BEST MONTHLY WEBINAR

ROTH IRA

Presented by:
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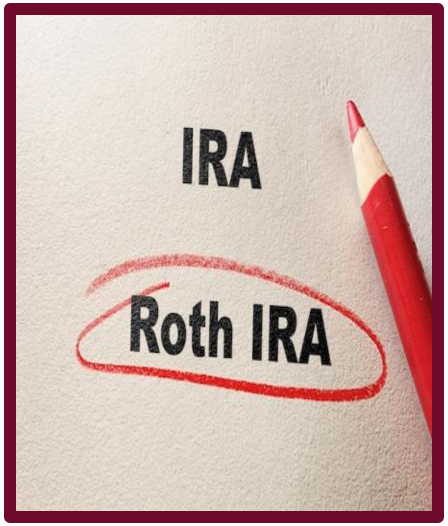
Agenda…

- Roth IRA Basics
- Roth IRA Conversions
- The Backdoor Roth IRA
- Roth IRA Recharacterizations
- Roth IRA Distribution Rules



Roth IRA Background

- Created by The Taxpayer Relief Act of 1997, Section 302:
  - Effective January 1, 1998
- An Individual Retirement Arrangement (IRA) providing tax advantages for "*eligible*" taxpayers while saving for retirement.
- Governed by IRC § 408 and IRC § 408A

Traditional IRA vs. Roth IRA

Traditional IRA [IRC § 408]	Roth IRA [IRC § 408A]
Contributions made with pre-tax and after-tax dollars	Contributions made with after-tax dollars IRC § 408A(c)(1)
Principal grows tax-deferred	Principal grows tax-free[1]
No contributions allowed after age 70½	Contributions allowed after age 70½ with earned income [IRC § 408A(c)(4)]
Required Minimum Distributions (RMDs) at age 70½	No Required Minimum Distributions for participant [IRC § 408A(c)(5)]
Distribution of pre-tax dollars 100% taxable; after-tax dollar recovery limited by pro-rata rules.	"Qualified" distributions are tax-free; "Nonqualified" distributions follow the "ordering rules" (first from contributions, next from converted amounts and last from earnings, which may have tax implications and penalty).

1. To be considered "qualified," a distribution of earnings must meet the following two criteria: the distribution must be made after a five-year holding period, and the individual must have reached age 59½. Earnings are tax-free only if withdrawn as qualified distributions.

Setting Up a Roth IRA

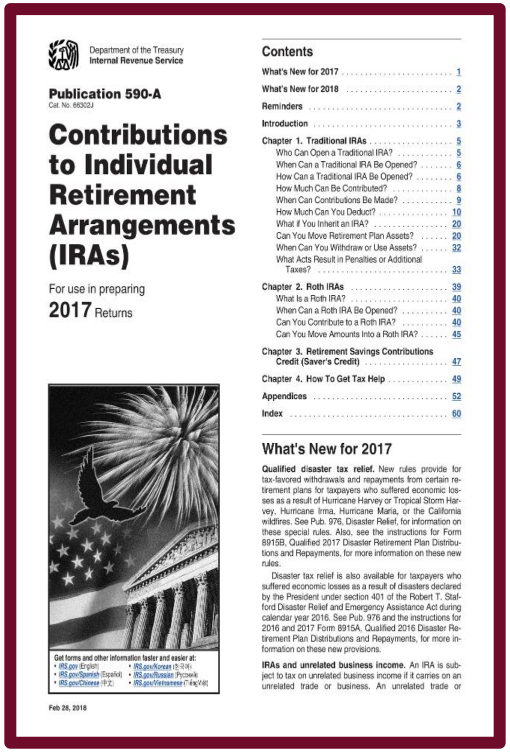
- Similar to a Traditional IRA can be either an account [IRC § 408(a)] or an annuity [IRC § 408(b)]:
  - Custodial account (IRS Form 5305-RA); Annuity account (IRS Form 5305 RB); and Trusteed account (IRS Form 5305-R)
- To be set-up as a Roth IRA, the account or annuity must be designated as a Roth IRA:
  - A SEP-IRA/SIMPLE IRA cannot be designated as a Roth IRA

