Roth Mathematics: Deal or No Deal!

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A Contrarian View

…the Bad,

…the Good,

… and the Ugly.

The Best Thing Since Sliced Bread?

Two Types of Roths--

1. Designated Roth Contribution Programs
   – IRC § 402A
      1. Roth 401(k)
      2. Roth 403(b)

2. Roth IRAs – IRC § 408A

The Best Thing Since Sliced Bread?

Designated Roth Accounts

- Roth 401(k) Effective: 2006
- Roth 403(b) Effective: 2006
- Roth 457(f) Effective: 2011

The Best Thing Since Sliced Bread?

- Effective: January 1, 2006
  - Added by 2001 EGTRA (IRC § 402A)
- Lots of publicity in the popular press
- **Lots of HR department and employee desire:**
  - **"We gotta have it!"**

The Best Thing Since Sliced Bread?

- **Where did it come from?**

ROTH IRA – The Parent

- Roth IRA added by Taxpayer Relief Act of 1997
  - Effective: January 1, 1998

ROTH IRA – The Parent

- Roth IRA added by Taxpayer Relief Act of 1997
  - Effective January 1, 1998 (IRC § 408A)
- **Turned conventional IRA concept upside down.**
  - **Give up current deduction for tax free growth AND tax free distributions of the entire account at retirement!**
- **Elimination of the $100,000 MAGI conversion limit, (after 2009) and if married, joint filing requirement.**

NEW (ROTH) MATH

- **Is neither good, bad or ugly.**
- **If you haven't heard this before, you may not believe it!**

"Inherently, the Roth concept is neither good nor bad from a tax standpoint."

NEW (ROTH) MATH

- **THE RULE:** Everything else being equal, the value of a Roth contribution and the value of a non-Roth contribution to a retirement account is **exactly equal** on a present value basis.

NEW (ROTH) MATH

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Roth PV = Non-Roth PV

- **But remember: everything else is NEVER equal!**

NEW (ROTH) MATH

- THE RULE: Everything else being equal, the value of a Roth contribution and the value of a non-Roth contribution to a retirement account is **exactly equal** on a present value basis.
- But remember: everything else is NEVER equal!
- **Only when other factors are introduced (changes in the status quo) can one argue that a Roth contribution is better or worse than a non-Roth contribution!**

NEW (ROTH) MATH

- **Assume** same **tax bracket** now and at retirement (any bracket you want).
- **Assume** any **rate of return** you want on the fund.
- **Assume** any **number of years** to retirement.
- **Assume** same starting amount before taxes.

Let’s assume $1,000 and a 25% tax bracket.

- -- $1,000 to a traditional deductible IRA (before tax)
- -- $750 to a Roth account (after tax) and $250 to the government now.

NEW (ROTH) MATH

- Take “after tax” Roth amount ($750) and compound it to retirement.
- Take “before tax” non-Roth amount ($1,000) and compound it to retirement.

NEW (ROTH) MATH

Take “after tax” Roth amount ($750) and compound it to retirement.

- Take “before tax” non-Roth amount ($1,000) and compound it to retirement.
  - **Now “tax” the accumulated non-Roth at the same tax rate – 25%.**

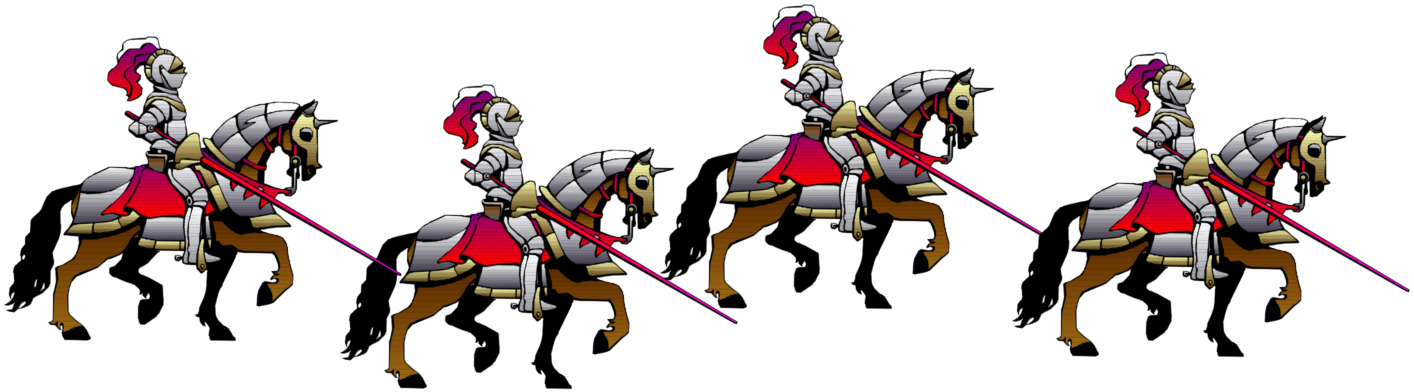
NEW (ROTH) MATH

The value of the resulting pot of money is IDENTICAL in both calculations!

NEW (ROTH) MATH

Even Congress recognized this: they "scored" the Roth provisions as "revenue raisers" rather than costing the government money.

- **People who opted for a Roth account and paid their taxes up front (instead of deferring them) provide a short term revenue boost to the government, but in the long run get only the same benefit they would have gotten if they had taken the deduction now instead.**



Roth Mathematics: Deal or No Deal!

Meet Lucy – a potential Roth contributor

NEW (ROTH) MATH

Example 1. Lucy, age 50, is in the 25% tax bracket and has a choice between making an after-tax Roth deferral of $4,500* or pre-tax deferral of $6,000.

Lucy's Objective: To purchase a small fishing lodge on a beach in the Bahamas—cost $13,500.

* $4,500 = $6,000 – ($6,000 x .25).

NEW (ROTH) MATH

Example 1. Lucy, age 50, is in the 25% tax bracket and has a choice between making a Roth deferral of $4,500 or pre-tax IRA deferral of $6,000.

– Lucy waits until the funds in the plan triples.

  » 9% - 13 years.
  » 8% - 15 years.
  » 7% - 17 years.
  » 6% - 19 years.

NEW (ROTH) MATH

- **Example 1.** Lucy waits until the funds in the plan triples--
  - Roth (after tax) account balance is **$13,500**
  - IRA (pre-tax) account balance is **$18,000**

NEW (ROTH) MATH

- **Example 1.**

Roth account balance is $13,500

- Lucy has **$13,500** to spend (tax free).
- The house is bought and Lucy goes fishing.

