The Kitces Report
Advancing knowledge in financial planning...
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Strategies To Maximize The Value Of A Tax-Free Roth

Executive Summary

- The decision of whether "To Roth Or Not To Roth" is driven primarily by a comparison of current versus future tax rates, with the goal to pay the tax liability whenever the *rate* is lower (which means using a Roth account when current tax rates are lower, and a pre-tax traditional retirement account if tax rates will be lower in the future).

- Additional factors that can slightly benefit a Roth IRA over a traditional IRA are the fact that Roth accounts do not have any RMDs during life (under current law), the tax-exclusive nature of the Roth contribution limits, and minimizing state (but not Federal) estate tax exposure.

- Income limits in the tax code prevent higher-income earners from contributing to a Roth IRA. However, anyone with earned income can contribute to a traditional IRA, and since 2010 there are no income limits on a Roth conversion, either. Which means anyone can contribute to a Roth IRA indirectly, by contributing to a traditional IRA (even if non-deductible) and then subsequently converting it, in what is often called a "backdoor Roth contribution".

- Since IRS Notice 2014-54, it's now possible to split out the after-tax funds from an employer retirement plan to do a direct Roth conversion. This not only makes it possible to turn existing after-tax dollars in a 401(k) plan into a future tax-free Roth, but even makes it appealing to start contributing additional after-tax dollars to the employer retirement plan, if possible, to do a conversion later.

- For those who must convert pre-tax (and therefore taxable) dollars when doing a Roth conversion, it's best to time the Roth conversions for years with lower income. And because a large Roth conversion can itself create so much income that it drives up the tax bracket, often the best strategy is to do a series of small partial Roth conversions over time.

- Unfortunately, it's often difficult to determine the optimal amount for a partial Roth conversion, because key elements of income or deductions may not be known until the very end of the year, when there is little time remaining to do a Roth conversion. Fortunately, this challenge can be resolved by deliberately converting more than enough, and simply doing a Roth recharacterization after the fact for the correct amount.

- When doing a Roth conversion, move the investments into a standalone account, not co-mingled with other existing Roth accounts. If the investments decline in value, the IRA owner can recharacterize the Roth conversion for that account (by the recharacterization deadline of October 15th of the following year), undoing what has turned out to be an unfavorable conversion.

- To more fully maximize the value of a Roth conversion, consider converting several multiples of the desired amount, each into its own account with each account invested differently. Whichever account and investment performs the best can be kept, with the remaining accounts recharacterized, even as the Roth recharacterization deadline allows a significant time window for a "free look" at investment results.

- Anyone who has never opened a Roth IRA should create one, even if it's done with just a nominal amount like $100, to start the 5-year clock for future tax-free "qualified" Roth distributions. The 5-year rule for tax-free growth only needs to be satisfied once per taxpayer for all his/her Roth IRAs.

- Given the tax-free nature of Roth accounts, be sure to invest Roth assets in whatever has the highest expected return over time. If there are several high-return investments, choose the one that is the least tax efficient, to further optimize the household's overall asset location!

About the Author

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Introduction

Congress first created the so-called "Roth IRA" under the Taxpayer Relief Act of 1997. Named after Senator William Roth of Delaware, it was meant to provide an alternative to the traditional (pre-tax) IRA, where contributions would no longer be deductible, but future growth could (potentially) be spent tax-free.

In the years since, Roth IRAs have exploded in popularity, a combination of the inherent appeal of a tax-free retirement account, the fear that tax rates will rise in the future given Federal deficits and a rising national debt, and a series of rule changes over the past 20 years that have made it easier and easier to get money into Roth accounts, from the elimination of the income limits on Roth conversions to the introduction of Roth-style employer retirement plans.

In fact, the ever-growing complexity of the Roth rules has not only liberalized their access, but also introduced numerous additional tax planning opportunities that can be harvested by navigating the finer points of the laws as written.

Accordingly, in this issue of *The Kitces Report*, we look in depth at strategies to maximize the value of tax-free Roth accounts, from doing "backdoor Roth" IRA contributions and "mega" backdoor Roth contributions through an after-tax 401(k), to doing systematic partial Roth conversions (into multiple accounts to take advantage of the Roth recharacterization rules), and why *every* client should get a Roth account started, even if just with a $100 contribution or conversion, to start the infamous 5-year clock for getting future tax-free Roth distributions!

The Four Factors That Determine When Roth Is Best (Or Not)

The rules for tax-preferenced retirement accounts allow for both pre-tax "traditional" IRAs (and employer retirement plans) where contributions are tax-deductible when made but the distributions are taxable, versus Roth style accounts that are funded with after-tax dollars but growth may eventually be received tax-free.

All else being equal, anyone would naturally prefer a tax-free account to one that will be taxable in the future. However, in reality, not all else *is* equal, because contributing to a traditional IRA produces an upfront tax deduction that also has economic value, while a Roth IRA does not. Or viewed alternatively, contributing to a Roth IRA requires *also* coming up with the money to pay the taxes that will be due on the contribution (since it's not deductible up front). Which means the comparison is somewhat more nuanced.

Ultimately, though, while there are many scenarios where a Roth or traditional IRA may be best, the financial outcome of the decision is driven by four key factors. They are:

- Current vs future tax rates;
- The impact of required minimum distributions;
- The tax-inclusive vs tax-exclusive nature of IRA contribution limits; and
- The impact of state (but not Federal) estate taxes.

Some of these factors solely benefit the Roth, but others can benefit the pre-tax account as well; as a result, choosing a Roth over a traditional pre-tax retirement account can either create or destroy wealth in the long run, depending on how the factors line up!

(Michael's Note: For further detail on the four factors that determine when the Roth is best, or not, see the May 2009 issue of The Kitces Report on "To Roth Or Not To Roth".)

Current Vs Future Marginal Tax Rates

By far, the most dominating factor in determining whether it's better to have a Roth or traditional retirement account is a comparison of current versus future tax rates. Current tax rates means the *marginal* tax rate that would be saved by contributing to a pre-tax account, or that would be paid today when contributing after-tax dollars to (or converting pre-tax dollars into) a Roth account. Future tax rates means whatever marginal tax rate would apply to the funds in the (pre-tax) retirement account when withdrawn in the future – ostensibly in retirement, or possibly even by the next generation if the retirement account is not expected to be depleted during the lifetime of the owner.

In other words, the fact that a traditional IRA obtains a tax deduction now (paired with, in the future, reporting the withdrawals in income and paying taxes), versus a Roth IRA that pays the taxes today, means the account owner has the choice and control over when to pay the tax bill: today, or in the future.

And given this dynamic, the optimal strategy is remarkably straightforward: the greatest wealth is created by *paying taxes when the rates are the lowest*.

Which means if rates are lower today and higher in the future – e.g., for the young worker, or someone in between jobs – go with the Roth contribution or conversion, and pay taxes at today's low rates. If rates will be lower in the future – e.g., for someone who has employment income driving up their marginal tax rate today, but whose taxable income will drop in retirement – the traditional IRA or similar pre-tax retirement account is the winner.

> *Example 1*. Andrew has $6,000 of pre-tax income available to save, and is trying to decide whether to contribute it to a traditional IRA or a Roth IRA. Assuming a 25% tax rate, and that his other available dollars have already been saved or consumed, this effectively leaves Andrew with the choice of whether to contribute the full $6,000 to a traditional IRA (where the tax deduction eliminates any current tax liability), or to contribute $4,500 to a Roth IRA (where he must hold aside $1,500 for the taxes that will be due, since there is no upfront tax deduction).
>
> If Andrew holds the investments in the account long enough that they double in value, his traditional IRA would grow to $12,000, while his Roth IRA will only grow to $9,000. However, if Andrew remains in the same 25% tax bracket in the future, the pre-tax IRA would face a $3,000 tax liability with a net value of $9,000, while the Roth IRA would face no tax liability and be worth $9,000 of spendable wealth (assuming it can be liquidated as a qualified withdrawal). Which means Andrew's net after-tax value would be the same $9,000 in both scenarios!
>
> However, if future tax rates are higher – for instance, the traditional IRA is liquidated at a 35% tax rate, reducing the net value to just $7,800 – then the Roth IRA fares better. Conversely, if the future tax rate is only 15% (lower than today), the net value of the pre-tax IRA would be $10,200, beating the Roth IRA.

As the above example reveals, the relative superiority (or inferiority!) of the Roth IRA over the traditional IRA depends entirely on whether the future tax rate – whenever the traditional IRA is liquidated – is higher or lower than the tax rate paid to get the dollars into the Roth IRA in the first place. Or viewed another way, getting the current-vs-future tax rate comparison right can create wealth, but getting it wrong can result in a significant destruction of client wealth, by unnecessarily paying taxes at high rates!

Notably, though, it's important to recognize that an individual's marginal tax rate is not merely their tax *bracket*. Additional factors that can impact the determination of a marginal tax rate, particularly for retirees, include the phase-in of taxable Social Security benefits, income-related Medicare Part B and Part D premium surcharges, the phaseout of itemized deductions and personal exemptions, the phase-out the AMT exemption (and the impact of the AMT tax brackets), and more. Furthermore, determining a future marginal tax rate should be evaluated *on top* of other "known" income that will already be present (e.g., passive portfolio income, taxable pension or annuity income streams, etc.). For a summary of key factors and thresholds that impact the marginal tax rate, see www.kitces.com/marginaltaxchart.

Impact of RMDs

One important distinction of Roth IRAs (although not Roth 401(k) accounts) is that they are *not* subject to required minimum distribution (RMD) obligations during the lifetime of the account owner, whereas traditional IRAs are.

The net result is a slight benefit in favor of the Roth IRA, for the simple reason that it allows dollars to stay longer inside the tax-preferenced wrapper of the retirement account. This is an outright benefit for Roth accounts, even if tax rates don't change, compared to the traditional IRA that slowly self-liquidates due to RMDs in the later years (which, in turn, forces money into taxable accounts where its future growth will be slowed by ongoing tax drag as well).

However, this benefit applies only as long as the IRA owner is alive! After death of the owner, *all* retirement accounts have required minimum distributions for beneficiaries, and the exact same rules apply whether it's an inherited IRA or an inherited *Roth* IRA (the RMD calculation itself is exactly the same, even though the tax treatment *of* the RMD amount may be different).

Accordingly, the benefit of avoiding lifetime RMDs applies only as long as the IRA owner is alive, and likewise applies only if the IRA owner actually lives past age 70 1/2 when RMDs begin! Otherwise, the avoiding-RMDs benefit is actually a moot point.

In addition, it's notable that the benefit of avoiding required minimum distributions for Roth accounts only matters as long as Roth IRAs continue to enjoy the favorable no-RMD treatment – a notable uncertainty, given that the President's budget proposals for the past several years have included a provision that would require Roth accounts to become subject to the same RMD rules (eliminating this Roth IRA advantage)!

Tax-Inclusive Vs Tax-Exclusive Contribution Limits

Another factor that favors the Roth IRA is the interaction between the IRA contribution limits, and the future tax liability of a pre-tax account.

> *Example 2*. Continuing the earlier example, imagine that Andrew actually had enough money to "max out" his contribution to an IRA of either type. Given that a Roth is funded with after-tax dollars, making a $6,000 maximum contribution actually entails *earning* $8,000 of pre-tax income, such that $2,000 will go to taxes and $6,000 will go to the Roth IRA (at a 25% tax rate).
>
> *However*, the comparison is now somewhat apples-to-oranges, because Andrew cannot make a comparable $8,000 pre-tax contribution to an IRA, given the contribution limit is just $6,000. Instead, he'd have to make the same $6,000 contribution to a pre-tax IRA (and obtain a $6,000 tax deduction), and of the $2,000 left over, he could save another $1,500 in a taxable account (with the remaining $500 going to upfront taxes).