Roth IRA Fees

- Advisor investment fees which were considered a miscellaneous itemized deduction subject to the 2% of AGI floor [IRC § 67] are no longer deductible as an itemized deduction.
  - Traditional IRA may pay IRA advisory fees from the IRA but not for financial planning fees [IRC § 212]. Using IRA to pay for other fees will be treated as a taxable distribution or even a prohibited transaction.
- Roth IRAs (after-tax funds) pay fees from other taxable funds
  - Roth fees cannot be paid from the Traditional IRA

Contributing Funds to a Roth IRA

- Two ways to contribute funds to a Roth IRA:
  - Annual (Regular) Contributions
  - Roth IRA Conversions



Department of the Treasury
Internal Revenue Service

Publication 590-A
Cat. No. 66302J

Contributions to Individual Retirement Arrangements (IRAs)

For use in preparing
2017 Returns

Get forms and other information faster and easier at:
- IRS.gov (English)
- IRS.gov/Spanish (Español)
- IRS.gov/Chinese (中文)
- IRS.gov/Korean (한국어)
- IRS.gov/Russian (Русский)
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Feb 28, 2018

Contents

What's New for 2017

Qualified disaster tax relief. New rules provide for tax-favored withdrawals and repayments from certain retirement plans for taxpayers who suffered economic losses as a result of Hurricane Harvey or Tropical Storm Harvey, Hurricane Irma, Hurricane Maria, or the California wildfires. See Pub. 976, Disaster Relief, for information on these special rules. Also, see the instructions for Form 8915B, Qualified 2017 Disaster Retirement Plan Distributions and Repayments, for more information on these new rules.

Disaster tax relief is also available for taxpayers who suffered economic losses as a result of disasters declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act during calendar year 2016. See Pub. 976 and the instructions for 2016 and 2017 Form 8915A, Qualified 2016 Disaster Retirement Plan Distributions and Repayments, for more information on these new provisions.

IRAs and unrelated business income. An IRA is subject to tax on unrelated business income if it carries on an unrelated trade or business. An unrelated trade or

www.irs.gov/pub/irs-pdf/p590.pdf

Roth IRA Annual (Regular) Contributions

- Limits similar to Traditional IRA [IRC § 408A(c)(2)][1]:
  - Regular contribution if only made to Roth IRAs [IRC § 219(b)(5)(B)]:
    - The lesser of:
      - $5,500 or
      - 100% of compensation
  - Catch-up contributions [IRC § 219(b)(5)(B)]
    - $1,000 age 50+

Source: [1] IRS Publication 590; www.irs.gov/pub/irs-pdf/p590.pdf

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Roth IRA Annual (Regular) Contribution Rules

- Regardless of age, anyone may be able to establish and make annual regular contributions (as long as they have "*earned income*").
- Contributions must be made in cash.
- Contributions must be made by the due date of the return not including extensions (generally, April 15th of the following tax year).
- Note: Do not have to report Roth contributions to IRS (only Roth IRA distributions).

Roth IRA Annual (Regular) Contribution Rules (con't.)