Lucy's Palacial Estate

Pre-tax account balance is **$18,000**

- Lucy pays $4,500 ($18,000 x .25) in taxes and she has the same **$13,500** to spend (after tax).
- The house is bought and Lucy goes fishing.

Lucy's Palacial Estate

NEW (ROTH) MATH

- All else being equal, a Roth deferral is mathematically equivalent to a *larger* pre-tax deferral.
- $6,000 IRA = $4,500 Roth.

[See Example 1.]

NEW (ROTH) MATH

- All else being equal, a Roth deferral is mathematically equivalent to a *larger* pre-tax deferral (see Example 1).

For any given Roth deferral and tax bracket, there exists a **larger** amount that, if deferred in a pre-tax 401(k) would:

- Have **same effect** on participant's paycheck.
- Have the **same effect** if the entire amount is withdrawn at retirement.

NEW (ROTH) MATH

- All else being equal, a Roth deferral is mathematically equivalent to a *larger* pre-tax deferral. See Example 1.

- **In other words, an after tax Roth deferral is not equivalent to a pre-tax deferral *of the same amount.***

NEW (ROTH) MATH

What is a Roth Deferral Equal To?

NEW (ROTH) MATH

Meet Zorro, an investor

NEW (ROTH) MATH

Example 2. Zorro and Lucy are each 50 years old. They are not married. They are both well off financially and both will continue to remain in the the **35%** tax bracket. They both have **$33,846** before taxes to invest each year for **15** years.

- Assume an 8% rate of return.

NEW (ROTH) MATH

Example 2. Zorro and Lucy are each 50 years old. They are not married. They are both well off financially and both will continue to remain in the 35% tax bracket. They both have $33,846 *before taxes* to invest EACH YEAR.

- **Zorro will make after-tax Roth deferrals.**
- **Lucy will make pre-tax 401(k) deferrals.**
- **The deferrals are made on December 31.**

NEW (ROTH) MATH

Example 2. Zorro makes a Roth Deferral.

– **Zorro gets no deduction and pays $11,846 ($33,846 x .35) in taxes each year leaving him with a $22,000* ($33,846 - $11,846) Roth deferral in his 401(k).**

*** $22,000 = $16,500 (normal limit) + $5,500 (catch-up limit)**

NEW (ROTH) MATH

Example 2. Zorro makes a Roth Deferral.

- Zorro gets no deduction and pays $11,846 ($33,846 x .35) in taxes each year leaving him with a $22,000 ($33,846 - $11,846) Roth deferral in his 401(k).

- 15 years later (at 8%) Zorro has **$597,347** in his after-tax Roth 401(k) account.

NEW (ROTH) MATH

Example 2. Lucy stays with pre-tax 401(k).

– **Lucy makes the same $22,000 annual deferral to a traditional <u>pre-tax</u> 401(k) plan.**

NEW (ROTH) MATH

- Example 2. Lucy stays with pre-tax 401(k).
  - Lucy excludes **$22,000** from her income.
  - Lucy will also have **$597,347** in her 401(k) plan account in 15 years.
  - Lucy establishes a **taxable account** to invest her tax savings.

NEW (ROTH) MATH

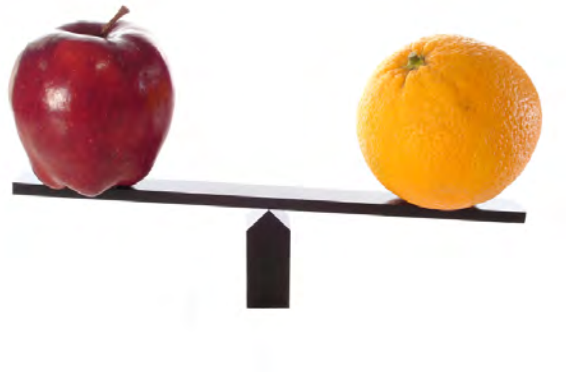
- Example 2. Lucy stays with pre-tax 401(k).
- She pays **taxes of $4,146** (35%) on the remaining $11,846 ($33,846, the starting "pre-tax" amount - $22,000).
- Lucy has **$7,700** ($11,846 - $4,146) left over and invests it at 8% for 15 years.
- Her "outside" investment grows to **$157,177** adjusted for taxes each year. [8% x .65 = 5.2%]
- Lucy has **$754,347** [$597,347 (pre tax) + $157,177 (after tax)] in her pension & outside accounts.

NEW (ROTH) MATH

- Example 2. Summary (Zorro and Lucy)
  - Lucy withdraws the $597,347 and pays a 35% tax of $209,071, leaving <u>$388,276</u> after tax.
  - Lucy <u>only</u> has $545,453 ($388,276 + $157,177) to spend.
  - Zorro has $597,347 to spend.
    - Lucy has **$51,894** ($597,347 - $545,453) **LESS** than Zorro to spend.

