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Crash Course on IRA Rollovers

By Elaine Floyd, CFP

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IRA rollovers are very good business for advisors because they bring in lots of assets and allow you to make a real difference for clients.

They often serve as a turning point for clients who have been handling the accumulation phase of retirement planning just fine, but when faced with a lump sum larger than anything they've seen before in their lives, suddenly need help.

It's not as if they won't receive plenty of offers for help. The Fidelities and Vanguards of the world who are providing the investments for their 401(k) plan would be more than happy to hang onto those assets and roll them right over into an IRA. Advisors have somewhat of an uphill battle in getting clients to take action because the big 401k providers assure retiring employees that they will take care of everything and make it nearly automatic.

But as we know, retirement income planning involves far more than moving money from a 401(k) plan to an IRA rollover account. Retirees need more help than a telephone customer service rep can give them. We're going to help you brush up on the technicalities of IRA rollovers so you can position yourself as an expert.

The opportunity is huge. According to Cogent, a market research firm, the value of rollover assets available this year will be nearly $347 billion. Advisors who are successful at obtaining in this market capture an average rollover account size of $355,000, which is 2.4 times larger than those advisors who do not make this market a priority.

In other words, IRA rollovers are not a part-time business. The more you do, and the more you specialize in them, the more accomplished you get and the more assets will flow your way.

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In this report, I'll discuss the annuity versus lump sum decision that clients are often faced with at retirement. Then we'll get into the nuts and bolts of IRA rollovers: Triggering events, what can and can't be rolled over, types of rollovers, and the 60-day Rule. We'll talk about net unrealized appreciation, rolling to a Roth IRA, the best ways to name beneficiaries, how rollovers are treated in divorce, and how rollovers are reported. By the end you should have a solid understanding of how rollovers operate, and how to guide your clients confidently though the thicket of choices they face in retirement.

Annuity or Lump Sum?

Let's start by looking at one of the first decisions clients must make when they leave employment: Should they take their retirement distribution as an annuity or a lump sum?

Back in the day, when retirement plans were primarily defined benefit plans, retirement benefits were stated as a monthly pension amount. Workers would receive a statement saying that upon retirement at age 65, they would be entitled to receive a pension of X dollars per month. Most companies also offered the option of taking the pension all at once as a lump sum distribution. They would apply an interest rate to discount the income stream to present value assuming average life expectancy, and offer that as a lump sum. Over the years, more and more retirees started taking their benefits as a lump sum—for reasons I'll talk about in a minute—and more companies started encouraging this option in order not to have to make pension payments for the rest of the employee's life. They wanted to pay off their retiring employees and get them out of there.

Of course, most retirement plans are defined contribution plans—401k or 403b plans—and the benefits are always stated as a lump sum based on the current value of the assets in the account.

It is rare today for a client to think of his retirement account in terms of an annuity.

A few companies do offer the option to take the retirement account as an annuity provided by a major insurance company. In fact, this is a growing trend as people become worried about outliving their assets. In most cases clients will simply take their retirement account as a lump sum. Still, there may be times when you'll be asked to help clients decide whether they should take the annuity or the lump sum.

AARP recently did a survey to find out people's attitudes about annuities. Here are the top four reasons why people choose an annuity over a lump sum.

- It helps you manage your budget because you get a predictable amount of money each month.
- Payments will continue for the rest of your life.

- Monthly income won't go down even if there's a drop in the stock market.
- Since the money never runs out, it can help you remain independent.

Of course, there are also reasons why people opt for the lump sum instead.

- They want to keep the money around in case there's an emergency.
- They don't see the value in lifelong monthly payments.
- Research has shown that when an amount of money is stated as a monthly payment versus a lump sum, the lump sum always seems like more.
- They're afraid they'll die before they get enough monthly payments.
- They think they can get a better return by managing the money themselves.

So what do people ultimately choose? Statistically, it seems the lump sum wins out. Only 24% of retirees chose the annuity.

Advantages and Options

There are some objective rather than perceived advantages to choosing a lump sum over an annuity.

First, you can keep deferring taxes if you roll it over. If you sign up for an annuity, part of the income will be taxable right off the bat, and this gives you less control over your tax bill all throughout retirement. With the annuity, you're pretty much stuck with paying taxes on that income all throughout your life.

The lump sum rolled to an IRA also provides more investment options.

One of the reasons people cite in favor of the lump sum is they thought they could get a better return on invested assets. This may or may not be true. With your help, of course, they'll increase their odds.

Another huge advantage to taking the lump sum is liquidity. Whether you want to have access to the money for investment purposes or as an emergency fund, there's something very comforting about being able to get at the money, even if you have to take a taxable distribution.

And again, the lump sum gives you more control over the timing and manner in which those funds will be taxed. Other than the RMDs that start at 70-1/2, you have the flexibility to convert the IRA to a Roth and have future income be tax-free. You can time your withdrawals to minimize taxes—the list goes on.

Even More Advantages to a Lump Sum

Annuities usually carry higher fees compared to other investments that may be made in an IRA rollover account.

