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Funding Roth Conversions: Using Nondeductible Contributions*

Robert S. Balter, J. D., LL.M. (Tax)

To say that there is a lot of discussion about Roth IRA conversions lately is an understatement, and I do not intend to repeat those discussions here. What I do intend to do is describe a technique that can be used in conjunction with the Roth IRA conversion and that, for some clients, may enhance that opportunity.

Many IRAs have, since 1987, received nondeductible contributions. Dealing with these nondeductible contributions generally adds complexity to the administration of the IRA because of "the cream in the coffee rule" of Internal Revenue Code § 408(d)(2) referring to IRC §§ 72(e)(2)(B), 72(e)(5)(A), 72(e)(5)(D)(iii) and 72(e)(8)(B).[1] Taken together, these rules require the aggregation of all traditional IRAs in determining what portion of an IRA distribution is a return of nondeductible contributions and therefore tax free, and what portion is a normal IRA distribution and therefore taxable as ordinary income. These rules also apply on conversion of a traditional IRA to a Roth IRA under United States Treasury Department Regulations § 1.408A-4, A-7(a).

While generally the "cream" (the basis) is taxable proportionately from the "coffee" (the distribution) under IRC § 408(d)(2), there is a way to separate them when the client is also a participant in a qualified plan or an IRC § 403(b) plan. A rollover from the IRA to the qualified or 403(b) plan will be treated as coming first from the taxable portion of the IRA under IRC § 408(d)(3)(H)(ii) because the non-taxable portion is not eligible for rollover.

Consider a rollover of an amount equal to the excess of the IRA balance over the nondeductible contributions, allowing only the nondeductible contributions to remain in the IRA.

This provides at least two opportunities. The first is a tax-free Roth conversion of the nondeductible contributions, and the second is a tax-free source of funds from which to pay the tax on the conversion of part or all of the qualified plan to a Roth IRA.

How much is involved? If a client contributed the maximum permitted nondeductible contribution every year from 1987 to 2002, he would have contributed a total of $32,000. From that point forward, the over 50-under 50 rules cloud things bit, but assuming the client was over 50 in 2002, the maximum aggregate contributions would be $10,500 (2002, 2003, and 2004 at $3,500 each)+$4,500 (2005)+$10,000 (2006 and 2007 at $5,000 each)+$12,000 (2008 and 2009 at $6,000 each) for a total of $69,000. A person under 50 throughout would have maximum contributions of $63,000.

By rolling the IRA over to the qualified plan so that only the nondeductible contributions are left in the IRA, the first opportunity is to simply convert the nondeductible contributions to a Roth IRA tax free!

A second option after the rollover is to withdraw the nondeductible contributions on a tax free basis, generating funds with which to pay the tax on the Roth IRA conversion from the qualified plan under Section 824 of the Pension Protection Act of 2006 and Notices 2008-30 and 2009-75.[2] Distributions from an IRA having only nondeductible contributions are tax free under IRC § 72(b)(2). Be careful that other IRAs do not exist or are combined first because IRC § 408(d)(2)(A) combines all IRAs into one for purposes of allocating deductible and nondeductible contributions.

The maximum nondeductible contributions would support paying tax immediately on conversions of about $200,000.

Note that this is not the optimal plan. The optimal plan is to pay the tax on the Roth conversion from funds outside the plan, thus permitting the nondeductible contributions to continue to generate earnings inside the converted IRA, earnings that will be tax exempt inside the Roth IRA.

But this technique is well suited to clients who are older and who may lack funds outside of the IRA with which to pay the tax. After all, if the older client doesn't convert for lack of outside funds with which to pay the conversion tax, amounts equal to the nondeductible contributions will likely be required to be withdrawn by the required minimum distribution rules in fairly short order, limiting the deferrals from that amount anyway. But there will be no required minimum distributions during the participant's lifetime from a Roth IRA.

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P.O. Box 579 Moorestown, NJ 08057-0579 • 856-234-0330 • Fax 856-727-9504 • www.philaepc.org

The benefit of this technique is to separate the tax-free from the taxable, allowing the Roth conversion to proceed more efficiently if your client only wishes to convert part of his or her IRA and that part of the IRA exceeds the total of the non-deductible contributions and the portion to be converted. Another benefit is the elimination of the complex application of the "cream in the coffee rule." Also, if the IRA owner is under 59 1/2, the 10% penalty may apply to a portion of the distribution used to pay taxes if this strategy is not utilized.

Robert S. Balter is a very versatile tax attorney with broad and deep experience in planning for high and ultra high net worth clients, with special expertise in life insurance planning and fiduciary income taxes. He holds an LL.M. in Tax from Temple University's Beasley School of Law, graduated from University of Pennsylvania undergraduate and from Pitt Law, and has written about a dozen peer reviewed articles on estate planning issues for national law journals, one of which was cited in the Petition for Certiorari in Knight v. Commissioner, 552 US – (2008).

Footnote:

** This concept was originally discussed by this author in Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter Message #521 (30-Mar-2010) who has graciously consented to this discussion.*

1 This phrase seems to have been originally coined by Ed Slott. See N. Choate, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS ¶2.1.10.

2 These Notices reflect elimination of limitations on making Roth conversions from plans other than IRAs.