The end result is that Andrew can have $6,000 of "all tax-preferenced" dollars in a Roth IRA, or $6,000 of pre-tax IRA dollars plus $1,500 in a taxable "side account" instead. Over time, this will create a natural tilt in favor of the Roth IRA, even if tax rates remain the same. Were Andrew able to get all $8,000 of his pre-tax funds into the traditional IRA, the scenarios would be the same, but the fact that the contribution limits are identical – despite one being pre-tax and the other being after-tax – creates a slight tilt in favor of the Roth IRA.

Or viewed another way, the fact that a traditional IRA is pre-tax means the contribution limit is "tax-inclusive" – the future tax liability of the IRA is included in the $6,000 annual limit. By contrast, a Roth IRA is a "tax-exclusive" account – the $6,000 contribution limit is used up entirely by money that can stay in the Roth IRA with preferential tax treatment, while the associated tax liability can be paid entirely with "outside" (and less tax efficient) accounts.

And notably, the same effect occurs when there is a Roth conversion. Given that the conversion from a traditional IRA to a Roth allows for 100% of the funds to be rolled over and converted, the net result is that a Roth conversion allows the individual to switch from a tax-inclusive traditional IRA to a tax-exclusive Roth IRA – at least, if there are available outside dollars to pay the tax liability.

> *Example 3*. Jessica has a $400,000 traditional IRA that she is considering whether to convert. If she converts the account at an average tax rate of 30%, and pays the tax liability with "outside" dollars, she will finish with a $400,000 Roth IRA, while diminishing her outside investment accounts (that would have grown less efficiently due to tax drag anyway) by $120,000.
>
> Given that she couldn't get those outside dollars into an IRA in the first place – due to contribution limits – using the outside account to pay the tax liability on a conversion is appealing, as it turns the $400,000 account from being tax-inclusive into tax-exclusive. Or viewed another way, a $400,000 tax-free Roth IRA can grow more effectively than a $400,000 pre-tax IRA plus a $120,000 annually taxable brokerage account (all else being equal).
>
> Notably, if Jessica had paid the tax liability *from* the Roth conversion – turning her Roth IRA into "just" $280,000 – she would not necessarily be worse off for converting (at least as long as she's not also subject to the 10% early withdrawal penalty). Assuming her 30% tax rate remains constant, a $280,000 Roth IRA still grows as efficiently as a $400,000 pre-tax IRA; if the accounts each grow until they double in value (a 100% cumulative return over time), the Roth IRA grows to $560,000, and the pre-tax IRA grows to $800,000, which is worth the same $560,000 at a 30% tax rate.

In other words, paying the tax liability from the Roth conversion still breaks even when there's no early withdrawal penalty and tax rates remain the same (and comes out ahead if tax rates are higher in the future), but paying the tax liability with outside dollars has an *additional* benefit of using a tax-inefficient side account to cover a future tax bill.

Notably, in practice using an outside account to pay the tax liability on a Roth conversion will usually be more appealing, because the 10% early withdrawal penalty *is* a real threat (unless the individual considering the strategy is already over age 59 ½ or is otherwise exempt from the penalty).

State Estate Taxes

The final factor that can favor a Roth IRA is estate taxes, for the simple reason that paying estate taxes on a retirement account can result in "double taxation" when a portion of the account is earmarked for Uncle Sam (as a pre-tax account) in the first place. The tax-exclusive nature of a Roth IRA avoids this outcome.

> *Example 4a*. Brian recently passed away with a $1,000,000 traditional IRA and a $1,000,000 investment account, and his executor has to report $2,000,000 on the estate tax return (combined with other assets that we assume put him over the Federal estate tax exemption).
>
> However, if Brian had converted the $1,000,000 traditional IRA into a $1,000,000 Roth IRA, paying $350,000 in income taxes and being left with only a $650,000 investment account, his total estate value would be reduced to $1,650,000. At a 40% estate tax rate, making $350,000 of investment dollars "disappear" can result in $140,000 of estate tax savings!

The caveat is that such conversion strategies don't necessarily help for Federal estate tax purposes, because of the IRC Section 691(c) "Income in Respect of a Decedent" (IRD) deduction, which allows beneficiaries to subsequently deduct for income tax purposes any estate taxes attributable to a pre-tax IRA.

> *Example 4b*. Continuing the prior example, if Brian had simply kept the $1,000,000 pre-tax IRA, the beneficiaries would have received a $400,000 IRD income tax deduction (for the 40% estate tax rate applied to the pre-tax IRA). Thus, the beneficiaries would have owed their assumed-to-be-average-of-35% tax rate on just the remaining $600,000 (after the IRD deduction), which produces a tax savings of $140,000… the exact same tax savings that would have occurred by converting to a Roth IRA before death.

In other words, the Federal estate tax savings of converting to a Roth IRA to save on estate taxes is exactly the same as the income tax savings granted by the IRD deduction. In fact, the whole purpose of the IRD deduction is to ensure that the scenarios match, and that there's no incentive or benefit to liquidate (or convert) pre-tax assets before death.

However, the IRD deduction applies only for *Federal* estate taxes. Most states that have a state-level estate tax do *not* have a state-level IRD deduction. As a result, affluent individuals who are exposed to state estate taxes in such states will find that a Roth conversion really does allow them to leave more money for the next generation, at least to the extent of the typically-up-to-16% state estate tax rate.

Of course, those with large pre-tax IRAs should still be cautious not to convert so much at once – and push up their tax rate so far with a big conversion – that the adverse income tax impact outweighs the state estate tax savings! In other words, the beneficiaries might be better off paying 16% estate taxes and a low 15% income tax rate on the stretch distributions from an inherited IRA (a total of 31%), rather than doing the giant Roth conversion all at once that minimizes the estate taxes but triggers a 39.6% top tax rate for the original IRA owner.

Strategies To Maximize Roth Contributions And Conversions

While there are certain environments and scenarios that will naturally favor a Roth IRA over a traditional – including when tax rates are low (and expected to be higher in the future), for those who will live a long time (and may avoid future RMDs), in situations where there are 'outside' tax-inefficient dollars to pay the tax bill for a contribution or conversion, and minimizing state estate tax exposure – the reality is that the flexibility of the rules for retirement account contributions and conversions allow for several additional strategies that can further maximize the long-term value of a Roth IRA (or other Roth-style accounts).

For the remainder of this issue of *The Kitces Report*, we will look at various Roth contribution and conversion strategies, and other ways that the value of a Roth IRA can be maximized in the long run.

Roth Contributions For High Income Earners Through The "Backdoor Roth" Strategy

Making A Backdoor Roth IRA Contribution

Given the Adjusted Gross Income limitation that prevents "high income" earners (over $132,000 for individuals, or $194,000 for married couples) from contributing to a Roth IRA, but *no* income limits on converting from a traditional IRA *to* a Roth IRA (since 2010), it is possible to indirectly achieve the desired result (a Roth IRA contribution) through the "backdoor Roth" strategy. The individual simply makes a traditional IRA contribution (presuming the individual has sufficient earned income to make an IRA contribution in the first place), followed soon thereafter by a Roth conversion.

If the IRA contribution is deductible, the end result will be a contribution to an IRA that produces a tax deduction, followed by a Roth conversion which causes that same income from the IRA contribution to be recognized for tax purposes after all. In the end, this means there will be an IRA deduction of up to $6,000 (in 2016, reported on Line 32 of Form 1040), a Roth conversion of up to $6,000 to match it (reported on Line 15 of Form 1040), and since both are above-the-line income/deductions on the tax return, the net result is $0 of Adjusted Gross Income (AGI) and a $0 tax liability, even while getting the whole $6,000 in a Roth IRA!

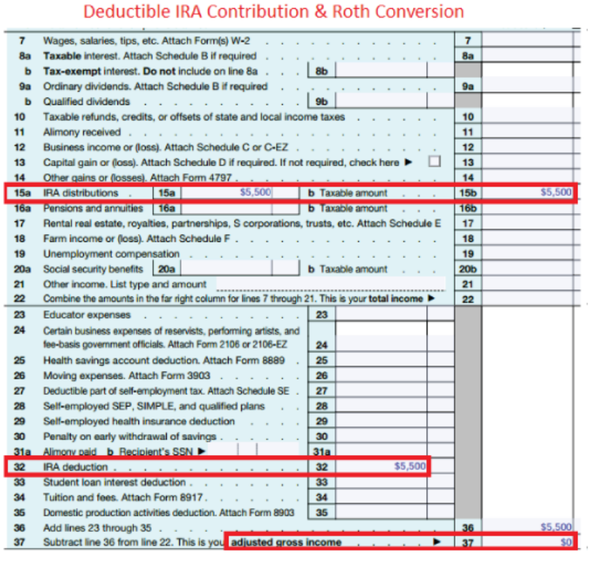
In the case that the IRA contribution is *not* deductible (e.g., because the high-income earner is an active participant in an employer retirement plan, and his/her high income level has therefore made the contribution non-deductible), the net result is still the same. The contribution into the IRA itself produces no tax deduction (Line 32 of Form 1040 is $0), with the after-tax portion of the contribution reported on Form 8606. The conversion of that non-deductible IRA is a taxable event, but the portion of the IRA that is attributable to non-deductible contributions is treated as a return of principal and thus has no tax consequences (thus Line 15a of Form 1040 is $5,500, but 15b, which reports the taxable amount, is $0). Thus, there will be no deduction for the IRA contribution, and no income from the Roth conversion of that after-tax money, and the net result again is a zero impact on AGI and a tax liability of $0, while still getting the whole $6,000 into a Roth IRA!

As shown in Figure 1, the net result either way is that $6,000 goes into an IRA, $6,000 ends out in a Roth IRA, and the net impact on Adjusted Gross Income (AGI) is $0, which means the tax impact is $0! The IRA contribution is *always* permitted (as long as there's earned income), and at that point it doesn't actually matter whether it's a deductible contribution or not, because the net result after Roth conversion is always the same – $0 of AGI, and $0 of tax liability!

