



CASE OF THE WEEK

Income Acceleration for Converted Roth Amounts Distributed Before 2012

Our ERISA consultants on the Columbia Management Learning Center Resource Desk regularly receive calls from financial advisors on a broad array of technical topics related to IRAs and qualified retirement plans. For example, through our relationship with the Columbia Management Learning Center, we routinely guide Columbia Management's financial advisor partners through the IRS rules and regulations that govern Roth IRA conversions.

A recent call with a Merrill Lynch advisor in Alabama is representative of a common scenario involving distributions of converted amounts following a 2010 Roth IRA conversion. The advisor asked:

For distributions occurring before 2012, what are the tax consequences of taking a Roth IRA distribution of an amount that was converted to the Roth IRA in 2010 if the IRA owner elected to include the converted amount in income over 2011 and 2012?

Highlights of Recommendations

- Generally, pretax dollars converted from a traditional IRA to a Roth IRA will be considered taxable income for the year of the conversion.
- A special rule applies for 2010 conversions as a result of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). In addition to eliminating the eligibility criteria for completing conversions (i.e., now anyone with convertible assets may convert them to a Roth IRA), TIPRA contained a special provision allowing individuals who convert amounts to Roth IRAs in 2010 the option of including the taxable amount in income over a two-year period (i.e., 2011 and 2012).
- To prevent abuse of the two-year taxable income spread, TIPRA also contains an "income acceleration" provision where the income included in the second year (i.e., 2012) would be reduced for any amount that was converted in 2010 then subsequently distributed prior to January 1, 2012. Ultimately, the amount of the conversion included as income for 2012 would be reduced by any conversion amounts distributed during 2010 and 2011, since the Roth IRA owner would be required to include those withdrawals in income for the year they were distributed.
- The 10 percent early withdrawal penalty does not apply at the time of conversion; however, it would apply to converted amounts withdrawn within five years of the conversion, unless an exception applies.
- Roth IRAs are subject to distribution ordering rules which treat contributory dollars as distributed first, conversion dollars as distributed second and earnings as distributed last.
- Columbia Management Learning Center has a series of client-approved Fast Facts available that shed light upon the most misunderstood aspects of Roth conversions.

- Income Acceleration EXAMPLE:

Tom, age 40, converts \$25,000 of his traditional IRA to his first-ever Roth IRA during 2010, and elects to include the taxable amount in income over two years. As a result, \$12,500 will be considered income for 2011 and \$12,500 will be considered income for 2012.

Tom then distributes \$5,000 of the converted amount during 2010. Consequently, the income acceleration rules apply, requiring Tom to include \$5,000 in income for 2010 and pay a 10% early withdrawal penalty on the amount.

In 2011, Tom takes another \$5,000 from his Roth IRA. Again, the income acceleration rules come into play, requiring Tom to include \$17,500 in income for 2011 (\$12,500 of the original converted amount + the \$5,000 withdrawal).

Finally, for 2012, the amount Tom would include in income is the lesser of

- 1) \$12,500** (half the original taxable conversion amount) **or**
- 2) \$2,500** [the converted amount (\$25,000) – the amount distributed in 2010 (\$5,000) – the amount distributed in 2011 (\$5,000) – the converted amount included in income in 2011 (\$12,500)].

A summary of Tom's tax consequences follows.

- 2010 - \$5,000 included as income, plus a 10% early withdrawal penalty tax on \$5,000
- 2011 - \$17,500 included as income, plus a 10% early withdrawal penalty tax on \$5,000
- 2012 - \$2,500 included as income

Conclusion

Those who complete Roth IRA conversions in 2010 and opt for the two-year spread of conversion income may want to think twice about withdrawing any of those converted amounts before 2012 as they will have to deal with the income acceleration rules, and a potential early withdrawal penalty. The income acceleration rules are a complicated tax matter best left to investors and their tax advisors. But financial advisors who can demonstrate their knowledge of these rules set themselves apart from the average advisor and, thereby, win more clients. As always, the Columbia Management Learning Center is available to help.