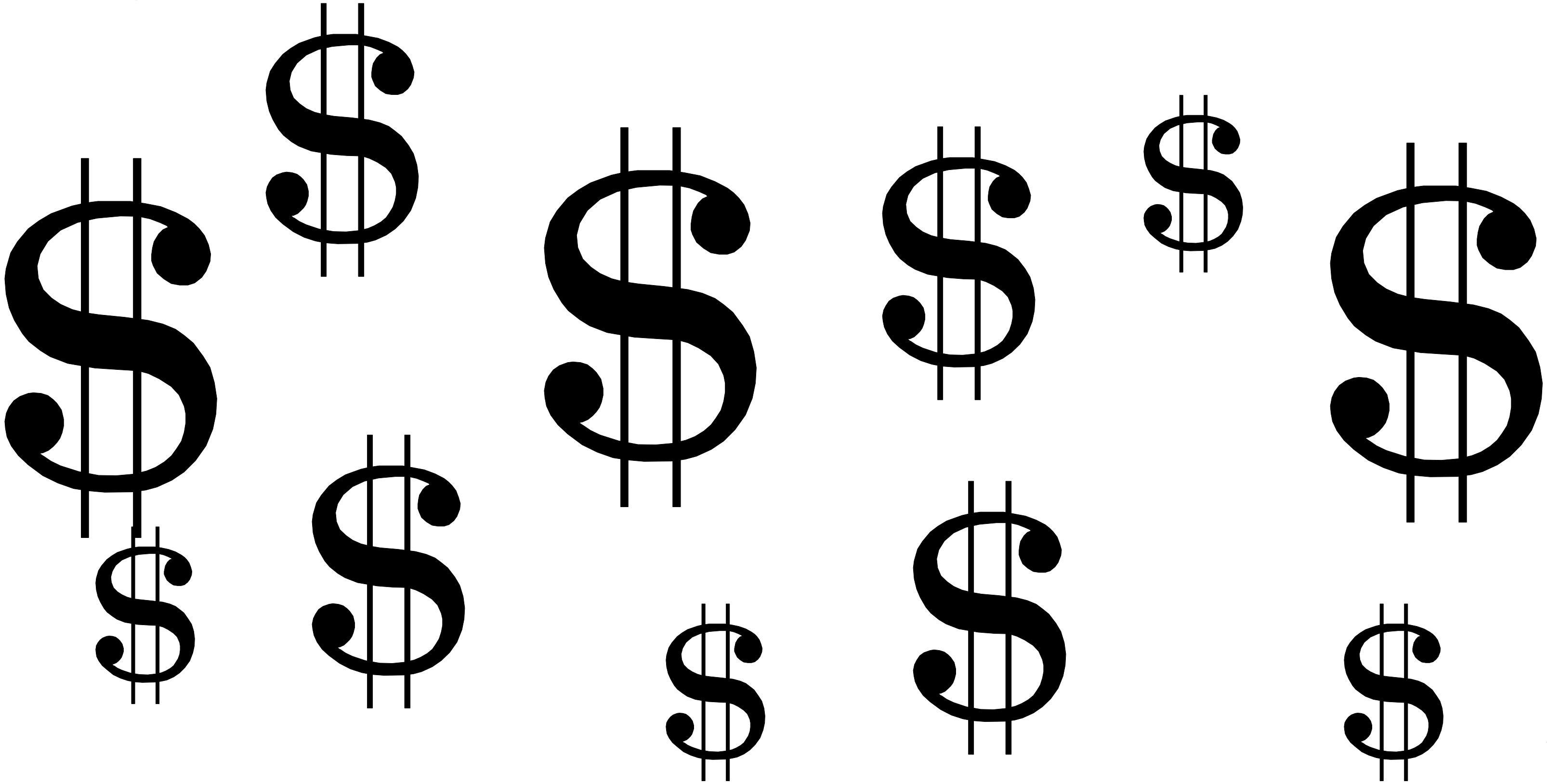
NEW (ROTH) MATH

In other words, a Roth deferral is *not* equivalent to a *pre-tax* deferral *of the* same *amount.*



NEW (ROTH) MATH

What is a Roth Deferral Equal To?



NEW (ROTH) MATH

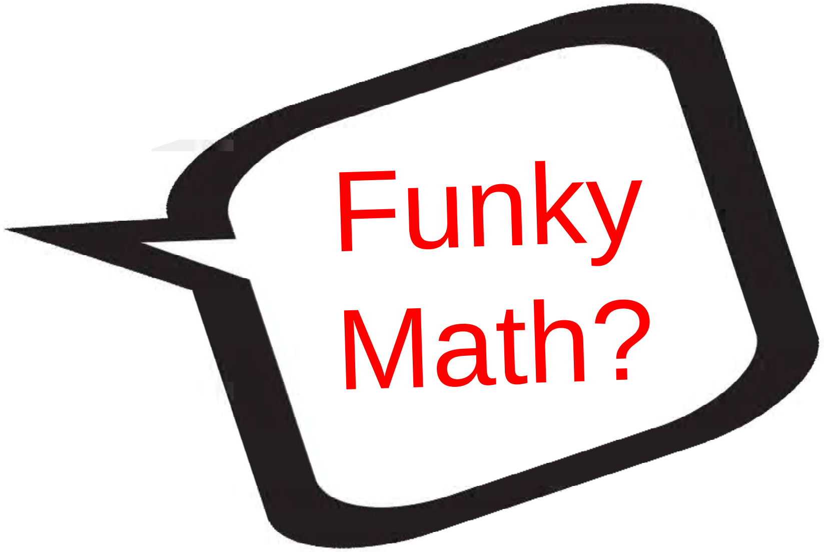
All else being equal, a Roth deferral IS mathematically equivalent to a *larger* pre-tax deferral.

See Example 1.

The 7% Solution

$ = $

WHAT DOES LUCY THINK?



 +   = Dinner

NEW (ROTH) MATH

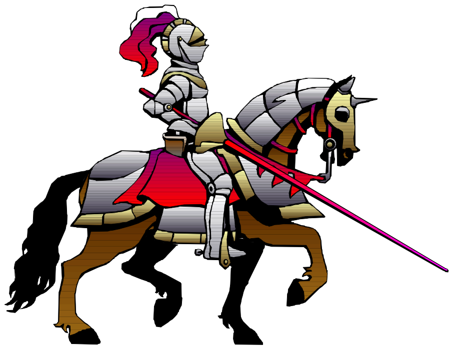
BUT

was the Roth

BETTER

Mathematically?