Planning Tip: The backdoor Roth strategy works regardless of whether the IRA contribution is deductible or not. The net result

Figure 1. Comparison Of Tax Reporting For Roth Conversion Of Deductible Or Non-Deductible IRA

Deductible IRA Contribution & Roth Conversion



7	Wages, salaries, tips, etc. Attach Form(s) W-2			7	
8a	**Taxable** interest. Attach Schedule B if required			8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b			
9a	Ordinary dividends. Attach Schedule B if required			9a	
b	Qualified dividends	9b			
10	Taxable refunds, credits, or offsets of state and local income taxes			10	
11	Alimony received			11	
12	Business income or (loss). Attach Schedule C or C-EZ			12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	
14	Other gains or (losses). Attach Form 4797			14	
15a	IRA distributions	15a	$5,500	b Taxable amount 15b	$5,500
16a	Pensions and annuities	16a		b Taxable amount 16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	
18	Farm income or (loss). Attach Schedule F			18	
19	Unemployment compensation			19	
20a	Social security benefits	20a		b Taxable amount 20b	
21	Other income. List type and amount			21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			22	
23	Educator expenses	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	Deductible part of self-employment tax. Attach Schedule SE	27			
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction	32	$5,500		
33	Student loan interest deduction	33			
34	Tuition and fees. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 35			36	$5,500
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	$0

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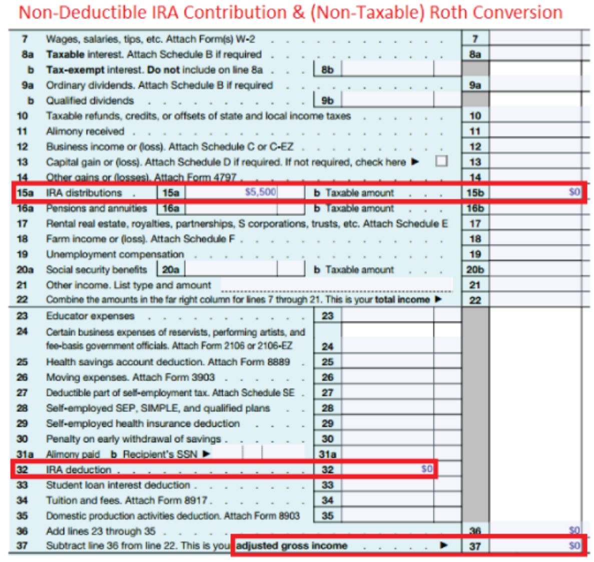
Non-Deductible IRA Contribution & (Non-Taxable) Roth Conversion



7	Wages, salaries, tips, etc. Attach Form(s) W-2			7	
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12	Business income or (loss). Attach Schedule C or C-EZ			12	
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15a	IRA distributions	15a	$5,500	b Taxable amount 15b	$0
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32	IRA deduction	32	$0		
33	Student loan interest deduction	33			
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35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 35			36	$0
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	$0

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will be the same either way, as long as the individual has enough earned income to be eligible *to* contribute to an IRA in the first place!

Notably, though, while this strategy of making a Roth IRA contribution through the "back door" by making a (potentially non-deductible) traditional IRA contribution followed by a Roth conversion seems relatively straightforward, there are some important caveats to consider in executing the strategy.

Caveats To The Backdoor Roth IRA Strategy

The IRA Aggregation Rule

The first caveat to the backdoor Roth contribution strategy is what's called the "IRA aggregation rule" under IRC Section 408(d)(2).

The IRA aggregation rule stipulates that when an individual has multiple IRAs, they will all be treated as one account when determining the tax consequences of any distributions (including a distribution out of the account for a Roth conversion). And the IRA aggregation rule is applied at the end of the taxable year, which means any other IRAs that exist at the time of conversion, *or that are created or added to after the conversion but before the end of the tax year*, will be considered in the calculation!

Planning Tip: Beware doing any rollovers from an employer retirement plan into an IRA in the same tax year you do a backdoor Roth contribution. Even if you do the rollover to create a new pre-tax IRA *after* the Roth conversion, it is still counted in the calculations under the IRA aggregation rule!

Notably, while the IRA aggregation rule does combine together all IRA accounts to determine the tax purposes of a distribution or conversion, it's important to note that the rule *only* aggregates together *traditional* IRA accounts under that individual's Social Security number.

Thus, a husband and wife's IRA accounts are not aggregated together across the marital unit (although the husband still aggregates *all* the husband's IRAs, and the wife aggregates all the wife's IRAs). Nor are an individual's own IRAs aggregated together with any inherited IRA accounts on his/her behalf. And any existing Roth IRAs – and the associated after-tax contributions that go into Roth accounts – are not aggregated either.

In addition, any employer retirement plans – e.g., a 401(k), profit-sharing plan, etc. – are *not* included in the aggregation rule. However, a SIMPLE IRA or SEP IRA, both of which are still fundamentally just an "IRA", *are* included.

How The IRA Aggregation Rule Impacts The Backdoor Roth

The IRA aggregation rule creates a significant challenge for those who wish to engage in the backdoor Roth strategy, but have other existing IRA accounts already in place (e.g., from prior years' deductible IRA contributions, or rollovers from prior 401(k) and other employer retirement plans). Because the standard rule for IRA distributions (and Roth conversions) is that any after-tax contributions come out along with any pre-tax assets (whether from contributions or growth) on a *pro-rata* basis, when all the accounts are aggregated together, it becomes impossible to *just* convert the non-deductible IRA.

> *Example 5.* Jeremy has $200,000 of existing IRA assets, accumulated from years of deductible IRA contributions plus growth when he was younger, along with a rollover from an old 401(k) plan. Jeremy is now a high-income earner, and wishes to make a $6,000 contribution to a non-deductible IRA, with the plan to convert *that* $6,000 into a Roth IRA.
>
> However, due to the IRA aggregation rule, *Jeremy cannot just convert the $6,000 non-deductible IRA contribution, even if it is held in a separate/standalone account*. Instead, Jeremy must treat any $6,000 conversion from *any* account as a partial conversion of *all* of his IRA assets.
>
> Accordingly, if Jeremy tries to do a $6,000 Roth conversion (with total IRA assets that now add up to $206,000, including the new $6,000 non-deductible contribution), the return-of-after-tax portion will be only $6,000 / $206,000 = 2.91% of the conversion. Which means the net result of his $6,000 Roth conversion will be $175 of after-tax funds that are converted, $5,825 of the conversion will be *taxable*, and he will end out with a $6,000 Roth IRA and $200,000 of pre-tax IRAs that still have $5,825 of associated after-tax contributions (the remaining portion of the $6,000 non-deductible contributions that were *not* converted).

Notably, the net effect of the IRA aggregation rule is that only a portion of the non-deductible contributions can actually be converted, *even if the non-deductible contribution is made to a new account and converted separately,* because the IRA aggregation rule combines all the accounts for tax purposes anyway! And the outcome would have been the same regardless of whether Jeremy had existing IRA assets, or rolled them into a new IRA after the Roth conversion (but in the same tax year), since the IRA aggregation rule is applied at the end of the year. Either way, when it applies, the IRA aggregation rule effectively "transfers" or shifts a large portion of the after-tax funds from being associated with the *new* $6,000 IRA over to the existing IRA instead!

On the other hand, it's important to recognize that because funds held in an employer retirement plan are *not* counted in the IRA aggregation rule, rollovers can be held aside in an employer retirement plan and transferred later to avoid tainting a backdoor Roth contribution. And in some cases, it may even be feasible to roll pre-tax IRA dollars *into* an employer retirement plan, just to avoid the aggregation rule! (See sidebar below for further detail.)

Planning Tip: Siphon pre-tax dollars out of an IRA into a 401(k) plan to avoid the IRA aggregation rule (if there's an available employer retirement plan that accepts roll-ins!). If the client has self-employment income, it may even be possible to create a 401(k) plan for the business that accepts roll-ins, just to facilitate the process.

Backdoor Roth Contributions And The Step Transaction Doctrine

The second potential blocking point for doing a backdoor Roth contribution is called the "step transaction doctrine", which originated decades ago in the 1935 case of *Gregory v. Helvering*. The step transaction doctrine stipulates that the Tax Court can look at what are formally separate steps of a transaction that have no substantial business purpose to be separate,

Avoiding The IRA Aggregation Rule Via Employer Retirement Plans
The upshot to employer retirement plans being separated out from the IRA aggregation rule is that as long as assets stay within a 401(k) or other employer plan, they can avoid confounding the backdoor Roth strategy.

Thus, in the earlier example 5, if Jeremy's $200,000 IRA was a $200,000 401(k) instead, then the $6,000 non-deductible contribution to an IRA really *could* be converted on its own, because that would be the only *IRA* involved.

The second opportunity that emerges when employer retirement plans are not included in the IRA aggregation rule is that funds in an IRA *can be removed* from the aggregation rule by rolling them *into* a 401(k) or other employer plan. Thus, again continuing the earlier example, if Jeremy wanted to begin doing backdoor Roth IRA contributions, he could roll over his existing $200,000 IRA into a 401(k) plan, reducing his IRA accounts to zero, and then open a new IRA with a new non-deductible contribution and just convert that account. In fact, given that the IRA aggregation rule is not done until the end of the tax year, Jeremy could even roll over the $200,000 IRA after the fact, just to eliminate it from the equation.

The tax-favorable outcome of the transfer to the 401(k) is further facilitated by IRC Section 408(d)(3)(A)(ii), which states that when funds that are rolled from an IRA specifically *to an employer retirement plan,* the transfer may *not* include any after-tax assets at all. In other words, if (under the IRA aggregation rule) Jeremy has $206,000 of total IRA assets, including $6,000 of after-tax funds, *he cannot roll all $206,000 into a 401(k) plan even if he wanted to.* Instead, he can *only* roll the $200,000 of pre-taxa assets (that would be taxable if distributed).

In essence, this rule becomes an exception to the normal "pro-rata" rule that applies to IRA distributions and rollovers, and permits IRAs with 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 (and/or to receive subsequent non-deductible contributions to convert in future years!).
Of course, the most important caveat to this rule is simply that the individual must *have* a 401(k) plan *that accepts roll-in contributions in the first place*, which is not always the case. In the extreme, if the individual has any Schedule C income for consulting or other self-employment activity (and no other employees), he/she could even *create* an individual 401(k) and make a small contribution from income, establishing the account which can subsequently be used to accept roll-ins from his/her other IRAs to execute the strategy.

conclude that they are a really just a single integrated tax event, and treat (and tax) it as such.

In the context of the backdoor Roth contribution, this means if the separate steps of non-deductible IRA contribution and subsequent conversion are done in rapid succession, there is a risk that if caught the IRS and Tax Court may suggest that the *intent* was to make an impermissible Roth contribution as a single transaction (just done in piecemeal steps)… and if the individual's income was too high to qualify in the first place, then the transaction would be disallowed (and potentially face an excess contribution penalty tax of 6% as well).

> *Example 6.* Betsy earns over $250,000 per year, and wishes to make a Roth IRA contribution in 2016, but cannot because her income is too high. Instead, Betsy decides to pursue the "backdoor Roth contribution" strategy, and makes a non-deductible IRA contribution on July 1st, followed up with a conversion to a Roth IRA on July 2nd (as soon as the funds have officially been deposited in the IRA account and are available to transfer to the Roth IRA account).
>
> The fact that Betsy did the steps in rapid succession implies that her intent all along was to complete a Roth IRA contribution, which she would not have been allowed to make due to her high income (above the AGI thresholds). Accordingly, under the Intent Test of the step transaction doctrine, if the IRS challenged the situation, the Tax Court may conclude that Betsy really did just make an impermissible Roth IRA contribution, which would then require her to remove the funds from the account, and be subject to a 6% excess contributions penalty tax as well. And if she had done so for several years, she could be subject to cumulative 6% excess contribution penalties for all prior (disallowed) backdoor Roth contributions, as each year an impermissible contribution remains in the Roth IRA, it accrues a new excess contribution penalty (which means the statute of limitations remains open).

It's crucial to recognize that with the step transaction doctrine, *each step of the transaction continues to be entirely legitimate*. The point is not that *each* step cannot be legally done, nor even necessarily to say that they can't be done one after the other. The ultimate point of the step transaction is that when the multiple steps are done in quick succession with the clear intent of accomplishing a single transaction, the Tax Court can recognize (and tax or penalize) it accordingly.

Avoiding The Step Transaction Doctrine On A Roth IRA Backdoor Contribution

So how is the step transaction doctrine avoided? Since the step transaction doctrine applies to a series of steps done in quick succession that have the substance of a single whole (and not permitted) transaction, such that the court determines by looking at the end result that it was the taxpayer's *intent* to do the single-step transaction in the first place, the solution is remarkably simple: spread out the steps of the transaction, so that they're clearly being done separately and *not* as a single event.