- Contributions are reduced by any contributions made to a Traditional IRA
- Excess contributions may be subject to a 6% penalty [IRC § 4973(a)]
- Contribution amounts will be phased-out depending on marital status and income [IRC § 408A(c)(3)]

2018 Roth IRA Phase-out Rules

Single Filer

< $120,000 (Indexed) Full Contribution	$120,000 – $135,000 Partial Contribution	>$135,000 (Indexed) No Contribution

Married Filing Jointly

< $189,000 (Indexed) Full Contribution	$189,000 – $199,000 Partial Contribution	>$199,000 (Indexed) No Contribution

Married Filing Single

< $10,000 Full Contribution	>$10,000 No Contribution

Roth IRA Conversions

- The second way to contribute to a Roth IRA. Types of retirement accounts eligible for conversion:
  - Traditional IRA
  - SEP IRA to a Roth IRA
  - A SIMPLE IRA to a Roth IRA (after 2nd year)
  - Rollover from QRPs, 403(b) and/or 457 plans direct to Roth IRA effective for plan years after 2007
- Reminder: Since 1/4/2010 (TIPRA) there are no income limits on Roth conversions.

Roth IRA Conversions

- Three conversion methods of a Traditional IRA:
    - A distribution from a Traditional IRA may be rolled over to a Roth IRA [IRC § 408(d)(3)(A)(i)];
    - Direct Rollover (trustee-to-trustee transfer); and
    - “Redesignate” all or part of a traditional IRA.
- An Inherited IRA nor an educational IRA can be converted to a Roth IRA

Roth IRA Conversion Rules

- There is no limit on the number (trustee-to-trustee) or amount of conversions.
- Conversions are dated January 1.
- RMDs do not count as income towards conversion.

Roth IRA Conversion Tax Reporting

- Trustees must report conversion amounts on IRS Form 1099-R and contributions to the Roth IRA on Form 5498.
- IRS Form 8606 must be completed to determine the nontaxable portion of Roth IRA conversion
  - Amount converted is included in participant's gross income (but not subject to 10% penalty).
- Individual must report Roth IRA conversion from a Traditional IRA on Form 1040 line 15

Roth IRA Conversion Rules with Basis

- Over half of Traditional IRA contributions are nondeductible:
  - These contributions impact taxable amount of Roth IRA conversion
- IRS requires filing IRS Form 8606 when:
  - Nondeductible assets are converted to a Roth IRA
  - Nondeductible assets are distributed from a Roth IRA
- Clients cannot "cherry pick", they must follow the following rules:
  - Aggregation rules [IRC § 408A(d)(2)], and
  - Pro-rata rules (IRS 72, IRS Pub 575, pg.16)

Case Study: Conversion w/Basis

Must calculate total 12/31 balance of all Traditional IRAs, SEP and SIMPLE IRAs in year of conversion

Hypothetical Illustration:

- Client has $30,000 Traditional IRA:
  - $25,000 is nondeductible contributions
  - $5,000 is earnings
- If he/she converts $30,000, what amount will he/she owe taxes on?

$$\frac{\$\,25{,}000}{\$\,30{,}000} \times \$30{,}000$$

= 83.33% x $30,000

= $25,000 converts tax-free

Of the $30,000 that is converted, client will only pay taxes on **$5,000**

Case Study: Rollover and Basis

Hypothetical Illustration:

- Client has $30,000 Traditional IRA:
  - $25,000 is nondeductible contributions
  - $5,000 is earnings
- Client rollover $220,000
- If he/she wants to convert $30,000, what amount will he/she owe taxes on?

$$\frac{\$\,25{,}000}{\$\,250{,}000} \times \$30{,}000$$

= 10% x $30,000
= $3,000 converts tax-free

Of the $30,000 that is converted, now client pays taxes on **$27,000**

Case Study Comparison

- If the client converts before the rollover, they pay taxes on $5,000:
  - Total taxes based on 24% tax rate = ***$1,200***
- If the client converts after the rollover, they pay taxes on $27,000:
  - Total taxes based on 24% tax rate = ***$6,480***

Planning Strategy: Reduce taxable amount of conversion by waiting to convert/rollover QRPs until after conversion. If rollover already occurred, rollback to employer sponsored retirement plan by December 31st in year of conversion.

