Advanced tax strategies using a Roth IRA conversion

The Roth IRA can act as an effective hedge against the prospect of rising tax rates in the future. This piece presents five strategies for talking to clients in a variety of financial situations about the benefits of a Roth IRA conversion.

1. Talk to small business owners about how to transform NOLs into tax-free income with a Roth IRA conversion

Small-business owners who will record a net operating loss (or "NOL") this year may be able to use the loss to their advantage. There are two options for using NOLs to offset income: "Carrybacks" allow NOLs to be applied to income earned in previous tax years, while "carryforwards" can be applied toward future tax returns for up to 20 years. Unlike net capital losses, where taxpayers are limited to only $3,000 annually to offset any ordinary income, there is no limit on how much of an NOL can be used to offset ordinary income. Clients carrying forward large NOLs can use those losses to offset the additional income from a Roth IRA conversion. In some cases, clients may be able to establish Roth IRAs without paying any additional taxes. The rules on calculating and utilizing NOLs are complicated, so it is critical for clients to consult with a qualified tax professional. If you have not done so already, forming strategic relationships with local CPAs who can assist business owners with these types of transactions is a good idea. Such relationships can also potentially lead to referrals for retirement and other investment business opportunities. More information on NOLs can be found within IRS publication 536, "Net Operating Losses for Individuals, Estates and Trusts."

Example

The illustration below makes the following assumptions:

- John is a sole proprietor, married, with two children
- He has a SEP IRA valued at $200,000
- Due to investments within the business and a poor economic environment, business losses total $150,000
- His wife earns $75,000 annually
- They report an additional $5,000 in income from interest and dividends
- Non-business deductions total $35,000 (itemized deduction + personal exemptions)

Simplified NOL calculation

Income		
Spousal wages	$	75,000
Interest and dividends	$	5,000
Total income	**$**	**80,000**

Deductions		
Net business losses (itemized deductions and personal deductions not allowed in NOL calculation)		($150,000)
NOL for tax year		**($70,000)**
Income from Roth IRA conversion	$	70,000
Net taxable income	**$**	**0**

End result: John is able to convert $70,000 of his SEP IRA to a Roth without tax consequences.

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2. **Clients can use losses on annuity contracts or 529s to offset Roth IRA conversion income**

With all the recent market volatility, you may have clients who own variable annuities or 529s whose current value is significantly lower than the purchase price. One option is to surrender the annuity contract, in which case the remaining principal is returned to the investor, minus any surrender charges. The loss on the contract (which excludes the surrender charge) is considered an ordinary loss, not a capital loss, which is capped at $3,000 a year. This ordinary loss may be used to offset the income reported on a Roth IRA conversion. Keep in mind that complex rules exist on whether to claim the loss as a miscellaneous 2% deduction, so be sure to consult with a tax professional. See the sidebar for more information on reporting losses on annuities.

The same principle can apply to 529 savings programs as well. In order to claim a tax loss on a 529, the entire account (as defined by same state, same account owner, and same beneficiary) must be liquidated. In order to avoid a 529 rollover that would negate the tax loss, you have to wait more than 60 days before reinvesting in another 529 program. Lastly, a loss from a 529 would be considered a miscellaneous 2% deduction, which means that any loss that exceeds 2% of adjusted gross income (AGI) can be used to offset ordinary income such as income generated from a Roth IRA conversion. There are potential gifting consequences of liquidating a 529 and subsequently reinvesting into another 529 program, so it is best to consult with an attorney specializing in estate planning. Also, there may be adverse state income tax consequences of liquidating a 529 savings program, so clients should consult with a local tax professional.

Options for reporting losses from annuity contracts on the federal income tax return

Since federal tax law is unclear, tax experts differ on how to claim a tax deduction for losses from the sale of an annuity contract. Two different approaches are highlighted below. Clients should consult with their tax professional for guidance on their particular situation.

1 CONSERVATIVE APPROACH

Report the loss as a miscellaneous 2% deduction

The loss would be reported on line 23 of Schedule A (IRS Form 1040) — Itemized Deductions. Miscellaneous 2% deductions are aggregated and reduced by 2% of the taxpayer's AGI. Also, a taxpayer subject to the alternative minimum tax (AMT) loses the opportunity to benefit from these types of deductions.

2 MORE AGGRESSIVE APPROACH

Report as an ordinary loss not subject to 2% limitation

In this case, the loss would be reported on line 14 of IRS Form 1040 — Other gains or (losses). Unlike a miscellaneous 2% deduction, ordinary losses are not disallowed under the AMT system. Some tax preparers cite a 1961 IRS revenue ruling (61-201) as precedent for this approach, but it is important to note that miscellaneous 2% deductions did not exist at the time of the revenue ruling.

3. **Time clients' charitable contributions with Roth IRA conversions**

Philanthropic clients who are considering a significant charitable contribution are limited to how much of a tax deduction they can claim based on a number of factors. The most important is your clients' income level. Gifts of up to a maximum of 50% of clients' adjusted gross income can be deducted in any one tax year, but that limit could be significantly lower depending on the type of gift (e.g., cash, stock, property) and the type of charity receiving it (one that benefits the general public versus one with a limited purpose). If the gift exceeds the limit, your clients may be forced to carry over a tax deduction for charitable contribution into future tax years, limited to five years. A Roth IRA conversion can generate additional income for your clients and allow them to make the full charitable deduction in the same tax year.