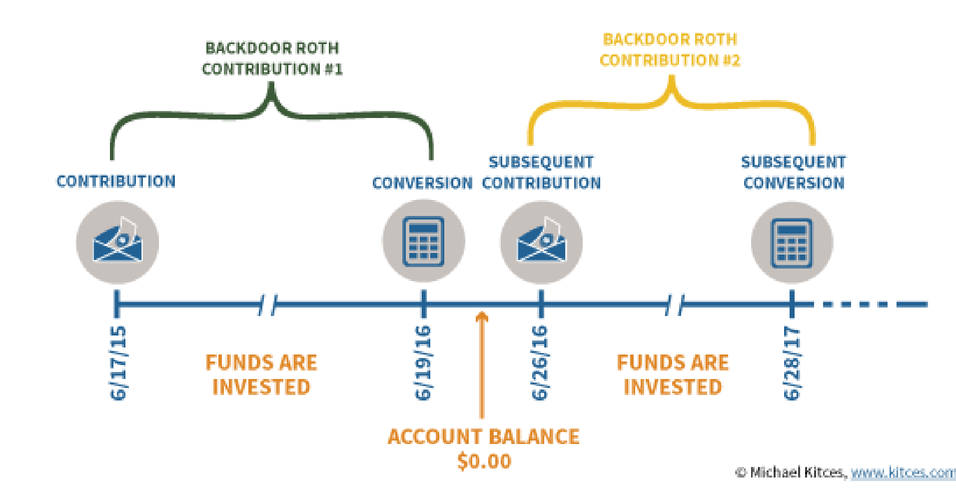
In other words, the best way to avoid the step transaction doctrine on a prospective backdoor Roth contribution is to put (more) time between the IRA contribution step, and the subsequent Roth conversion step. If there is a deliberate time gap between when the (non-deductible) IRA contribution is made, and when the subsequent Roth conversion occurs, it's easier to claim that the end result of dollars in the Roth wasn't part of a sole intent to circumvent the rules. Again, the reality is that each event separately *is* permissible, but the goal is to clearly establish that each step really *is* separate.

The caveat is that there's no hard-and-fast rule about "how long" it takes to avoid the step transaction. A prudent but arguably conservative rule of thumb in the context of the backdoor Roth contribution is to wait a year between contribution and subsequent conversion. Though notably, IRA guru Ed Slott and his team have suggested a much shorter time period is sufficient, such as waiting "one statement" until an end-of-month statement is released to show the IRA contribution being made.

Planning Tip: Wait 12 calendar months between when a (non-deductible) IRA contribution is made, and when the subsequent Roth conversion occurs, to clearly establish they were separate transactions and should not be subject to the step transaction doctrine.

For those who plan to do ongoing annual Roth IRA backdoor contributions, the strategy might be repeated again from year to year, where each non-deductible contribution is made, after 12 months *that* amount is converted (and the account balance goes to $0), and then a few days or weeks later a *new* non-deductible IRA contribution is made again, which in turn will be converted again another 12 months hence. As shown in Figure 2, this allows for a distinct sequencing of cash flows, where each non-deductible contribution can clearly be shown to have had time to "age", introducing the possibility that circumstances might have changed, and affirming that the subsequent conversion was an independent transaction.

Figure 2. Timing Of A Backdoor Roth Contribution To Avoid Step Transaction



And ideally, the funds should actually be *invested* during this intervening year as well. While investing the funds creates the potential that there will be a small tax liability when the conversion occurs if there was any growth along the way (if the $5,500 account grows to $5,750, the $250 of gains will be taxable at the time of Roth conversion). However, a tax liability will only occur if there was *growth* (which still isn't a bad thing in the end, because it means the investor still made money!). And in reality, the fact that the funds were invested for growth, and had the possibility of creating a tax liability, is also what helps to reinforce that the steps were independent and not done with the sole intent of defeating the Roth IRA contribution limits as a step transaction!

Planning Tip: During the waiting period between IRA contribution and subsequent Roth conversion, invest the account, rather than just leaving it in cash. It may create a small potential tax liability on the growth when the conversion occurs, but further substantiates that the contribution and later conversion were separately, independent transactions, given the investment risk that occurred in the intervening time period!

But perhaps the most important key to avoid the step transaction doctrine is the simplest one: *do not, in any notes or records, indicate that you are doing to do a "backdoor Roth IRA contribution" in the first place*! After all, the reality is that the application of the step transaction doctrine is based on the court's determination of *intent* – so when you *say* you are trying to do a backdoor Roth IRA to bypass the Roth contribution income limits, *you are making the case for the IRS!*

In addition, it's important to remember that in the case of financial advisors, *client notes and records are discoverable documents if the client winds up in Tax Court!* Unlike in the case of CPAs in certain circumstances, non-CPA client notes and advisor-client communication *are not privileged* (confidential and not accessible by the courts). Thus, advisors should also be cautious *not to record in the advisor's CRM and client file that the advisor is facilitating a backdoor Roth contribution*, or risk that the advisor's written recommendation to do a "backdoor Roth contribution" is used against the client to unwind the strategy!

Planning Tip: Given the aggressive nature of the strategy, don't keep client notes that state the client was advised to make a "backdoor Roth" contribution, or (especially for non-CPA financial advisors) those notes can actually be used as evidence against the client to substantiate their step transaction intent!

Converting After-Tax Contributions In 401(k) And Other Employer Retirement Plans

While the standard rule for contributing to a 401(k) plan is that the contributions are tax-deductible (i.e., pre-tax) going in, and taxable (as ordinary income) when withdrawn, or can be after-tax when made to a Roth 401(k), some 401(k) plans will allow people to make non-deductible, after-tax contributions to their (otherwise pre-tax) accounts as well.

Of course, if a Roth 401(k) is available, it's better to make after-tax contributions there, and if there's no Roth option then it's preferable to make a tax-deductible contribution to the traditional 401(k). However, for those who have maxed out on pre-tax contributions, it may be appealing to make *additional* contributions above the pre-tax threshold of the 401(k) plans, up to the overall annual defined contribution limit (which in 2016 is up to $53,000 from all employee and employer contributions).

Upon retirement (or otherwise leaving the company), both the pre-tax and after-tax funds can be rolled over to an IRA, retaining their original character.

> *Example 7a*. Charlie has a $100,000 balance in his 401(k) plan that includes $20,000 of after-tax contributions. Upon rolling the funds over to his (traditional) IRA, the account would still be a $100,000 account with $20,000 of after-tax contributions. When eventually withdrawn for spending purposes, the standard rules for withdrawals from pre-tax IRAs under IRC Section 72 dictate that distributions are a pro-rata share of pre-tax and after-tax amounts; thus, for instance, if Charlie later takes a $15,000 distribution from this account that is 20% after-tax funds ($20,000 out of $100,000), then 20% of the distribution ($3,000) will be after-tax return of principal and only the last $12,000 will be taxable as ordinary income.

When funds are rolled *out* of a 401(k) plan, though, a special rule applies that allows retirees to get their after-tax contributions back immediately, and just roll over the pre-tax remainder, if they wish. Under IRC Section 402(c)(2), if the retiree takes the aforementioned $100,000 account and requests to "just" roll over $80,000 and receive a $20,000 check, the tax code allows the retiree to receive the $20,000 check as all after-tax funds (therefore with no tax consequences) and claim the entire $80,000 rollover amount as pre-tax. This form of "partial rollover" strategy effectively harvests out the after-tax funds for personal use at the time of rolling out of the 401(k), while doing a pre-tax rollover of the rest, and without otherwise facing the pro-rata rule.

The potential for liquidating a 401(k) plan and getting "two checks" – one for the pre-tax amount, and one for the after-tax portion – became more interesting after the Pension Protection Act of 2006 (and subsequent IRS Notice 2008-30), which, for the first time, allowed a *direct* Roth conversion from a 401(k) plan to a Roth IRA. In the past, employer retirement plan assets could only be converted by rolling over to a traditional IRA, and subsequently converting, which subjected the funds to the IRA aggregation rule. With the potential for a direct rollover, though, *and* the possibility of receiving separate checks for pre-tax and after-tax funds, it suddenly became feasible to do a Roth conversion of *just* the after-tax funds (and roll over the remaining pre-tax funds to a traditional IRA).

> *Example 7b.* Continuing the prior example, when Charlie requests a rollover of his $100,000 401(k) account balance, he might receive two checks – one for the $80,000 pre-tax, and one for the $20,000 after-tax. He could then aim to roll over *both*, but to separate destinations – the $80,000 pre-tax to a traditional IRA, and the $20,000 of after-tax directly to a Roth IRA (now permitted as a direct Roth conversion under the Pension Protection Act, but tax-free because it's all after-tax funds). The end result – Charlie would now have $80,000 of all pre-tax funds in an IRA, $20,000 in a Roth IRA, and the tax cost was zero!

Early on, this splitting strategy was controversial, as arguably the original intent of the IRC Section 402(c)(2) rules was not to do separate rollovers of pre-tax and after-tax – it was to roll over the pre-tax and *keep* the after-tax (for retirees who needed to spend the funds). Accordingly, after the new direct-Roth-conversion-from-401(k)-plans rules took effect, the IRS issued IRS Notice 2009-68, which affirmed that when all the funds are rolled over from a 401(k) plan, but are split across multiple destination accounts, the pro-rata rule was supposed to still apply to carve up the after-tax amounts amongst the accounts, and not allow a direct Roth conversion of just the after-tax.

However, in 2014 the IRS acquiesced, and issued IRS Notice 2014-54, allowing taxpayers to split pre-tax and after-tax funds from an employer retirement plan after all. This effectively blessed the strategy of isolating the after-tax cost basis of the 401(k) plan for a Roth conversion.

Under the new rules, the IRS outright declared that in a situation where there are two or more direct rollovers from a plan that are all scheduled to be made at once (such that they will all be treated as a single disbursement), "the recipient can select how the pretax amount is allocated among these plans. To make this selection, the recipient must inform the plan administrator prior to the time of the direct rollovers."

Notably, though, to the extent a retiree takes out only *part* of the account, the pro-rata rules under IRC Section 72(e)(8) *do* still apply to determine how much is coming out in the first place. The purpose of IRS Notice 2014-54 was simply to establish that, for whatever portion of the distribution was pre-tax and after-tax, it could be split to separate destinations.

> *Example 7c*. Continuing the prior example, if Charlie requested *only* a $30,000 distribution from the account, which is 30% of the total, then the distribution would include only 30% of the after-tax funds (or $6,000) and the remaining $24,000 of the distribution would be pre-tax. At that point, IRS Notice 2014-54 would allow Charlie to send the $6,000 of after-tax funds to the Roth IRA (as a direct conversion) and the $24,000 of pre-tax to a traditional IRA as a rollover.

As the example above illustrates, it's possible to split pre-tax and after-tax funds to go to the desired rollover and Roth IRA accounts, but the after-tax dollars still leave the employer retirement plan on a pro-rata basis. Which means to get *all* the after-tax funds out, it's necessary to liquidate the *entire* account balance. For those who have already separated from service, this is a relatively straightforward liquidation process. However, for those who are still employed, it may not be *possible* to liquidate the entire account for a rollover (and split all the after-tax funds to a Roth conversion), unless the plan document actually permits in-service distributions for the entire account balance.

Planning Tip: It's possible to convert just the after-tax funds of an employer retirement plan. But to convert all the after-tax dollars, it's necessary to roll over the *entire* account balance. Which may not even be permitted for an employee who is still working for the employer sponsoring the plan, unless full in-service distributions are allowed.