Back Door Roth IRA Contribution via Conversion Of A Nondeductible IRA

- High-income individuals who are not eligible to make a Roth IRA contribution have been able to make an indirect "*backdoor Roth contribution*" by simply contributing to a non-deductible IRA and converting it "*shortly*" thereafter.
- There are some important caveats to consider in executing the strategy.
  - IRA Aggregation Rules;
  - Pro-Rata Rules; and
  - Step-transaction Doctrine.

Aggregation Rules

- The rule stipulates that when an individual has multiple IRAs, they will all be treated as one account when determining the tax consequences of any distribution [IRC § 408(d)(2)].
- It's important to note that the rule *only* aggregates together IRA accounts (includes SEP/SIMPLE IRAs), and only the T*raditional* IRA accounts for that individual.
  - A married couples accounts are not aggregated together
- Note: Employer retirement plans are not aggregated, nor inherited IRAs or Roth accounts.

Pro-Rata Rules

- The application of the “pro-rata” rule limits the ability to convert *just* a new non-deductible IRA.
- Exception to the Rule: When there is a combination of taxable and after-tax funds to “siphon-off” the pre-tax portion by rolling into a 401(k), leaving only the after-tax funds as a remainder to then be converted [IRC § 408(d)(3)(A)(ii)].

The Step Transaction Doctrine

- A judicial doctrine that combines a series of formally separate steps, resulting in tax treatment as a single integrated event.[1]
- So does the strategy of contributing to a non-deductible IRA and converting it to a Roth IRA to avoid the Roth IRA contribution income limit constitute a step transaction scenario?
- In the end, the contribute-and-then-convert strategy is not expressly prohibited by the tax code, but the IRS does have the right to tax a transaction according to its true economic reality.

Source:[1]Wikipedia; https://en.wikipedia.org/wiki/Step_transaction_doctrine

Recharacterization

- Reverse a Roth IRA Conversion:
- Reasons for “recharacteriztion”:
  - Higher than expected taxable income and/or the additional income from the Roth IRA conversion resulted in a bump to a higher federal income tax bracket.
  - The value of investments in the converted Roth IRA has declined since the date of the conversion.
  - Taxable income in retirement will likely be lower than expected, reducing the potential benefits of a Roth IRA’s tax-free distributions.
  - Not enough cash on hand to pay the taxes resulting from the conversion.
- Recharacterization Strategy with multiple accounts

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Recharacterizations After TCJA of 2017

- Section 13611 has repealed the rule permitting re-characterization of Roth IRA conversions [IRC § 408A(d)(6)](B)], effective 12/31/2017.
- The IRS still permits IRA owners to re-characterize ("undo") ***annual contributions*** from one type of IRA (i.e. Roth or Traditional) to the other [IRC § 408A(d)(6)(A)]:
  - Must be done as **a direct (trustee-to-trustee) rollover**
  - The deadline for re-characterizing a contribution is the extended due date of the tax return for the year of contribution [IRC § 408A(d)(7)]:
    - This would normally be April 15th following the year of contribution, or October 15th, of this subsequent year if you have filed for and obtained an extension (IRS Form 4868).

Note: On January 18, 2018, the IRS FAQs - Recharacterizations of Roth Rollovers and Conversions will allow Roth conversions in 2017 to be recharacterized up until October 15, 2018. Tax arbitrage strategy

Roth IRA Conversions After TCJA of 2017

- Critical Decision Factors
  - What is my tax rate in year of conversion vs. tax rate in year of withdrawal?
  - Where are the funds coming from to pay the tax?
  - Do I need any of the Roth IRA funds to live on?
  - What's my time horizon?
    - RMDs must be taken into consideration

Principles and Mathematics

- A Traditional IRA will provide the same after tax results as a Roth IRA assuming the same growth rate and same tax rates at conversion and withdrawal.

Traditional IRA	Roth IRA
$1,000,000 (200% growth rate until death)	$1,000,000
$3,000,000	Minus 40% tax rate
Minus 40% Tax Rate	$600,000 (200% growth rate until death)
Net after-tax = $1,800,000	Net after-tax = $1,800,000

So when does it make sense to do a Roth IRA Conversion?