Example

Let's consider a hypothetical example to see how clients may benefit from a Roth IRA conversion in this situation.

AGI	$250,000
Stock gifted to charity	$ 105,000
Maximum allowable deduction (30% of AGI)	$ 75,000
Charitable carryover **without Roth conversion**	**$ 30,000**

AGI including $100,000 Roth conversion	$350,000
Stock gifted to charity	$ 105,000
Maximum allowable deduction (30% of AGI)	$ 105,000
Charitable carryover **with Roth conversion**	**$ 0**

In this example, the client is gifting appreciated stock (capital gain property) to a public charity, resulting in a 30% deduction of AGI. Assuming no other charitable gifts in the year, the maximum deduction the client can claim on the tax form is 30% of AGI or $75,000. Since the amount of the charitable gift ($105,000) exceeds the amount of the maximum charitable deduction ($75,000) allowed for that year, the excess charitable deduction ($30,000) must be carried forward to future tax years. This can be done for a maximum of five years.

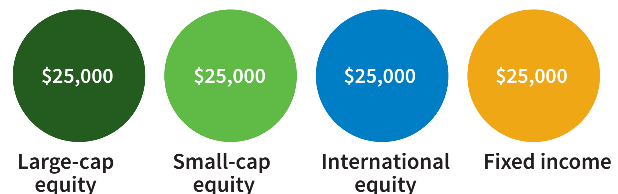
In this situation, a client interested in the benefits of a Roth IRA may want to consider a conversion to increase income and enable the entire amount of the charitable gift to be deducted on taxes during that year. This results in the elimination of the charitable deduction carryover. Taxpayers should consult with a tax professional to learn if this strategy makes sense based on their personal circumstances. IRS Publication 526, "Charitable Contributions," includes detailed information on this topic.

4. Establish separate Roth IRA conversion accounts for "smart" recharacterization

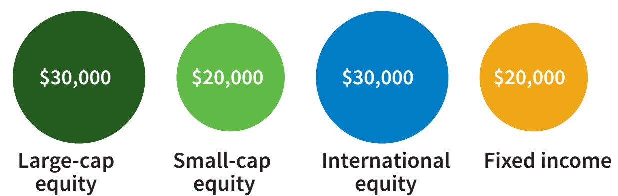
Roth IRA recharacterization is a rule that essentially allows clients to undo a conversion from a Traditional IRA or other retirement account to a Roth IRA. Clients have until the tax-filing deadline (generally April 15) or the maximum extension if applicable (generally October 15) to reverse the transaction and place the assets back into a Traditional IRA as if the conversion had never taken place.

There are several instances when recharacterizing (i.e., "undoing") a Roth IRA conversion may make sense. One is simply that the account owner realizes after the fact that the extra income generated from the conversion will be too much of a tax burden. Another instance relates to markets. For example, suppose an investor who converted $100,000 to a Roth IRA subsequently sees a sharp decline in its account market value to $80,000 prior to the investor's tax-filing deadline. In this case, it might make sense to recharacterize to avoid reporting $100,000 of income (value of IRA account at point of conversion) for an account that is now worth only $80,000. The account owner benefits from the flexibility of undoing the Roth IRA conversion after the fact given current circumstances. Consider how this simple strategy can be expanded strategically to maximize the flexibility of the recharacterization option. Instead of converting a $100,000 Traditional IRA to one Roth IRA, establish multiple Roth IRA accounts based on different investment objectives.

Example



It is likely that some of these asset classes may appreciate and some may depreciate from the time of the conversion up to the tax-filing deadline:



Because separate accounts are established, the client could opt to keep the large-cap and international equity conversions in place while recharacterizing the small-cap equity and fixed-income accounts. The end result would be $50,000 in income reported on the tax return from the conversion for Roth IRAs currently worth a total of $60,000 (a current tax-free gain of $15,000). Converting to one Roth IRA does not allow the flexibility of recharacterizing based on the market activity of a specific asset class.

Of course, the amount of additional paperwork and potential IRA custody fees will be a factor on whether to employ this type of strategy, and if so, how many separate Roth IRA conversion accounts to establish.

5. High-income clients paying the AMT could convert at a lower rate

Clients who are high-income earners and, because of substantial deductions and exemptions, find themselves subject to the AMT may wish to consider a Roth IRA conversion. The additional income generated by converting retirement assets to a Roth IRA may be taxed at either the 26% or 28% AMT rate, which could represent a significant tax savings if the client is typically in either the 33%, 35%, or 39.6% federal income tax bracket. If paying AMT rates is inevitable for certain clients, converting to a tax-free Roth IRA this year may be a smart move. Be sure to consult a tax professional before converting assets: Adding too much income will eventually push the client out of the AMT bracket and would subject the converted retirement assets to higher ordinary income tax rates.

AMT brackets

AMT income	Tax rate
$0 – $187,800	26%
Over $187,800	28%

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