However, it's important to bear in mind that rollovers to facilitate the Roth conversion of after-tax funds in an employer retirement plan need to be balanced against other strategies that are negatively impacted by doing a rollover, such as losing the ability to avoid the early withdrawal penalty on 401(k) plan distributions when separating from service after age 55 (but before age 59 ½), and the opportunity to take advantage of the net unrealized appreciation (NUA) rules. Though these scenarios may not be common, they have significant potential impact for those who are eligible, and should at least be coordinated with the overall Roth conversion strategy (e.g., by waiting until after age 59 ½, or carefully considering what to convert, what to roll over, and what employer stock to distribute in-kind).

Days Numbered For After-Tax Roth Conversions?
While the IRS implicitly blessed a version of the backdoor Roth contribution with IRS Notice 2014-54, and has not been very aggressive in enforcing against Backdoor Roth IRA contributions (yet?), shutting down these backdoor Roth rules already appear to be a target in Washington.

In the President's most recent budget proposal issued in the spring of 2016 (for FY2017), there was a specific line-item proposal that would alter the Roth rules and render after-tax dollars ineligible for a Roth conversion. This would immediately "kill" all forms of backdoor Roth contributions, both for IRAs and 401(k) or other employer retirement plans. Retirement accounts with existing after-tax funds would simply have those funds "stuck" in the pre-tax account, subject to the usual pro-rata rules for distribution (and still able to be recovered tax-free), but without any ability to earn future tax-free *growth* on the funds.

While it remains to be seen whether this new rule will be implemented – such proposals can remain in "proposed" status for years, and some never become law at all – it signals nonetheless that shutting down the backdoor Roth rules are on the radar screen, which means their days are likely numbered.

Of course, it's still possible to take advantage of the rules as long as this change hasn't actually been implemented. But those who are contributing after-tax funds to a 401(k) plan but cannot do an in-service distribution, and hope to convert later, should be cognizant that it's possible the option will no longer be available when the time comes. On the other hand, at worst he/she will still have an account that has enjoyed years of tax-*deferred* growth (on that after-tax contribution), which isn't necessarily a bad thing!

The 401(k) Mega Backdoor Roth Contribution

On a prospective basis, perhaps the most interesting aspect of the rules allowing a standalone conversion of after-tax funds in a 401(k) plan is that *it is now more appealing to make after-tax contributions to a 401(k) in the first place, in anticipation of converting them in the future!* In other words, while after-tax contributions to a traditional IRA allow for a backdoor Roth contribution, a 401(k) plan that may allow even larger after-tax contributions can provide for a "mega" backdoor Roth contribution.

In order to do so, though, the employer retirement plan must actually allow for after-tax contributions (which is specified in the plan document). In addition, the employee who wishes to make those contributions must have enough income to contribute (over and above making the initial pre-tax 401(k) contribution), have the available cash flow (recognizing that as after-tax contributions, taxes will still be due on that income being contributed), and the plan must not run afoul of the Actual Contribution Percentage (ACP) test.

Nonetheless, for those who are eligible for and able to make after-tax contributions – ultimately up to the $53,000 (in 2016) maximum contribution to defined contribution plans, after accounting for pre-tax salary deferral and any employer contributions – it may now be appealing to do so, specifically to make a form of "Deferred Roth contribution" where the after-tax funds go in now, and are shifted to the Roth IRA later. For those plans that allow in-service distributions, the employee might even do a full distribution of the account balance *every* year, contributing the maximum (of pre-tax and after-tax funds), and then splitting the distribution into a pre-tax rollover and an after-tax Roth conversion, as a form of ongoing mega backdoor Roth contribution.

Notably, though, the first priority for an employee would still be to maximize their *normal* salary deferral options, either with a pre-tax contribution to the 401(k) plan, or an after-tax contribution to a Roth 401(k) plan, if available (which is better because both the contributions *and growth* are in Roth status immediately). Further after-tax contributions are only relevant *above* the even-more-tax-preferenced salary deferral limits.

Planning Tip: For those who have already maxed out the salary deferral of a 401(k) plan and want to save more, consider a "mega backdoor Roth" contribution of after-tax funds to the 401(k) plan, if the plan permits. Subsequent Roth conversions can be done at retirement or separation from service, or even on an ongoing basis if the plan allows for full in-service distributions every year!

Maximizing The Use Of Low Tax Brackets With Partial Roth Conversions

The virtue of doing a Roth conversion is that once converted, subsequent growth in the account can be spent tax-free as a qualified Roth distribution in the future. The caveat, of course, is that doing the Roth conversion forces the value of the account to be reported as income today, triggering an immediate tax liability. As discussed earlier, this generally comes out ahead when the current tax rate at the time of conversion is lower than what the marginal tax rate would have been in the future if the individual had just held onto the original pre-tax IRA.

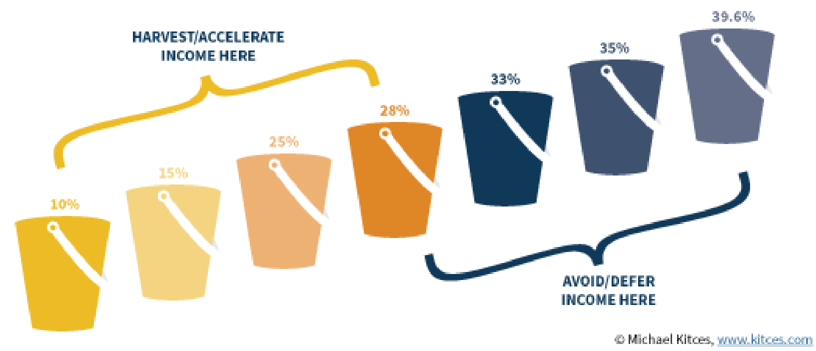
Yet given that a Roth conversion itself *is* income for tax purposes, a large single-year Roth conversion can become self-defeating; because tax brackets are progressive (the higher the income, the higher the tax rate), if enough dollars are converted at once, so much income is created that the taxpayer is driven *into* the top tax brackets now. Which ironically means there really is such a thing as doing "too much" of a Roth conversion, where the effort to create a large tax-free account all at once with a huge conversion drives up tax rates to the point of making it less desirable (or outright destructive!) in the long run to have done so!

> *Example 8a*. Jeremy and Linda's current combined income after deductions is $60,000, putting them in the 15% tax bracket. They have a $500,000 IRA that they are considering whether to convert to a Roth IRA to avoid what is anticipated to be a 28% marginal tax rate in the future when their RMDs begin. If they convert the entire account now, though, their taxable income will be increased to $560,000, driving them up into the top tax bracket of 39.6%. Which means a Roth conversion that may have been appealing initially (converting at 15% to avoid a future 28% rate) becomes very *unappealing* by the end (as the last ~$100,000 crosses into the 39.6% tax bracket today, just to avoid a lower 28% rate in the future!).

Fortunately, though, the reality is that there's no requirement to convert *all* of an IRA at once. The Roth conversion rules simply state that whatever *is* rolled over from a pre-tax retirement account into a Roth is a conversion; it's up to the account owner to decide whether, *or how much*, to convert.

In scenarios where the IRA (or other pre-tax retirement account) is so large that a full conversion would drive up the tax bracket to an untenable level, the alternative of a *partial* Roth conversion suddenly becomes appealing.

Figure 3. Accelerating Income To Fill Lower Tax Bracket Buckets



For instance, while in the earlier scenario converting the entire account would drive the couple's marginal tax rate into the top 39.6% bracket (so high that they probably would have been better off just leaving the money as a pre-tax IRA and spending it in the future at a lower rate), a partial Roth conversion allows them to create just enough income to be subject to the lower tax brackets, while stopping before they reach the upper brackets.

> *Example 8b*. Continuing the prior example, Jeremy and Linda could convert as much as $15,300 and still remain within the 15% tax bracket (which tops out at $75,300 for a married couple in 2016). Alternatively, the couple might choose to convert as much as $91,900, filling up the remainder of the 15% bracket and all of the 25% bracket (which ends at $151,900 for married couples filing jointly), but stopping before they ever actually hit the 28% bracket today. Thus, the couple is avoiding the top tax brackets today, while also converting enough dollars now (at today's 15% and 25% tax rates) to avoid being driving into the 28%+ tax bracket in the future!

Planning Tip: Plan for Roth conversions to be done in small pieces over time, converting just enough each year to fill the lower tax brackets.

The end result of the strategy is that the couple can convert exactly enough to ensure that their IRA is subject to the lower tax brackets today, but *only* those lower and more favorable tax rates. Of course, given that there's only so much room to convert until the higher brackets are reached, this means the bulk of the couple's IRA may remain in pre-tax form. Yet given a multi-year – or even a multi-decade – time horizon before they need to spend/use all the money, this isn't necessarily a problem. *It simply means the couple will repeat the partial Roth conversion systematically each year in the future as well*, continuing to whittle down the size of the pre-tax IRA (and grow the size of the Roth IRA), while ensuring each year that the conversions are modest enough to avoid ever hitting the top tax brackets now, either.

Ultimately, then, the goal of partial Roth conversions is to find a balance, where the converted amount is low enough to avoid top tax rates today, but not so little that the remaining retirement account balance plus compounding growth causes it to be exposed to top tax brackets in the future, either. And the timing is crucial, because the availability of a low tax bracket strategy is effectively a "use it or lose it" scenario, as once the tax year closes there's no way to push income *back* into prior low-income years after the fact. Thus, December 31st becomes a hard deadline for any annual low-tax-bucket-filling savings (and if you're already in top brackets, you may as well just continue to enjoy the tax deferral as long as you can).

Planning Tip: Do enough partial Roth conversions every year to "harvest" income and fill the bottom tax brackets, as any tax bracket buckets that are left empty at the end of the year are permanently lost. However, if income is already high, there's usually no sense in doing a Roth conversion at all; just keep deferring any pre-tax income (and its associated tax liability) to the future, as shown in Figure 3 (above).

Identifying Low Tax Rate Opportunities For Partial Roth Conversions

Clearly, one challenge to the strategy of (partial) Roth conversions is that the benefits are highly dependent on what future marginal tax rates turn out to be, in a world where we don't necessarily know that outcome for certain as of today. Projecting future wealth and known future income streams can be a good starting point for estimating a future marginal tax rate (e.g., what will tax rates be for the retiree who already has Social Security benefits, portfolio interest and dividends, real estate or other passive income sources, and/or Required Minimum Distributions [RMDs]), but clearly some uncertainty remains, not the least because Congress could just outright change the tax laws between now and then (although whether Congress will make tax rates higher or lower in the future is not entirely clear, as discussed in the sidebar to the right!).

Nonetheless, we *can* know what the marginal tax rate will be for *this* year, and in practice there are many situations where that tax bracket is low enough that we can virtually be certain it is favorable compared to almost any likely future.

For instance, if someone experiences a layoff that leaves them without employment income for most of the year, his/her tax bracket may be just 10% or 15%, a rate that's hard to beat in any foreseeable future as long as there's *any* income tax system. In the extreme, if deductible household expenditures (e.g., property taxes, charitable giving, the deductible portion of advisory fees, etc.) continue while there's no income for the year, taxable income could even be *negative*, which means the partial Roth conversion would be *tax-free,* just absorbing the otherwise-unusable deductions (which are permanently lost if not offset and absorbed by other income in the same tax year!).

Similarly, a business owner that experiences a significant (pass-through and otherwise deductible) business loss might have an 'unusually low' income year where a partial Roth conversion can benefit at the low rate. Alternatively, a household that has an unusually large amount of deductions (e.g., for a significant charitable contribution, or perhaps paying a large outstanding state tax liability balance from the prior year?) might also want to apply them against at least a partial Roth conversion.