NEW (ROTH) MATH



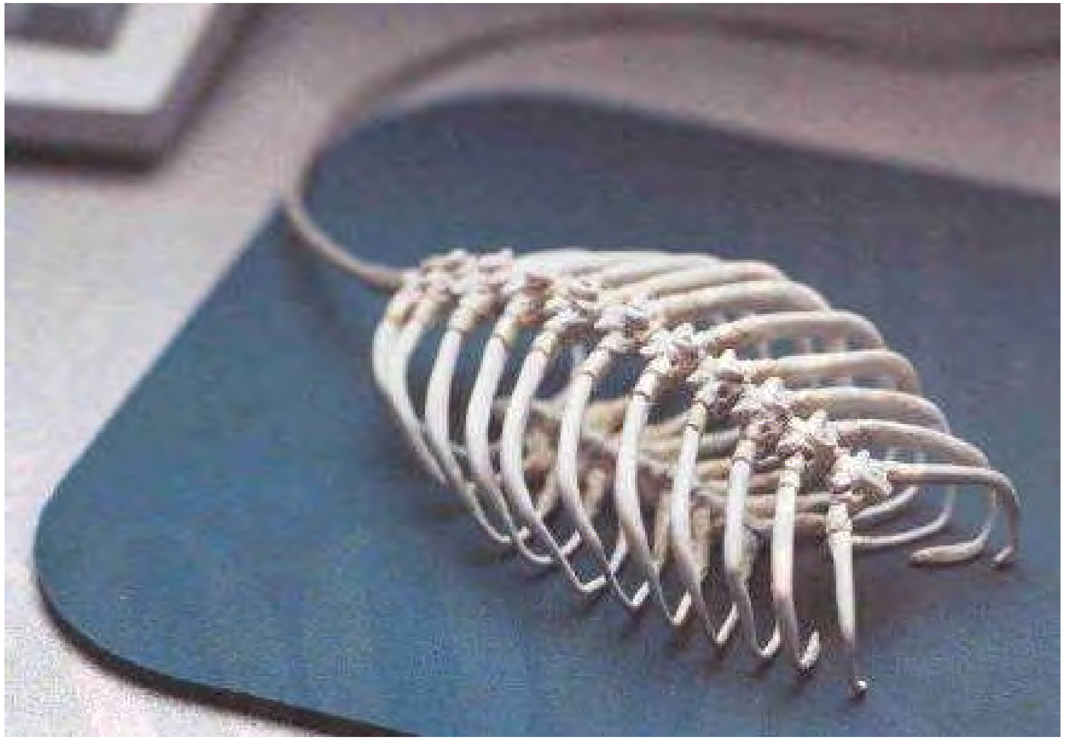
DID

the Roth perform

BETTER

Over Time?

The Bad



So, who benefits from Roth?

The Tax Bracket Question

So, who benefits from Roth?

Most significant issue: the tax bracket question!

Only if we change our assumption, and assume that the tax bracket at retirement is HIGHER than it is at the time of contribution will the Roth type account be a better economic performer.

So, who benefits from Roth?

If current tax bracket is lower than the ultimate tax bracket, a positive economic benefit can be shown--that is, the Roth type account will be a “better deal.”

So, who benefits from Roth?

- If current tax bracket is lower than the ultimate tax bracket, a positive economic benefit can be shown (that is, the Roth type account will be a “better deal.”
- **Popular hype is that current tax brackets are “historically low” and that we should only expect that future tax brackets will return to the “good old days.”**
  - **Reasonable assumption?**

So, who benefits from Roth?

Higher Taxes ?

So, who benefits from Roth?

Participant has to give up a "sure thing" (current deduction) for *just a chance* that the future benefit will be more valuable (and a strong likelihood that it won't!).

So, who benefits from Roth?

Human

Nature?

So, who benefits from Roth?

- **Human nature values a current *known benefit* much more than a future *unknown benefit*.**

- **Most people are more likely to opt for the sure thing (the current deduction).**

Do You Trust Congress?

Do You Trust Congress?

HELL NO!

Do You Trust Congress?

For Roth type accounts to be a "good deal"

- Need to be in a **higher** tax bracket at retirement

Do You Trust Congress?

- For Roth type accounts to be a “good deal”:
  – Need to be in a higher tax bracket at retirement

Have to believe Congress will NOT change the tax rules on us between now and then.

Do You Trust Congress?

- For Roth type accounts to be a “good deal”:
  - Need to be in a higher tax bracket at retirement
  - Have to believe Congress will NOT change the rules on us between now and then.

The rules that provide that Roth type distributions are tax free upon distribution.

Do You Trust Congress?

But, wouldn't they "grandfather" existing accounts if they change the rules later?

Do You Trust Congress?

Remember what they did to Social Security benefits?

Do You Trust Congress?

- Remember what they did to Social Security benefits?

For most of the first 50 years, Social Security benefits were INCOME TAX FREE!

Do You Trust Congress?

Then what happened?

Congress made up to 50% of SS benefits subject to income tax; just like that!

Do You Trust Congress?

- Congress made up to 50% of SS benefits subject to income tax; just like that!

Why 50%? Because that was the part that was paid by the employer with "before tax money" that had never been taxed.

Do You Trust Congress?

Any “grandfathering”?

Do You Trust Congress?

- Ha !
  - In 1993 they raised the amount that could be subject to income taxation to 85% of the SS benefit.

Do You Trust Congress?

- Why?
  - **Because they needed the money!**
  - **And they argued that 85% really was 50% of the value of SS benefits.**

Do You Trust Congress?

Any “grandfathering”?

Do You Trust Congress?

Well, at least it was just on high income people, right?

Do You Trust Congress?

- NOPE!
  - Well, at least it was just on high income people, right?

    Sure, if you're married, filing jointly, and ½ of your SS benefits plus your other income exceeds $44,000; $34,000 for all other filers, GOTCHA!

Do You Trust Congress?

The Bottom line--

– Won’t change the rules for the worse, or

– Will anything be grandfathered?

List of Social Security Legislation

- 1935 - Social Security Act, Pub. Law 74-271
- 1939 - Social Security Amendments of 1939, Pub. Law 76-379
- 1942 - Revenue Act of 1942, Pub. Law 77-753
- 1943 - Pub. Law 78-211
- 1943 - Revenue Act of 1943, Pub. Law 78-235
- 1945 - Federal Insurance Contributions Act, Pub. Law 78-495
- 1945 - Revenue Act of 1945, Pub. Law 79-214
- 1946 - Social Security Amendments of 1946, Pub. Law 79-719
- 1947 - Social Security Amendments of 1947, Pub. Law 80-379
- 1948 - Provision for Exclusion of Certain Newspaper and Magazine Vendors from Social Security Coverage, Pub. Law 80-492
- 1948 - Provision to Maintain Status Quo Concept of Employee, Pub. Law 80-642
- 1950 - Social Security Amendments of 1950, Pub. Law 81-734
- 1952 - Social Security Amendments of 1952, Pub. Law 82-590
- 1954 - Social Security Amendments of 1954, Pub. Law 83-761
- 1956 - Social Security Amendments of 1956, Pub. Law 84-880
- 1958 - Social Security Amendments of 1958, Pub. Law 85-840
- 1960 - Social Security Amendments of 1960, Pub. Law 86-778
- 1961 - Social Security Amendments of 1961, Pub. Law 87-64
- 1965 - Social Security Amendments of 1965, Pub. Law 89-97
- 1966 - Tax Adjustment Act of 1966, Pub. Law 89-368
- 1967 - Social Security Act Amendments, Pub. Law 90-248
- 1969 - Tax Reform Act of 1969, Pub. Law 91-172
- 1971 - Social Security Amendments, Pub. Law 92-5
- 1972 - Social Security Amendments, Pub. Law 92-336
- 1972 - Social Security Amendments of 1972 (Supplemental Security Income), Pub. Law 92-603
- 1973 - Social Security Benefits Increase, Pub. Law 93-233
- 1977 - Social Security Amendments of 1977, Pub. Law 95-216
- 1980 - Social Security Disability Amendments of 1980, Pub. Law 96-265
- 1980 - Reallocation of Social Security Taxes Between OASI and DI Trust Funds, Pub. Law 96-403
- 1980 - Retirement Test Amendments, Pub. Law 96-473
- 1981 - Omnibus Budget Reconciliation Act of 1981, Pub. Law 97-35
- 1981 - Social Security Amendments of 1981, Pub. Law 97-123
- 1983 - Pub. Law 97-455
- 1983 - Social Security Amendments of 1983, Pub. Law 98-21
- 1984 - Social Security Disability Benefits Reform Act of 1984, Pub. Law 98-460
- 1985 - Balanced Budget and Emergency Deficit Control Act, Pub. Law 99-177
- 1986 - Omnibus Budget Reconciliation Act of 1986, Pub. Law 99-509
- 1987 - Omnibus Budget Reconciliation Act of 1987, Pub. Law 100-203
- 1988 - Technical and Miscellaneous Revenue Act of 1988, Pub. Law 100-647
- 1989 - Omnibus Budget Reconciliation Act of 1989, Pub. Law 101-239
- 1990 - Omnibus Budget Reconciliation Act of 1990, Pub. Law 101-508
- 1993 - Omnibus Budget Reconciliation Act of 1993, Pub. Law 103-66
- 1994 - Social Security Administrative Reform Act, Pub. Law 103-296
- 1994 - Social Security Domestic Reform Act, Pub. Law 103-387
- 1996 - Senior Citizens' Right to Work Act of 1996, Pub. Law 104-121
- 1999 - Ticket to Work and Work Incentives Improvement Act, Pub. Law 106-170
- 2000 - Senior Citizens' Right to Work Act of 2000, Pub. Law 106-182

