deadline for completing the conversion.

Potential for Congressional change

A major concern with an R-IRA conversion is that the rules, especially regarding MRDs, could be changed in the future. With tax reform currently being debated, one way for Congress to raise revenue while cutting taxes would be to modify highly favorable retirement provisions embedded in the Code. Joan Crain, a senior director and wealth strategist at BNY Mellon Wealth Management in Fort Lauderdale, was quoted in the *Wall Street Journal* in 2015:

> The whole retirement space of tax-deferred and tax-exempt accounts are under scrutiny because, frankly, it's perceived as just too good. Roths are the apex of this. They are just a really good deal for a lot of high-net worth people.[14]

The Obama Administration had proposed an MRD for R-IRAs and limiting conversions to pretax dollars. Neither proposal gained much

[12] Saunders, "Everything You Need to Know About Required 401(k) and IRS Withdrawals," *The Wall Street Journal*, 2/5/17, www.wsj.com/articles/everything-you-need-to-know-about-required-401-k-and-ira-withdrawals-1486350722.

[13] Ruffenach, "When the 5-Year Clock Starts on a Roth IRA," *The Wall Street Journal*, 2/7/16, www.wsj.com/articles/when-the-5-year-clock-starts-on-a-roth-ira-1454900916.

[14] Prior, "Some Advisers Hesitate with Roth IRA Conversions," *The Wall Street Journal*, 4/1/15, www.wsj.com/articles/some-financial-advisers-hesitate-with-roth-ira-conversions-1427903433.

traction in Congress. Further, many contend that retirement reforms tightening rules would be fought hard by many.[15] If change occurs, an existing R-IRA could be grandfathered regarding MRDs. Possible retirement Code tightening could result in:

1. Requiring that an R-IRA have MRDs.
2. Disallowing the ability to do a conversion to an R-IRA.
3. Reducing the amount that can be contributed annually (for example, the general $18,500 annual 401k limit).
4. Disallowing recharacterization of R-IRA conversions.

One significant current advantage for a conversion to an R-IRA is that taxes paid reduce a taxpayer's taxable estate. However, both the 2016 House Republican tax plan[16] and President Trump have called for the elimination of the estate tax.

Future federal ordinary tax rates could be lowered, which would decrease the cost of a conversion to an R-IRA, but decrease the projected future tax savings. However, if tax rates were lowered now and raised later, then an established R-IRA would likely afford taxpayer protection from future possible tax increases because of Roth distributions not being taxed currently. Future tax rates and tax provisions are always an unknown variable and even more so in the current political environment.

Conclusion

Currently, R-IRA conversions are a valuable tool for taxpayers to create highly favorable tax-free assets that can last multiple decades and benefit future heirs. The potential for lower tax rates would make an R-IRA conversion less costly, but taxpayers risk Code changes that could eliminate or restrict their ability to elect a Roth conversion. As of 2016, there was $7.9 trillion invested in IRAs making this an area of significant opportunity for taxpayers and tax practitioners (see Exhibit 5).

Tax practitioners should identify clients with retirement accounts that will be taxable when withdrawn and who have the financial wherewithal to prepay taxes. This will often be high-net-worth clients with liquids assets. Critically, this can be done outside of the tax season rush. Under current rules, conversions can be made over several years allowing a taxpayer to at least partially avoid higher tax brackets and income limitations. Modeling rough potential future outcome implications is relatively straightforward. One can even model essentially assured outcomes (other than future tax rates) if taxpayers invest and hold to maturity an R-IRA that is invested solely in long term U.S. Treasury securities. ■

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15 *Id.*

16 "A Better Way: Our Vision For A Confident America," 6/24/16, abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-Policy-Paper.pdf.

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