And notably, because deductions are applied against ordinary income *first* and capital gains second, someone with high *total* income due to capital gains could *still* be eligible for low tax rates on a partial Roth conversion (although this can still phase out the benefits of 0% long-term capital gains tax rates), and/or have their deductions apply favorably to shelter further partial Roth conversions that year.

Planning Tip: 'Unusual' low-income years, such as when there's a layoff or job loss, or there are large deductions (from business losses to a big charitable donation) that occur, can be an excellent time to strategically use a partial Roth

Rising Taxes May Not Burden IRA Tax Rates
With looming Federal budget deficits and a growing national debt, there is a common perception that "at some point" tax rates *must* rise to resolve the issue. Yet the reality is that while Congress may ultimately be compelled to change the laws to increase the total tax *burden* on U.S. citizens, there are many ways this could be accomplished *without* increasing the income tax rates applicable to IRA withdrawals.

For instance, future tax reform could alter the income tax system by eliminating deductions and actually *reducing* tax rates – a formula that has been used numerous times in the past (including, most notably, during the 1980s), and in fact has been the cornerstone of most recent bipartisan tax reform proposals. Of course, the outcome may still increase an individual's total tax *burden*, by eliminating more in deductions than they "get back" via lower tax rates. Nonetheless, numerous proposals to *increase* income tax burdens had top tax rates varying from 25% to 35%, which are *lower* than today's top brackets!

In addition, the reality is that the greatest driver of our long-term fiscal deficits are from the Social Security and Medicare entitlement programs, which are funded primarily from FICA taxes on *wages*, not via the income tax system at all. Which means the most straightforward form of tax increase – to raise FICA tax rates, and/or increase the Social Security wage base – would actually have no impact on the income tax rate applied to future IRA withdrawals.

Furthermore, the U.S. is actually one of the only developed nations in the world that does not have some form of national consumption tax – either a national sales tax, or a value-added tax (similar to a sales tax, but paid by companies when they manufacture goods, rather than at the cash register when those goods are bought). The introduction of a VAT would increase total tax burdens, but wouldn't be associated with higher *income* tax rates on IRAs. (In fact, ironically, a VAT would be an indirect form of taxing a Roth IRA, as the growth would remain *income* tax free, but *spending* that tax-free growth would result in paying value-added taxes instead!)

The bottom line: the mere belief that "taxes must go up" in the future does not mean that income tax rates *on retirement account withdrawals* will be higher in the future. Which means owners of pre-tax retirement accounts like IRAs should be cautious about being too aggressive in doing Roth conversions in top tax brackets today, as it's entirely possible that the top tax bracket of the future could be *lower*, even if the total tax burden rises!

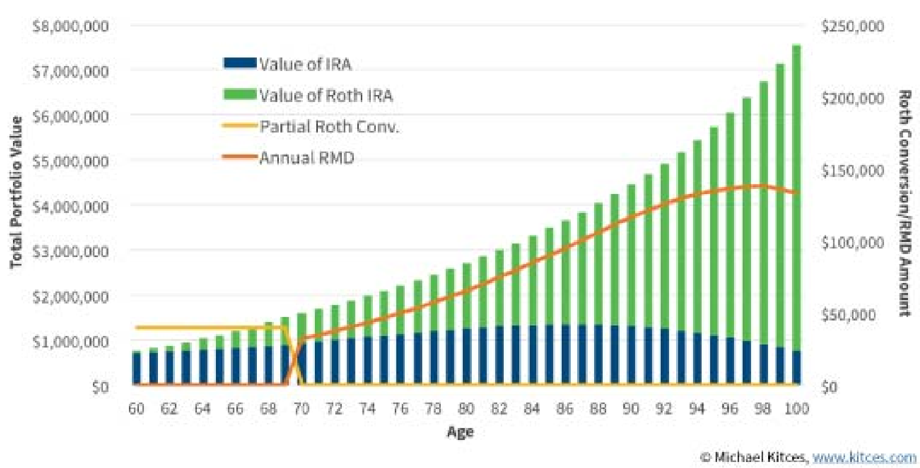
conversion to fill low tax bracket buckets (or even absorb negative taxable income)!

Systematic Partial Roth Conversions In Early Retirement

For those transitioning *into* retirement, the early years after wages and employment income end, but before Required Minimum Distribution (RMD) obligations kick in at age 70 ½, can also be especially appealing for timing partial Roth conversions. For instance, a retiree in their early 60s might do a partial Roth conversion *each* year throughout their 60s, whittling down the size of a pre-tax IRA over time, such that by the time RMDs actually begin at age 70 ½, there isn't much of a pre-tax IRA left!

> *Example 9*. Betsy is a single 60-year-old female who recently retired with a $20,000/year Social Security survivor benefit and a $40,000/year survivorship pension from her deceased husband. Betsy also has a $200,000 brokerage account, and a substantial $700,000 IRA (the combined value of her original IRA, and a spousal rollover from her deceased husband's 401(k)). In a decade, when her RMDs begin, Betsy will face RMDs of upwards of $50,000/year (assuming an 8% growth rate in the IRA between now and then), propelling her into the 28% tax bracket even after her moderate deductions; by her 80s, the RMDs are projected to be more than $100,000/year, topping out the 28% rate and approaching the 33% bracket!
>
> To manage the exposure, Betsy decides to do a partial Roth conversion of $40,000 each year for the next 10 years, which after her deductions just barely fills up her current 25% tax bracket, but stops short of the 28% tax rate. Repeated each year, this gives Betsy the opportunity to significantly whittle down her overall IRA exposure; in fact, at this pace, her pre-tax IRA will still only be about $900,000 by the time her RMDs begin, which will produce RMDs of barely $35,000, allowing her to remain in the 25% tax bracket, as shown in Figure 4 (right)! In the meantime, Betsy will have accumulated a tax-free Roth IRA projected to have grown to over $700,000 by age 70 ½!

Figure 4. Minimizing IRA RMDs With Systematic Partial Roth Conversions



The end result: by doing systematic partial Roth conversions for several years in a row in early retirement, it's possible to remain in (and fully utilize) the lower tax brackets, while avoiding higher tax rates today, and whittling down pre-tax retirement accounts to the point that RMDs won't be subject to higher tax rates in the future, either!

Planning Tip: Use systematic partial Roth conversions to fill the "low income" years after retirement begins and before age 70 ½ when RMDs kick in. Filling the low tax bracket buckets in those years can whittle down a pre-tax IRA to the point that when RMDs begin, the tax bracket remains favorably low!

In addition, it's notable that the strategy of partial Roth conversions works in retirement, even as the retiree is also liquidating those accounts for retirement spending purposes. In fact, the approach aligns well with the "traditional" view that with retirement accounts, it's best to spend down taxable investments (e.g., brokerage accounts) first, while allowing tax-deferred retirement accounts to grow. Except rather than merely allowing those pre-tax IRAs and other retirement accounts to compound to the point of creating a larger tax liability in the future, the retiree can engage in systematic partial Roth conversions of the IRA, even as withdrawals are taken from the available taxable accounts. (See sidebar, next page, for further detail.)

Tax-Efficient Retirement Liquidations Using Partial Roth Conversions
The classic approach to liquidating investment accounts in retirement is fairly straightforward: after-tax "taxable" brokerage accounts should be liquidated first, while retirement accounts like IRAs and 401(k) plans that receive preferential (tax-deferred) treatment should be liquidated last. This allows the retiree to spend down the least tax efficient portion of the portfolio first – the brokerage account with potential capital gains, and annually taxable interest and dividends – while preserving tax-deferral (and the benefits of tax-deferred compounding growth) as long as possible.

For instance, imagine a retiree who has $750,000 in a brokerage account and $750,000 in an IRA, and plans to withdraw $80,000/year from the portfolio (with spending adjusted annually for inflation), on top of other available income sources (e.g., Social Security).

If the IRA is liquidated first, even at an 8% growth rate the retiree quickly spends down the account in less than a decade (as at an average 20% tax rate, it actually takes close to $100,000/year of withdrawals to support $80,000/year of net spending). At that point, the retiree must rely on the brokerage account – which will never grow quite as quickly in the first place, as the annual drag of taxation on interest, dividends, and capital gains will reduce the ability of the account to compound. The portfolio barely makes it to the end of a 30-year time horizon.

By contrast, if the retiree reverses the order, the results are more favorable. By drawing on the brokerage account first – which is growing in a less tax efficient manner anyway, but still takes about 12 years to deplete – and allowing the pre-tax IRA more time to compound, the strategy of spending the brokerage account first and the IRA second allows the portfolio to sustain withdrawals for a longer period of time, retaining a significant remaining balance even after 30 years (while the prior spenddown strategy was nearly depleted by the end of the 30th year).

However, given the dollar amounts involved in this example, if the retiree waited 12 years to tap the IRA at all, and then began liquidations, the inflation-adjusted withdrawals would be so large, it would likely cross over into higher tax brackets, which can actually result in less wealth after the average tax rate on IRA withdrawals rises. And if larger distributions for higher inflation-adjusted spending don't trigger higher tax rates in the future, the onset of RMDs likely will.

Accordingly, a strategy that takes a *split* of the required spending distributions from *each* account annually can actually be more efficient than trying to do all the withdrawals first from either account type. This approach effectively ensures that the lower tax brackets are fully utilized in the early years, whittling down the IRA to reduce exposure to upper tax brackets in the later years as well.

Yet splitting distributions between the taxable account and the IRA is not the only way to fill up the lower tax bracket buckets. As noted earlier, it's also possible to fill the tax brackets in the early years with partial IRA distributions (while doing spending from the original taxable account). And it turns out, spending the taxable account first while doing partial Roth conversions is superior to either of the alternatives – it whittles down the IRA's exposure to higher tax brackets in the future, but does so not by merely spending the IRA earlier, but turning a significant portion of it into *tax-free* Roth dollars instead!

The end result of this approach is that the brokerage account will still be depleted throughout the first half of retirement, but the retiree's tax rate isn't driven up at that time, because spending from that point forward will be sustained by a tax-efficient blend of IRA and Roth IRA distributions. In other words, by engaging in partial Roth conversions, the retiree can have the benefits of the "split" strategy to keep IRA distributions (filling low tax brackets early and avoiding higher brackets later), but done in a manner that still spends down the brokerage account first and allows tax-preferenced IRA and Roth IRA accounts to compound as long as possible.

Ultimately, the combination of taking advantage of lower tax brackets (and avoiding higher brackets) *plus* the additional tax-favored compounding in the traditional and Roth IRA accounts means that spending taxable accounts first, while doing partial Roth conversions of pre-tax retirement accounts along the way, produces greater (net after-tax) wealth than any of the other scenarios.

Using Roth Recharacterizations To Optimally Fill Low Tax Brackets

Unfortunately, one of the biggest challenges in doing a Roth conversion to fill the lower tax brackets is that the IRA owner may not know exactly what income (and deductions) will be until the very end of the year, leaving little or no time to do the calculations and the 'last minute' conversion.

The solution to this challenge is to take advantage of the Roth recharacterization rules, which allow a Roth conversion to be undone in the following tax year (as late as October 15th). Which means those who aren't certain how much *to* convert to fill the bottom tax brackets can simply convert more than enough now, and then recharacterize the excess later!