Do You Trust Congress?

For the Roth contribution to be more valuable, you have to give up a known deduction now, hope you're in a higher bracket later, and pray that Congress doesn't change the rules along the way!

What's Lucy Opinion?

What's Lucy Opinion?

Who Do You Really Trust?

What will the future bring?

There's only 3 things that can happen to future income tax brackets:

What will the future bring?

There's only 3 things that can happen to future income tax rates:

- **Lower**
- **Same**
- **Higher**

What will the future bring?

- Those in a **lower bracket** at retirement:

  – Should <u>not</u> be interested in a Roth benefit.
    - Even assuming Congress keeps the rules the same

  – This should be most of the population of the US!
    - Maybe 70 – 80%?
    - **But that leaves 20 – 30%**

What will the future bring?

- Those in a **lower bracket** at retirement:
  - Maybe 70 – 80%?
    - **Most people struggle to save enough for retirement and will be in a lower tax bracket than when they were actively employed.**
    - **Most likely, these people are better off with the current tax deduction offered by the non-Roth type account.**

What will the future bring?

Those who would be in the **same tax bracket** at retirement also shouldn't be attracted to Roth type accounts.

–There is no economic advantage today.

What will the future bring?

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Keeping it that way depends on Congress not changing the tax rules.

What will the future bring?

- Those who would be in the same tax bracket at retirement also shouldn't be attracted to Roth type accounts.
  - There is no economic advantage today
  - Keeping it that way depends on Congress not changing the tax rules.

Is this another sucker's bet?

What will the future bring?

Who’s left? Those whose **future tax rates** will be **higher** (assuming no changes in the rules along the way).

What will the future bring?

- Who's left? Those whose **future tax rates** will be **higher** (assuming no changes in the rules along the way).

No question; there will be some of these (another assumption).

What will the future bring?

- **Those paying small amount of taxes now because they are in the early part of their careers (especially, younger workers; our children).**

- **Those in low brackets because of large tax deductions for childcare and home ownership whose future brackets should grow substantially.**

What will the future bring?

- **Problem:** where are these low bracket/low income folk going to get the money to put away into a voluntary retirement account (Roth or otherwise)?
  - Poor people don't have much discretionary money.

    It is true that a small group of these taxpayers will have disposable funds to allocate toward retirement savings, and "everything else being equal," a Roth type account could make sense.

The Good

Are There Any Advantages?

Low income tax credit (18 or older, not a full time student, not claimed as a dependent on another tax return).

- **Credit rate (50%, 20%, or 10%).**
- **Based on first $2,000 contributed to Roth or traditional IRA, up to $1,000 per year.**

Are There Any Advantages?

Practical applications for Roth

Are There Any Advantages?

What if the OBJECTIVE is to pass as much benefit to heirs as possible?

Are There Any Advantages?

Required Minimum Distributions (RMDs) at age 70½ do NOT apply to Roth IRAs.

- **They do apply to Designated Roth Accounts!**

Are There Any Advantages?

- Required Minimum Distributions (RMDs) at age 70 ½ do NOT apply to Roth IRAs.
  - They do apply to DRAs!

However, a little planning will let you roll your QP into an Roth IRA (that's perfectly permissible) prior to age 70½ and thereby avoid RMDs on Roth money that was in the 401(k) plan as well.

Are There Any Advantages?

- Required Minimum Distributions (RMDs) at age 70½ do NOT apply to Roth IRAs.
  - They do apply to DRAs!

Generation Transfer Skipping options are available (e.g., Roth IRA Trust).

Are There Any Advantages?

BUT WAIT!

- RMD's no longer apply to non-owners (rank and file employees) in a regular retirement plan.

Are There Any Advantages?

BUT WAIT!

– RMD’s no longer apply to non-owners (rank and file employees) in a regular retirement plan.

– **The rule that RMDs apply only to 5% owners is patently discriminatory against small business.**

Are There Any Advantages?

BUT WAIT!

What if at some point, RMDs are eliminated for 5% owners as well.

Are There Any Advantages?

- BUT WAIT!

And that would make the Roth's lack of an RMD (no 70½ rules before death) less of a benefit.

Are There Any Advantages?

- Here’s the argument to Congress:
  - ”How can Congress apply RMDs to the owner of the local bakery but NOT to the president of Apple Computers?”

Are There Any Advantages?

Premature

Distributions

Are There Any Advantages?

- Premature Distributions (NONQUALIFIED DISTRIBUTIONS)

Roth IRA - Basis returned first

- Ordering rules (earnings distributed last)

Designated Roth Account – Basis allocated

- Treated as a separate account under Code § 72
- No ordering rules
- Restrictions on distributions

Are There Any Advantages?