2018 Taxable Income Brackets

Marginal Tax Rate	Married Filing Jointly	Single
10%	$ 0 – 19,050	$ 0 - $9,525
12%	$19,051 - $77,400	$9,526 - $38,700
22%	$77,401 - $165,000	$38,701 - $82,500
24%	$165,001 - $315,000	$82,501 - $157,500
32%	$315,001 - $400,000	$157,501 - $200,000
35%	$400,001 - $600,000	$200,001 - $500,000
37%	Over $600,000	Over $500,000

Reminder: Roth IRA conversions must take into consideration the 3.8% NIIT, AMT, and state income taxes.

Source: Internal Revenue Service

Estate Planning with Roth IRAs

- Roth IRA conversion make sense if your wealthy clients do not need the funds and have an estate tax problem.
  - Use Roth as funding mechanism for the B-Trust provides more growth than Traditional IRA.
  - IRC 691(c) Deduction (federal only)
    - Missing; and Fading

Reconversions

- Taxpayers may choose to “reconvert” their re-characterization:
  - But may not “un-convert” it and reconvert the same IRA money in the same year [Reg. §1.408A-5, Q&A-9 (a)].
  - Even if you straddle different calendar years, taxpayer must still wait 30 days before reconverting a Roth IRA that he/she had previously converted and “unconverted” [Reg. §1.408A-5, Q&A-9 (a)].
- This timing rule applies regardless of whether the re-characterization occurs during the tax year in which the amount was converted to a Roth IRA or the following tax year [Reg. §1.408A-5, Q&A-9 (a)(1)].

Distribution Rules for Roth IRA

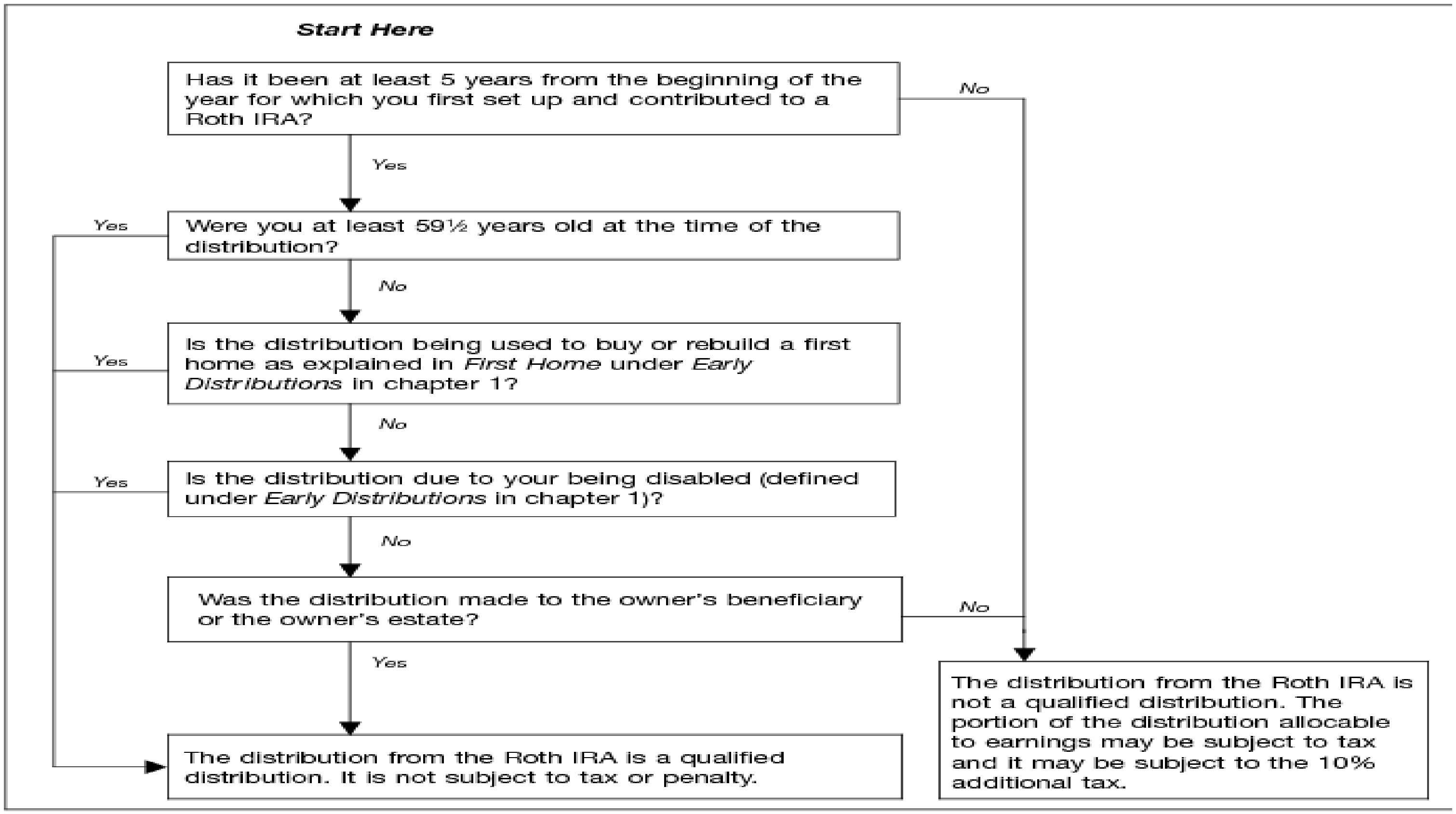
- Distributions during participant's lifetime:
  - Qualified (not subject to income tax), and
  - Nonqualified (may be subject to income tax and penalty)*