> *Example 10.* Donald and Donna are retired and have approximately $50,000 of current income and $15,000 of deductions, and want to do a Roth conversion to fill their 15% tax bracket (which ends at $75,300 of taxable income). However, their nearly $1,000,000 portfolio in a taxable account holds several mutual funds that could deliver end-of-year capital gains and dividend distributions, which won't be announced until very late in the year.
>
> To avoid the risk that the portfolio distributions will be small enough to allow room for a Roth conversion, but come so late in the year there's no time to do one, Donald and Donna do a partial Roth conversion, now, of $50,000. This amount is more than sufficient to fill their 15% tax bracket, even if total distributions from their investments turn out to be $0.
>
> After the close of the tax year, it turns out that Donald and Donna have total income of exactly $57,322 and total deductions of $19,137. Their taxable income is $38,185, which means they could have converted exactly $37,115 of their IRA and still remained within the 15% tax bracket.
>
> Accordingly, they recharacterize $12,885 of their $50,000 Roth conversion (plus or minus the pro-rata share of any gains/losses from that $12,885 conversion), which results in a taxable Roth conversion of $50,000 – $12,885 = $37,115, *the exact dollar amount they wanted to convert*, as shown in Figure 5.

Planning Tip: If uncertain how much to convert to a Roth IRA to optimally fill up the low tax bracket buckets, convert more than enough, and recharacterize the excess after the close of the tax year, when all the income and deduction amounts are known for certain!

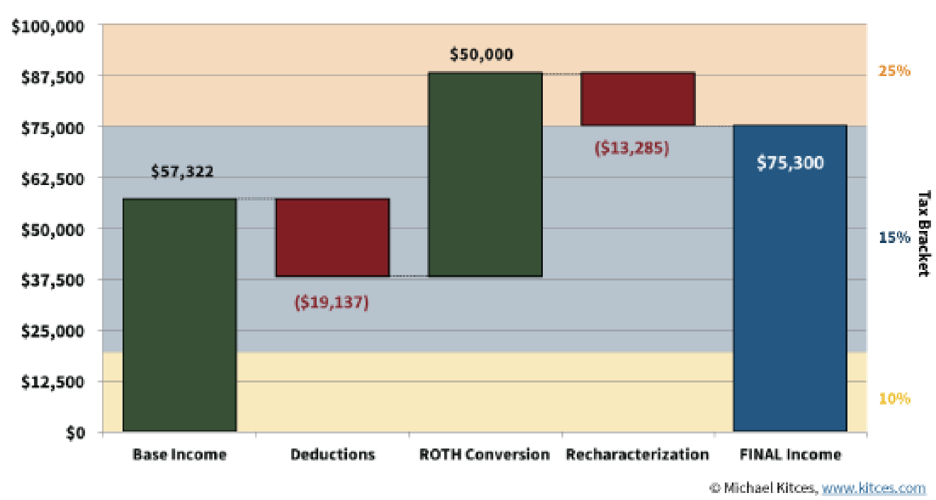
Multiple Accounts Roth Conversion And Recharacterization Strategy

Allocating Gains & Losses With Partial Roth Recharacterizations

One issue to consider when engaging in Roth conversions and potential recharacterizations is that, because time passes between the original conversion and subsequent "undo", the investments in the account may end out with some gains or losses during the intervening time period. And those gains and losses must be considered when doing the recharacterization.

If an entire Roth IRA that was converted is subsequently recharacterized, the process is relatively straightforward: the entire Roth IRA is transferred back to a traditional IRA, since it will implicitly include any gains/losses that occurred during the temporary

Figure 5. Roth Conversion And Partial Recharacterization To Fill Tax Brackets



conversion period, simply by virtue of the fact that it's the entire account.

However, if the recharacterization is only a portion of the account, the rules under Treasury Regulation 1.408A-5 Q&A-2(c)(1) stipulate that the recharacterization must include a pro-rata share of the gains/losses on the *entire* account. This could occur because the Roth conversion was added to an existing account (such that recharacterizing the entire conversion is still only part of the total account), or because the IRA owner is doing a *partial* recharacterization (as it's permitted to recharacterize all, none, or any portion of a Roth conversion).

> *Example 11a.* Jeremy converted $50,000 of XYZ stock from his traditional IRA into his Roth IRA, adding it to an existing $200,000 Roth IRA account balance that's invested in a broad range of assets (bringing the total value up to $250,000). Early next year, Jeremy realizes that the $50,000 of XYZ stock from the Roth conversion has declined 30% (to $35,000), while the rest of the account is up 20% (to $240,000). As a result, Jeremy would like to recharacterize the Roth conversion of the XYZ stock, since it triggered $50,000 of income tax consequences but is now only worth $35,000!
>
> However, Jeremy cannot recharacterize *just* the stock; instead, he must recharacterize a pro-rata share of the *entire* account. And the overall account is up 10% (from $250,000 originally, to $275,000 now), which means Jeremy must recharacterize his original Roth conversion ($50,000) plus 10%, for a total of $55,000. Even though the XYZ stock that was *actually* converted is down to $35,000!
>
> Which means to recharacterize the conversion, Jeremy would have to put back all of the $35,000 XYZ stock, *and* another $20,000 of investments that were originally in the Roth IRA in the first place! Which makes it far less appealing to recharacterize after all!

Separate Account Rules For Roth Recharacterizations

Fortunately, there is a way to avoid the unfavorable result of the preceding example. Under Treasury Regulation 1.408A-5, Q&A-2(c)(4), the pro-rata recharacterization rule only applies to the actual IRA containing the particular Roth conversion dollars to be recharacterized. As a result, if a Roth conversion occurs to a standalone account, only that account – and the associated gains/losses – must be considered when completing a recharacterization. Other Roth IRAs do *not* need to be aggregated together.

> *Example 11b.* Continuing the prior example, if Jeremy had converted the $50,000 of XYZ stock to a standalone second Roth IRA (instead of mixing the money in with the first Roth IRA), then Jeremy would only need to recharacterize $35,000 (the actual value of the entire second Roth IRA containing XYZ stock) to avoid the tax consequences of the original conversion, instead of being forced to recharacterize $55,000. This would allow Jeremy to enjoy the benefits of recharacterization (avoiding $50,000 of conversion income on stock now only worth $35,000) without being forced to shift additional Roth IRA assets back to a traditional IRA just to do so (as occurred in the earlier pro-rata rule example).

In fact, given how much more favorable and flexible it is to recharacterize a particular investment that has gone down in value after a Roth conversion, it arguably should be a standard best practice to always do new Roth conversions to a standalone Roth IRA, if there is *any* chance that there could be a material decline that would trigger a desire to recharacterize. At worst, the second Roth IRA can always be merged back in with the first for simplicity after the time window has passed for recharacterization and it is certain the converted Roth amount will remain in place.

Out and About

- Michael will be a judge at the Orion Fuse FinTech Hackathon in Park City, Utah, on September 10th

- Michael will be presenting at and chairing the XY Planning Network national conference in San Diego on September 19th to 21st

- Michael will also be speaking about "Strategies For Managing Sequence of Return Risk" for the IMCA Wealth Management conference in Chicago on September 29th

Interested in booking Michael for your own conference or live training event? Contact him directly at ***speaking@kitces.com***, see his calendar at www.kitces.com/schedule, or check out his list of available sessions at www.kitces.com/presentations.

Planning Tip: Do Roth conversions into separate, standalone Roth IRAs, to maintain the flexibility to recharacterize *that* conversion if the investments decline in value before the deadline. The separate Roth accounts can always be merged later, after the recharacterization window is over (or it's otherwise been decided that the original Roth conversion will remain intact).

Diversifying A Roth Conversion Across Multiple Accounts For Potential Recharacterization

While the "separate account" rule for Roth recharacterizations is really just an acknowledgement that each Roth account can be recharacterized on its own (without being aggregated), in practice the rules also allow for a more proactive Roth conversion strategy: where multiple Roth conversion accounts are deliberately created, just so the IRA owner can "cherry pick" which investments to recharacterize!

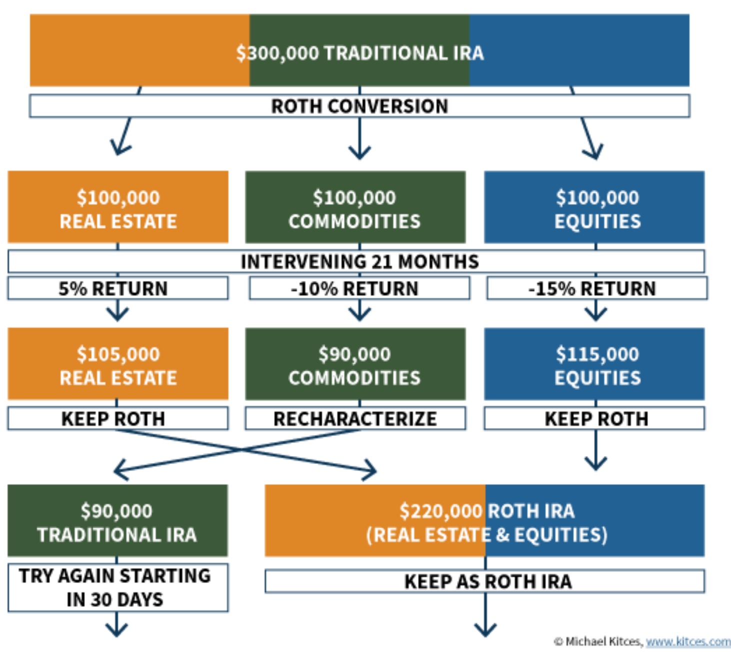
> *Example 12*. Harold plans to convert $300,000 of various investments in his traditional IRA, which is comprised equally of real estate (in the form of a REIT), a commodities fund, and various equities. Rather than transfer the $300,000 of investments into an existing Roth IRA, or "just" into a standalone $300,000 Roth IRA, Harold can instead create three new $100,000 Roth IRAs, one for the REIT, another for the commodities, and a last for the equities.
>
> If Harold completes these conversions at the beginning of the year in January, he can wait upwards of 21 months (until early October of next year) to decide whether to recharacterize any of them. If after the time interval, the equities are up 15%, the real estate is up 5%, and the commodities are down 10%, Harold can "cherry pick" to keep the converted equities and real estate in place, but recharacterize the now-worth-$90,000 commodities allocation. And because each investment is held individually in its own Roth IRA, Harold can recharacterize *just* the $90,000 commodities account, and doesn't need to allocate the gains/losses of the other asset classes, as shown in Figure 6 (below).

The essence of the convert-multiple-asset-classes-into-multiple-Roth-IRAs is the opportunity to cherry pick, one asset class/investment at a time, which will be kept as a Roth (because the investment is up) and which will be recharacterized (because the investment is down). Notably, though, the strategy only works by converting into *multiple* accounts; if multiple investments are converted into a single Roth IRA, then all the investments within that account share in the pro-rata rule when determining gains/losses associated with the recharacterization, and it's not possible to selectively choose which investments to keep and which to recharacterize.

Planning Tip: To be able to selectively recharacterize the investments that go down after a Roth conversion (but before the recharacterization deadline), be certain to convert each investment into its *own* standalone Roth IRA account!

One important caveat of this strategy is that if the individual who recharacterizes wants to try again to *re-convert* (e.g., the commodities that were recharacterized in example 12), it's necessary to wait until the later of the tax year after the conversion, or 30 days after the recharacterization. Thus, in the earlier example, if the original conversion was January 2016 and the recharacterization occurred at the October 15th deadline in 2017, the new re-conversion couldn't occur until November 15th of 2017 (which could then remain invested for 11 months until the next recharacterization deadline on October 15th of 2018).

Figure 6. Splitting Multiple Roth Conversions For Separate Account Recharacterization



An alternative version of the multiple accounts strategy is to deliberately do multiple Roth conversions, all for the full amount of the intended Roth conversion, with the plan to simply keep whichever performs the best, and to recharacterize the rest. In this case, the point isn't to keep what goes up as a Roth conversion and recharacterize the losers, but to convert multiple potential winners and keep the one that generates the absolute best performance by the deadline, as shown in Figure 7 and explained below.