"Qualified Distributions"

A *qualified distribution* is one that occurs after a five-year period of participation AND that either (1) is made on or after the date the employee attains age 59½, (2) is made after the employee's death, or (3) is attributable to the employee being disabled. The final regulations clarify that if the distribution is made to an alternate payee or beneficiary, the participant's age, disability status, or death are used to determine whether the distribution is a "qualified distribution."

Conversion Factors

Major Variables

Conversion Factors

The Ten Factors

1. Tax rates (state and federal) at time of contribution and deduction

2. Tax rates (state and federal) at time of distribution and taxation

Note. The possibility of a national value added tax (VAT) or sales tax (consumption taxes) resulting in lower federal tax rates may also need to be considered.

[Buckley, Allen, *The 2010 Roth Conversion: What is Known, What is Easy, and What is Hard*, 9 Daily Tax Report 243, Bureau of National Affairs, Inc (BNA) (Dec. 22, 2009) extremely insightful and effective article regarding the future tax system and rates relative to the system and rates at the time of distribution.]

3. Rate of return (growth)

Conversion Factors

The 10 Factors (continued)

4. Deferral period (time)

5. Effect of RMD in a traditional IRA and the ability to maximize benefits to heirs in a Roth IRA

6. Inflation rate

7. Current and future cash flow needs

8. Estate and inheritance tax implications

Conversion Factors

The 10 Factors (continued)

9. Short- and long-term liquidity needs (funds may be needed within 5 years)

10. Belief that Roth distribution taxation rules will not change and that Congress would not offer relief if tax rates dropped significantly

The 10 Factors (continued)

Practice Pointer. Each variable has a different sensitivity influence on the result, depending on the circumstances.

[That sensitivity has been effectively demonstrated in a comprehensive series of case studies prepared by Gobind Daryanani, Ph.D. [G. Daryanani, *Roth IRA Book: An Investor's Guide* (Bernardsville, N.J., Digiqual Inc., 1998)]

Conversion Observations

Observations (by Daryanani)—

a. A Roth IRA will do significantly better than a traditional IRA even if a tax deduction from a traditional IRA contribution is available *and* that amount is invested. In most cases, individuals do not invest their tax savings; thus, the loss of the current year's deduction will not be significant. See example 2.

b. The Roth IRA will be an even better choice if the tax savings are *not* invested.

c. Roth IRA assets are generally the last assets that should be used for retirement income.

Conversion Observations

Observations (continued)

d. Significantly lower tax rates at retirement may make the traditional IRA more advantageous.

e. It takes five years of tax-free growth in the Roth IRA to nullify the advantage of a 5 percent lower average tax at retirement.

f. The Roth IRA advantage increases as the duration of the deferral period increases. Conversely, the traditional IRA advantage increases as the deferral period decreases.

Conversion Observations

Observations (continued)

g. An estate will be worth significantly more if Roth IRA assets are left intact until age 80.

h. Higher rates of return favor the Roth IRA.

i. Inflation affects all IRAs almost equally.

j. A plan that makes matching contributions of 50 percent to 100 percent (e.g., a 401(k) plan or a 403(b) plan) will be a better choice than the Roth IRA. At lower percentages, 0 percent to 25 percent, a Roth IRA is generally a better choice.

Conversion Observations

Specific observations regarding Roth IRA conversions are as follows:

1. A Roth IRA conversion will generally provide an advantage if the conversion taxes are paid from outside assets.
2. A Roth IRA conversion may make it possible to use deductions that would otherwise be lost under the carry forward rules. A charitable deduction carry forward, for example, must be used within five years. Without a Roth IRA conversion, a portion of the charitable deduction could be lost.

Conversion Considerations

Specific observations (continued)

3. A partial conversion may be appropriate. For example, if funds are needed within five years, a taxpayer may be better off not converting all of his or her traditional IRA. Penalties may also have to be considered.

4. If tax rates are lower in retirement and funds from a traditional IRA are needed within 15 years, a partial conversion (of amounts not needed within 15 years) may be a better alternative.

Conversion Observations

Other Factors

a. A taxpayer who converts to a Roth IRA may have to make quarterly installments of estimated tax (to meet one of the safe harbors).

b. Generally, the best source of funds to pay taxes on a Roth IRA conversion is outside cash or high-basis investment accounts. If assets that have a low basis are used, more taxes will have to be paid and more assets will have to be sold to generate the cash needed to pay the tax.

Conversion Observations

Other Factors (continued)

c. State creditor and Federal bankruptcy protection issues.

d. Ability to recharacterize contributions allows hindsight

e. Post-death Roth distributions are tax free (if 5-year rule met)

Some Practical Applications

Twisting

IRC § 402(g)

(The Elective Deferral Limits)

Some Practical Applications – Twisting the 402(g) Limit

- Assume a 25% tax bracket.
- A $22,000 (the 2010 limit) Roth (after tax) deferral is mathematically equivalent to a pre-tax deferral of $29,333 (at a 25% tax bracket); $33,846 (at 35% tax bracket.
- The 402(g) limit *doesn't allow* a deferral of $29,333 or $33,846!

Some Practical Applications – Twisting the 402(g) Limit

ROTH

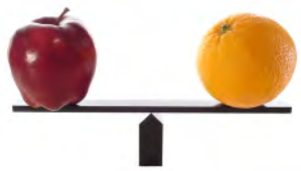
allows an after-tax deferral

(e.g., $22,000)

THAT IS MATHEMATICALLY

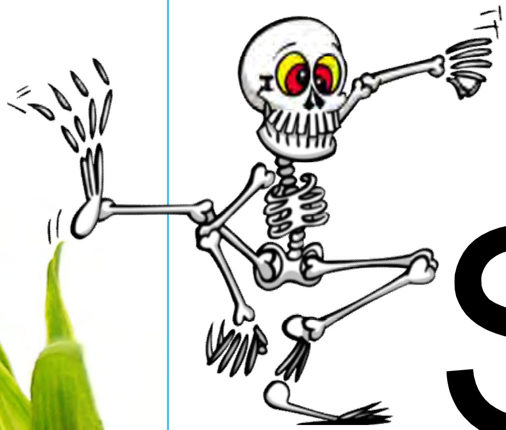
EQUIVALENT TO THE FORBIDDEN HIGHER TAX DEFERRAL

($29,333/$33,846).