Qualified Distributions

- Must meet two requirements:
  - 5-year holding period, and
  - Age 59½, or meet one of the following exceptions:
    - Death,
    - Total disability, or
    - Qualified first time home purchaser (24 months/120 days/ maximum limit $10,000)
- All qualified distributions are tax-free not only to the participant but, also to the beneficiary after death of the participant.

Qualified Distribution

Figure 2-1. **Is the Distribution From Your Roth IRA a Qualified Distribution?**



Nonqualified Distributions

- Distributions made prior to the 5-year holding period, or
- Made after expiration of 5-year holding period, but was under age 59½, and did not meet one of the additional requirements:
  - Death
  - Participant's total disability
  - Qualified first-time home purchaser
- A nonqualified distribution may still receive favorable tax treatment as compared to traditional IRAs because of the "Ordering Rules."

Ordering Rules for NQ Distribution

- Regular Contributions (tax-free and no 10% penalty)
- Conversions (tax-free):
  - Ordering rules: FIFO basis:
    - Taxable portion (may be subject to 10% penalty if distribution did not meet the 5-year holding period (penalty box) or age requirement (59½) or, one of the other exceptions), next
    - Non-taxable portion (no 10% penalty)
- Earnings on contributions - subject to ordinary income and may be subject to the 10% penalty, unless distribution meets:
  - 5-year test and one of the exceptions under IRC § 72(t)(2) Death; Participant's total disability; Qualified first-time home purchaser

5-Year Rule for Roth Conversions

- Each Conversion has its own 5-year period, with multiple conversions there will be multiple 5-year periods [Treas. Reg. § 1.408A-6, Q&A-5 (b)]
- Withdrawals will be deemed on a first-in, first-out basis [IRC § 408A(d)(4)(B)(ii)(II)].
    - The Ordering Rules: withdrawals are after-tax contributions first, conversions second, and earnings third.
- If a withdrawal from a conversion is made within the 5-year window, the principal may be tax-free, but there may be a premature tax penalty (10%) if withdrawn prior to age 59 ½ .
    - Over 59 ½, withdrawal both tax free and penalty free