> *Example 14.* Christopher is a recent retiree who plans to do a $75,000 Roth conversion to fill his 15% and 25% tax brackets, carved out of a much-larger $800,000 IRA. Rather than just doing a single $75,000 Roth conversion, though, Christopher does three conversions for $75,000 each (a total of $225,000). The first $75,000 goes into one Roth IRA and is fully invested in the S&P 500. The second $75,000 goes into another Roth IRA and is fully invested in the Russell 2000. The last $75,000 goes into a third Roth IRA and is solely invested into international stocks. (Presuming that these were investment allocations that Christopher already held and wanted to own.)
>
> Next year, as the Roth recharacterization deadline approaches, it turns out that the S&P 500 is up 7%, the Russell 2000 is up 18%, and the international investments are up 11%. Accordingly, Christopher recharacterizes the first and third accounts (with the S&P 500 and international stocks), and keeps the third Roth IRA with Russell 2000, ensuring that his Roth conversion ends out with the investment that performed the best. Assuming Christopher converted in January of 2016, he would have had nearly 21 months – until next October of 2017 – to *see* which investment or asset class actually did perform the best and decide which to keep.

In practice, there is some hassle to maintaining multiple Roth conversion accounts, from the administrative effort to create and fund via in-kind transfers the multiple Roth IRAs, to the need to plan for and manage the recharacterizations, and the likely need to get an extension on the tax return (since the IRA owner won't know the "final" numbers for tax reporting until all the recharacterizations have been completed). As a result, the multiple accounts strategy probably won't be appealing until/unless the Roth conversion is a "sizable" amount. Nonetheless, anyone who is willing to manage the Roth conversion and recharacterization process, and open up and track the multiple accounts, can do so. However, it is crucial to remember that the strategy works best when each IRA holds substantively different investments, so it's *possible* for one account to materially outperform another in the first place!

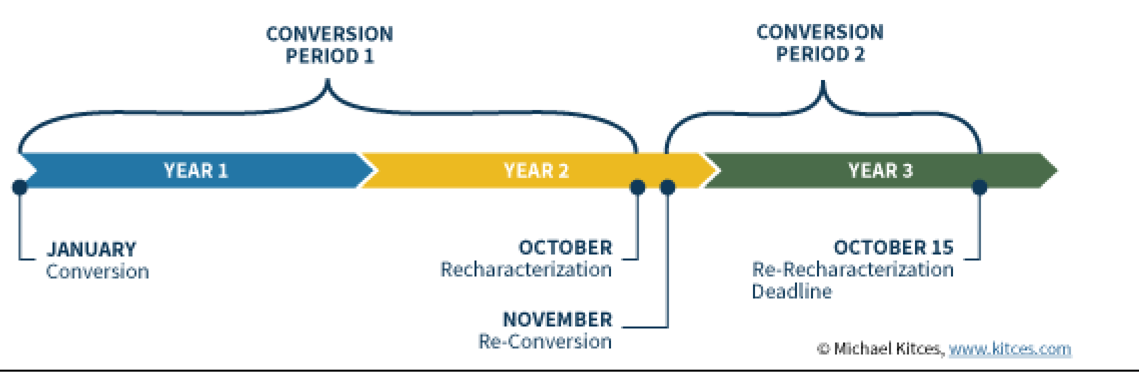
Planning Tip: When planning a sizable partial Roth conversion, do *several* conversions of the full dollar amount (if there is sufficient wealth to do so!), each into a separate Roth IRA, invested into different asset classes. Then at the Roth recharacterization deadline, keep the one Roth conversion account that had the best performing investing, and recharacterize the rest.

Satisfying The 5-Year Rule For Tax-Free Qualified Roth Distributions

A key assumption for virtually all of the Roth contribution and conversion strategies discussed thus far is that when it comes time to take distributions, the Roth account will enjoy its coveted tax-free treatment. However, in reality not all distributions from a Roth IRA are automatically tax-free.

While original after-tax contributions can always be recovered tax-free, the *growth* in a Roth IRA is only

Figure 7. Roth Conversion, Recharacterization, Re-Conversion, & Re-Recharacterization Deadlines



tax-free if it is a "qualified withdrawal", meeting two specific requirements under IRC Section 408A(d)(2):

1) The payment must be made:
- On/after the date the owner attains age 59 ½
- Made to a beneficiary after the death of the account owner
- To a (totally) disabled individual (as defined under IRC Section 72(m)(7))
- For a first-time homebuyer (as defined in IRC Section 72(t)(2)(F))

2) A 5-year rule must be satisfied

While satisfying the first test is relatively straightforward, the requirements of the 5-year rule are somewhat more complex.

The 5-year rule states that five *tax years* must pass from when the first contribution is made to (any) Roth IRA, after which a qualified (tax-free) distribution can be made. Because the measurement is based on *tax* years, this means that a contribution to a Roth IRA as late as April 15 of 2017 will still count as a contribution for the 2016 tax year (in essence, it counts as though the contribution was made January 1st of 2016), which means the first year of a potential qualified distribution would be 2021 (because the five years that passed would have been 2016, 2017, 2018, 2019, and 2020). Notably, this means that a "5-year" qualified distribution could actually be satisfied in as little as 3 years and 8 months of money actually being in the account, as a contribution on April 14 of 2017 (made in 2017 but for 2016) would allow for tax-free distributions as early as January 1st of 2021.

Under Treasury Regulation 1.408A-6, Q&A-2, for the purposes of this 5-year rule, the clock starts the first time any money is funded into *any* Roth IRA, whether by contribution or conversion. There is not a new 5-year clock for each Roth contribution, nor for each Roth account that is held. All Roth IRAs (but not Roth 401(k)s, see sidebar) are aggregated together to determine whether the 5-year rule is met for any/all of them (which indirectly means that rollovers from one Roth IRA to another do not change or reset the 5-year requirement). Funds rolled into an existing Roth IRA from an employer retirement plan (including from a Roth employer retirement plan) continue to use the 5-year rule as already determined for that Roth IRA.

The fact that the 5-year requirements are aggregated across IRAs effectively means that once the 5-year rule has been satisfied a single time for a taxpayer (i.e., if you've already had a Roth for at least 5 tax years), it's been satisfied for good (though remember that the other part of the test – being age 59 ½, deceased, disabled, or using the distribution for a first-time homebuyer exception – must *also* be satisfied).

Nonetheless, the fact that the 5-year rule effectively must just be satisfied once, ever, for all Roth IRAs, means that *recent* contributions (or rollovers from a Roth employer retirement plan, or Roth conversions) may actually be eligible for withdrawal as a qualified distribution even if they've been in the account for less

Special Application Of The 5-Year Rule For Roth Employer Retirement Plans

In the case of a Designated Roth Account under a 401(k) or other employer retirement plan, the 5-year rule again applies to determine eligibility for a qualified distribution. *However*, under Treasury Regulation 1.402A-1, Q&A-4(b), the 5-year rule for an employer retirement plan is counted *separately* from the 5-year rule for any/all Roth IRAs. Thus, even if the 5-year rule has already been satisfied for qualified distributions from a Roth IRA, a Roth 401(k) still has to satisfy its own 5-year period.

In addition, where someone has multiple Roth accounts under multiple employer retirement plans, *each* employer plan is subject to its *own* 5-year rule. If one Roth employer retirement plan is directly rolled into another – e.g., if the balance of one Roth 401(k) is rolled into another Roth 401(k) – then under Treasury Regulation 1.402A-1, Q&A-4, the 5-year period is based on whichever plan has been around *longer* (the original plan or the new one being rolled in to). Thus, once a designated Roth account under an employer retirement plan has satisfied the 5-year rule, it can continue to be satisfied with a new designated Roth account as accounts are merged together.

On the other hand, when a designated Roth account from an employer retirement plan is rolled into a Roth IRA, *the years in the Roth employer plan* **do not** *count towards the Roth IRA.* Instead, under Treasury Regulation 1.408A-10, Q&A-4(a), for a Roth IRA it's the *original* 5-year rule for that Roth IRA that counts.

And if there was no existing Roth IRA and the rollover from the Roth 401(k) creates the account for the first time, that starts a new 5-year clock for the IRA, *even if* the 'old' Roth 401(k) had satisfied its own 5-year rule. Again, any years in the Roth 401(k) (or other Roth employer retirement plan) do *not* carry over and get tacked onto the Roth IRA.

than 5 years, as long as the taxpayer has already met the 5-year requirement with respect to any Roth IRA. On the other hand, the 5-year rule for an individual's Roth IRAs even transcends his/her death; if the 5-year rule hasn't been satisfied, the beneficiary cannot withdraw the growth from an *inherited* Roth IRA and receive tax-free treatment (as the distribution *would* be after death, but would *not* have met the 5-year rule, and *both* tests for qualified Roth distributions must be satisfied)!

As noted earlier, to start the clock for the 5-year period (so it can be satisfied once and forever), the Roth IRA owner simply needs to have created any Roth IRA, and funded it with an actual contribution or conversion (for any amount).

Planning Tip: For any individual who does not have a Roth IRA, create one, even with just a nominal dollar amount, to start the 5-year clock. Fund the account with a Roth IRA contribution if permitted, or a small Roth conversion, if necessary (particularly for those whose income was too high to ever create a Roth IRA, prior to the conversion income limits being repealed in 2010). Remember to do one for each member of a married couple, as a husband and wife must each separately satisfy the 5-year rule for their own Roth accounts.

It's important to bear in mind, though, that Roth conversions have their own (second) 5-year rule which applies, just to Roth conversions, in determining whether the *principal* will be *penalty-free* (as opposed to the main Roth IRA 5-year rule, which determines whether *growth* is *tax-free*).

Conclusion

In the end, the rules for tax-preferenced retirement accounts – including the ability to convert from a traditional IRA (or other employer retirement plan) to a Roth IRA at any time – provide incredible flexibility to maximize wealth over time. By deliberately triggering the income tax consequences of a pre-tax retirement account when tax rates are low, it is possible to minimize an individual's lifetime average tax rate, which can result in significantly more spendable wealth over time. And the opportunity is even more appealing in scenarios where the conversion won't even *be* taxable, because it's a conversion of after-tax dollars in the first place. (At least, as long as Congress permits such conversions to continue!)

In turn, the rules for Roth recharacterizations allow for even more flexibility to ensure that a Roth conversion is off to a good start, with the ability to "undo" a Roth conversion that declines in value in its first year (by the recharacterization deadline). Or, an IRA owner can do multiple Roth conversions into separate accounts for more than is necessary or desirable to convert, with the upfront intention of recharacterizing all except the very best performer.

Of course, to truly maximize the value of a Roth IRA, it's not just about getting money into the account at the lowest possible tax cost. It's also necessary to actually grow the account – which means for asset location purposes, the Roth IRA should have the investments with the highest expected return (which may also be the most volatile), to create the most tax-free upside potential for all the Roth dollars that are available!

Planning Tip: Be certain the Roth IRA dollars are allocated to the most aggressive investments with the highest expected return, to generate the maximal opportunity for tax-free growth! If there are multiple choices with favorable expected returns, use the one that is the *least* tax efficient, to further maximize the household's overall asset location!

Unfortunately, the reality is that some Roth maximization tactics may eventually be limited by future Acts of Congress, and several crackdowns have already been proposed. Nonetheless, as long as the current rules remain in place, then in the words of the famous Judge Learned Hand: "Any one may so arrange his affairs that his taxes shall be as low as possible..." Provided, of course, that the advisor is ready to help make such arrangements!