[See Example 1]

Some Practical Applications



Skinning IRC § 415

(Annual Addition Limitations)

Some Practical Applications – Skinning IRC § 415 ($49,000 / 100%)

Similarly, participants can make after-tax Roth deferrals that are mathematically equivalent to a higher pre-tax deferral.

Some Practical Application

Uncapping ADP Limits

IRC § 401(k), § 403(b), and after 2010, 457(f)

Some Practical Applications – Uncapping ADP Limits

Again, participants can make after-tax Roth deferrals that are mathematically equivalent to a higher pre-tax deferral.

Rollover Chart 2010

ROLLOVER FROM	ROLLOVER TO									
	Qualified Plan	**403(b) Plan**	**457(b) Plan (Governmental)**	**Thrift Savings Plan**	**Traditional IRA**	**SEP IRA**	**SIMPLE IRA**	**Roth IRA**	**Coverdell ESA**	**Designated Roth Account**
Qualified Plan	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES. No rollover of after-tax contributions allowed.	YES. If contribution is after tax, Form 8606 is required.	YES. If contribution is after tax, Form 8606 is required.	NO	YES, after 2007, as a conversion.	NO	YES, direct internal rollover for distributions after Sept. 27, 2010, if plan accepts.
403(b) Plan	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES. No rollover of after-tax contributions allowed.	YES. If contribution is after tax, Form 8606 is required.	YES. If contribution is after tax, Form 8606 is required.	NO	YES, after 2007, as a conversion.	NO	YES, direct internal rollover for distributions after Sept. 27, 2010, if plan accepts.
457(b) Plan (Governmental)	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES. No rollover of after-tax contributions allowed.	YES. If contribution is after tax, Form 8606 is required.	YES. If contribution is after tax, Form 8606 is required.	NO	YES, after 2007, as a conversion.	NO	YES, direct internal rollover for distributions after 2010, if plan accepts.
Thrift Savings Plan	YES	YES	YES	NO, see Form TSP-65	YES	YES	NO	YES, after 2007, as a conversion.	NO	NO
Conduit IRA	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES. No rollover of after-tax contributions allowed	YES, but taxpayer should keep conduit IRA separate.	YES, but taxpayer should keep conduit IRA separate.	NO	YES, as a conversion.	NO	NO
Traditional IRA and SEP IRA	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES. No rollover of after-tax contributions allowed.	YES	YES	NO	YES, as a conversion.	NO	NO
SIMPLE IRA	YES, if plan accepts; only after 2 years.	YES, if plan accepts; only after 2 years.	YES, if plan accepts; only after 2 years.	YES, only after 2 years.	YES, only after 2 years.	YES, only after 2 years.	YES	YES, as a conversion after 2 yrs.	NO	NO
Roth IRA	NO	NO	NO	NO	NO	NO	NO	YES	NO	NO
Coverdell ESA	NO	NO	NO	NO	NO	NO	NO	NO	YES	NO
Designated Roth Account (DRA)	NO	NO	NO	NO	NO	NO	NO	YES	NO	YES

The Ugly

More Disadvantages

No deduction for a Roth contribution (compared generally to IRA) increases the adjusted gross income, which could result in the loss of certain tax benefits that are subject to “phase out” rules.

- Childcare credit
- Homebuyer credit

Administrative Issues

Up to this point, the discussion has been generic to Roth (it applied equally to both Roth IRA and Roth 401(k) type of Roth accounts).

Administrative Issues

Adding Roth 401(k) features to a 401(k) plan adds significant complications.

Administrative Issues

Roths are neither simple nor inexpensive!

Administrative Issues

Plan needs to be amended to add Roth features.

Administrative Issues

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- **Summary Plan Description (SPD) needs to be modified and re-distributed to all participants.**

Administrative Issues

- Plan needs to be amended to add Roth features.
- Summary Plan Description (SPD) needs to be modified and re-distributed to all participants.

- **Payroll records need to be modified to reflect after-tax Roth contributions separately from pre-tax contributions.**

Administrative Issues

- **Service provider must begin separate tracking and record keeping for DRA and traditional elective contributions and investment gains and losses (this is required by law).**
  - **Substantial cost here; who will pay for this?**

Administrative Issues

Design issues need to be addressed:

- **Will Roth amounts be made available for hardship distributions?**

Administrative Issues

- Design issues need to be addressed:
  - Will Roth amounts be made available for hardship distributions?
  - **Will Roth amounts be made available for security for loans?**

Administrative Issues

- Design issues need to be addressed:
  - Will Roth amounts be made available for hardship distributions?
  - Will Roth amounts be made available for security for loans?
  - **If plan allows for incoming rollovers and transfers, would one want to allow for incoming Roth amounts from other eligible retirement plans?**

Administrative Issues

- Design issues need to be addressed:
  - **What will be the effect on Qualified Domestic Relation Orders that do not differentiate between Roth (non-taxable) and non-Roth (taxable accounts)?**

Administrative Issues

- Design issues need to be addressed:
  - What will be the effect on Qualified Domestic Relation Orders that do not differentiate between Roth (non-taxable) and non-Roth (taxable accounts)?

- ***The YEAR* of first Roth contribution to the plan has to be maintained for each participant.**

Administrative Issues

- Design issues need to be addressed:
  - What will be the effect on Qualified Domestic Relation Orders that do not differentiate between Roth (non-taxable) and non-Roth (taxable accounts)?
  - *YEAR* of first Roth contribution to the plan have to be maintained for each participant.
  - **There is a 5 year period required before a distribution from the plan can be treated as a tax-free Roth distribution.**

Administrative Issues

How will death benefits be determined when there are multiple beneficiaries and both Roth and non-Roth money is involved?

- Who gets the taxable amount?
- Who gets the tax free amount?

Special plan language will probably need to be developed.

Administrative Issues

Assuming participants will be able to “mix and match” between Roth and non-Roth deferrals—

How will that be tracked as the money goes in?

Administrative Issues

– Assuming participants will be able to “mix and match”

between Roth and non-Roth deferrals

– How will that be tracked as the money goes in?

How will participants elect those percentages and change those percentages?

Administrative Issues

- – Assuming participants will be able to “mix and match” between Roth and non-Roth deferrals
- – How will that be tracked as the money goes in?
- – How will participants elect those percentages and change those percentages?

- **Will the employer be able to handle that accurately?**

Administrative Issues

Will the employer be able to accurately report that information to the service provider and their payroll operation or outside service?

Administrative Issues

What are the chances
the small business
owner will get it right?