Distribution Rules After Death of Participant

- RMD rules may apply depending on who is named the beneficiary:
  - Spouse
  - Non-spouse
- RMD will be applied as if the participant died before his/her RBD

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Spouse As Beneficiary

- Elect to treat as their own (only if “sole designated beneficiary”), or rollover into a Roth IRA of their own
- Spouse treated as plan participant
- The 5-taxable year holding period ends at the earlier of:
  - The end of either the 5-taxable year holding period of deceased spouse, or
  - The surviving spouse’s own Roth IRA 5-taxable year holding period

Non-Spouse Beneficiary

- RMD Rules: Death prior to RBD:
  - Lump sum distribution
  - 5-year deferral
  - Take distributions over life expectancy (single life/minus one)
- RMDs must begin by 12/31 of the year following the year of death of the participant
- RMDs must be taken separately from each inherited Roth IRA (cannot aggregate)
- RMDS will be either:
  - Qualified distributions, or
  - Nonqualified distributions

5-Taxable Year Holding Period NSB

- 5-taxable year holding period requirement is not waived simply because of the participant's death:
  - Does not start running over again
- The 5-taxable year holding period runs separately (non-spouse) for each inherited Roth IRA

IRS Note 2008-30

- IRS Notice 2008-30 (issued March 5, 2008) allows for post-death Roth conversions from QRPs by non-spouses directly to Roth IRAs.
- The notice created two classes of beneficiaries:
  - IRA beneficiaries who cannot convert inherited IRAs to inherited Roth IRAs, and
  - Company sponsored retirement plan beneficiaries who can convert their inherited balances to an inherited Roth IRA.

Steps to Take…

- Review your client's goals and priorities
- Review client's asset allocation strategies inside their retirement plans
- Calculate the impact of the conversion
- Help your client make an informed decision
- Consult with your client's tax advisor and estate planning attorney

Additional IRA Resources

- Books:
  - “Life and Death Planning for Retirement Benefits, 7th Edition,” by Natalie Choate
  - “The Retirement Savings Time Bomb … and How to Defuse It,” by Ed Slott
  - “Individual Retirement Account Answer Book,” by Fleisher, Lippie, and Levy
  - “Go Roth! 2012 Edition,” by Kay A. Thomas
  - “FA’s Guide to IRAs, 2013 Edition,” by Edward J. Barrett
  - “Retire Secure! Pay Taxes Later,” by James Lange
- Websites:
  - www.ataxplan.com (Natalie Choate’s website)
  - www.wealthcounsel.com
  - www.IRAhelp.com
  - www.fairmark.com
- Newsletters:
  - “Ed Slott’s IRA Advisor”
  - “Choate’s Notes,” by Natalie Choate
  - “Employee Benefits and Retirement Planner Newsletter,” by Leimberg Information Services Inc. (e-mail only)


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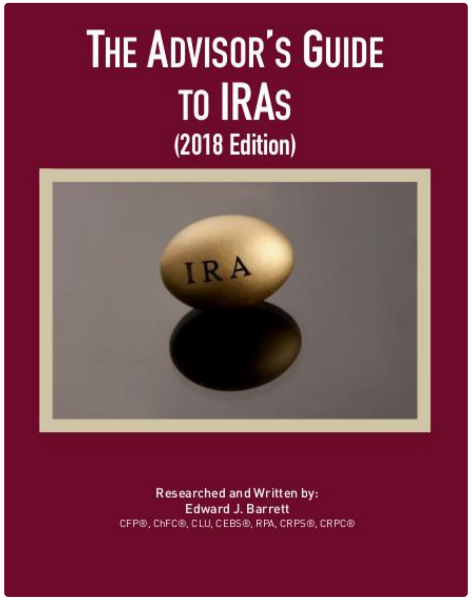

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