Administrative Issues

Most Significant Issues—

- **Employee communications--**
- **This is the biggest challenge.**
- **Employees are already overwhelmed with all kinds of information about contributions and investments.**
- **Probably where it will all fall apart in small businesses.**

Administrative Issues

- In the real world, these complexities could lead employees to just throw up their hands and give up!

Administrative Issues

- In the real world, these complexities could lead employees to just throw up their hands and give up!
  - **Small business owners are not equipped to deal with these issues.**

Administrative Issues

In the real world, these complexities could lead employees to just throw up their hands and give up!

– Small business owners are not equipped to deal with these issues.

– **Many participants will just do nothing.**

Administrative Issues

It's going to be a significant challenge to explain Roth 401(k) in a manner that is easy to understand for employees and that won't consume significant resources of the small business owner.

Administrative Issues

- It’s going to be a significant challenge to explain Designated Roth Accounts in a manner that is easy to understand for employees and that won’t consume significant resources of the small business owner.
- **If employees plead for this new Roth feature, it’s important to remind the employer that:**

Administrative Issues

It's okay to JUST SAY NO!

Deal or No Deal?

TINY TIDBITS

- Direct Rollovers and 60-Day Rollovers
  - QPs and DRAs - IRS Notice 2009-68
- No Abusive Transactions
  - Dirty Dozen Tax Scams - see IRS IR-2010-32
  - See also, United States of America v. A. Blair Stover, Jr., 08-6018-CV-SJ-ODS and Steven Burchard, et al. v. Philip A. Kaiser, et al., 2106CC-04544.
- No Life Insurance
- Roth IRA Trusts Allowed

Tiny Tidbits (continued)

- Irrevocable Life Insurance Trust – The 4 Requirements
  - Treas. Reg. Section 1.401(a)(9)-4, Q&A 5(b)
  - PLR 200147039 (second to die)
  - PLRs 2004322027 through 2004322029, 200440031
- Multiple Beneficiaries:
  - See PLRs 200537044 and 200317041, and 200317043 through 44
  - But see, PLRs 200209058 and 200209059
- ADP refunds to high-paid employees may cause complications:
  - From which account [Roth or traditional 401(k)]
  - By March 15 each year

Plan Limitations

Summary of Employee Benefit and Related Limits (2010-2009)

Elective Deferral Limits	2010	2009
401(k), 403(b), and SARSEP	$16,500	$16,500
457 plan	$16,500	$16,500
Simple IRA and Simple 401(k)	$11,500	$11,500
Catch-Up Contributions (age 50)		
401(k), 403(b), 457, and SARSEP	$5,500	$5,500
Simple IRA and Simple 401(k)	$2,500	$2,500
Maximum Plan Compensation Cap	$245,000	$245,000
§415 Annual Limits		
Defined contribution plan	$49,000	$49,000
Defined benefit plan	$195,000	$195,000
Highly Compensated Employees	$110,000	$110,000
Key Employees		
Officer compensation	$160,000	$160,000
1% Owners	$150,000	$150,000
Gov't Plan Compensation Limit	$360,000	$360,000
Controlled Employee Limits	$95,000	$95,000
§1.62-21(f)(5)(i) and (iii)	$195,000	$195,000
ESOP Limits		
Threshold account balance	$985,000	$985,000
Normal/additional periods	5	5
One year extension threshold	$195,000	$195,000
SEP Eligibility Compensation Floor	$550	$550
Coverdell ESA	$2,000	$2,000

IRA - Individual Retirement Arrangements	2010	2009
Annual contribution limit	$5,000	$5,000
Catch-up contribution limit (age 50)	$1,000	$1,000
Roth IRA		
Annual contribution limit	$5,000	$5,000
Catch-up contribution limit (age 50)	$1,000	$1,000
Roth conversion limit	None	$100,000
HSA - Health Savings Accounts		
Individual contribution limit	$3,050	$3,000
Family contribution limit	$6,150	$5,950
Catch-up contribution limit (age 55)	$1,000	$1,000
Qualified Transportation Fringe Benefits		
Employer-provided parking (monthly)	$230	$230
Mass transit pass and vanpool (monthly)	$230	$120/$230*
Social Security		
OASDI rate	6.2%	6.2%
Medicare rate	1.45%	1.45%
FICA	7.65%	7.65%
SECA	15.3%	15.3%
Taxable wage base (TWB)	$106,800	$106,800
Social Security Earnings Limit		
Under full retirement age ($1 for $2 reduction)	$14,160 /yr.	$14,160 /yr.
Attains full retirement age ($1 for $3 reduction)	$37,680 /yr.	$37,680 /yr.
Over full retirement age	Unlimited	Unlimited

IRA, Roth-IRA, and ESA Phase-out Ranges	Single 2010	Single 2009	Married Filing Jointly 2010	Married Filing Jointly 2009	Married Filing Separately 2009 and 2010
Traditional IRA - active participant	$56,000 – $66,000	$55,000 – $65,000	$89,000 - $109,000	$89,000 - $109,000	$0 - $10,000
Traditional IRA – only spouse active	n/a	n/a	$167,000-$177,000	$166,000-$176,000	$0 - $10,000
Roth IRA – contributions	$105,000 - $120,000	$105,000 - $120,000	$167,000 - $177,000	$166,000 - $176,000	$0 - $10,000
Coverdell ESA – contributions	$95,000 - $110,000	$95,000 - $110,000	$190,000 - $220,000	$190,000 - $220,000	n/a

HSA Limitations	2010 Self-Only Coverage	2010 Family Coverage	2009 Self-Only Coverage	2009 Family Coverage
HSA maximum contribution	$3,050	$6,150	$3,000	$5,950
HSA catch-up (age 55 by end of year)	$1,000	$1,000	$1,000	$1,000
HDHP minimum annual deductible	$1,200	$2,400	$1,150	$2,300
HDHP maximum out-of-pocket	$5,950	$11,900	$5,800	$11,600

* American Recovery and Reinvestment Act of 2009 § 1151, increased the $120 limit to $230 for months beginning after 2/17/09 and before 1/1/11.

“THANK YOU”

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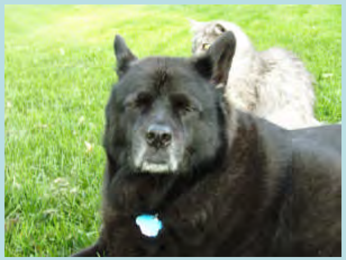

Have a Great Day!