If you haven't run through all your money during your lifetime, your kids might get a little bit, whereas with the annuity the money is gone after your or your spouse's death.
Some advisors say that buying an annuity is like disinheriting your kids. No one wants to do that. (Well, almost no one.)

Some people forget that when they retire they will already have an annuity in the form of Social Security. Taking their retirement benefits as a lump sum is a hedge against that type of income, particularly with regard to life expectancy. If they die soon, they'll have the lump sum to leave to their heirs. If they live a long time, the Social Security will keep going even if the lump sum runs out.

Really, there's no rush. If forced to make a decision, people should take the lump sum—they can always buy an annuity later if they decide that's what they want.

The older they are when they buy it, the better deal it will be. They might want to take the lump sum, do the rollover, invest the money for a few years, and then, after they've aged a bit and maybe interest rates have gone up, they can buy an annuity if they want the guaranteed income.

Asking the Right Questions

Despite these overwhelming advantages of the lump sum over the annuity, advisors should still approach the question with some measure of neutrality. The Pension Rights Center poses these questions that people should ask.

- **How long are you likely to live?** A long life expectancy would suggest the annuity. But remember that Social Security will take care of that. Having both protects against dying too soon or too late.

- **How good are your investing skills?** This question will either scare people into taking the annuity or rolling over the lump sum with an advisor such as yourself. The ability to invest the lump sum should not be underestimated, but clients don't have to do this on their own. They can get help.

- **What is the value of your lump sum and how large is your benefit?** These questions presume that people want to analyze how the employer came up with the equivalent amounts. But clients are not actuaries, and neither are you. You just have to assume that the two amounts are actuarially equivalent.

- **Will you change your mind?** If you can't decide, take the lump sum. End of discussion. You can always do something different with the money later.

Triggering Events

Clients will usually be taking their retirement distributions as a lump sum, that much is clear. Let's go over what actually triggers an IRA rollover.

Going back to the very basics, it’s important to understand that you can't just put any lump sum of money into an IRA rollover account. IRAs have special tax privileges in that the investment returns are not taxable in the year they are earned. The IRS wants to make sure that any money going into an IRA is an eligible contribution. In addition to annual contributions, a lump sum distribution may be placed into an IRA as long as the lump sum distribution itself is eligible for favorable tax treatment. To meet the definition of an eligible rollover distribution it has to be distributed from a qualified retirement plan due to the employee's separation from service, the attainment of age 59-1/2, or the death or disability of the employee.

When in doubt, ask the client if it is an eligible rollover distribution. The client should receive a written explanation from the plan stating that the distribution may be paid tax-free directly to an IRA or other eligible plan.

Even if you have an eligible rollover distribution, it is not always clear what can and can't be rolled over.

What Can and Can’t be Rolled Over

Here's what CAN be rolled over.

Cash, of course. It is common for the investments to be liquidated and the distribution to consist of cash.

This scenario may be rare, but it is possible for a client to take a distribution of property, sell the property, and then roll over the proceeds. If there were a gain, it would not be taxable as long as the entire proceeds are rolled over. If part of a distribution is nontaxable and the property is sold and only a portion is rolled over, the client may designate which part of the rollover is nontaxable.

A client could also take a distribution of property and put that same property into the IRA, as long as the custodian accepts it.

Here's what CAN'T be rolled over.

Loans. A client can't take a loan from his 401k plan and roll it into an IRA. In fact, if he has taken a loan from his 401k, he'll need to pay it back before leaving the job. Otherwise, the loan will be considered a taxable distribution and may also be subject to the 10% premature distribution penalty.

Hardship distributions also cannot be rolled over. They're supposed to be for hardship, after all.

Required minimum distributions cannot be rolled over. Employees who are 5% owners have to start taking distributions from their qualified retirement plans when they turn 70-1/2, even if they're still working. These RMDs may not be rolled over.

Payments that are part of a series of substantially equal period payments under section 72t cannot be rolled over.

And you can't roll over different property. You can sell and roll over the proceeds, but you can't keep the property and roll over the same amount of cash.

All of these are pretty rare, but you should be aware of them.

After-tax Contributions

After-tax contributions may be rolled over, but the IRA will forever comprise both taxable and after-tax money. That means the client will have to keep track of the ratio of pretax to after-tax money. All IRAs are aggregated for this purpose, and all distributions are a mix of pretax and after-tax money. You can't just take out the after-tax money in order to avoid taxes on the distribution.

You also can't separate out the after-tax money and convert it to a Roth without paying any taxes. There used to be some confusion about this, but the IRS has made it clear that it will not look kindly on elaborate schemes to separate out the after-tax money to be converted to a Roth tax-free.

Having an IRA with both pretax and after-tax money isn't that big a deal, though. The client just needs to file form 8606 the year after the rollover and in any year there is a distribution in order to specify what proportion of the distribution is taxable and what proportion is tax-free. Do remind clients to file this form. Otherwise all distributions will be fully taxable and they'll end up paying taxes twice on the same money.

Over 70-1/2

If a client is over 70-1/2, he can roll over plan assets to an IRA even though he would be prohibited from making a regular annual contribution to an IRA. He can't roll over any distributions required by the plan. The RMDs on those rolled over assets would start the following year.

Self-Employed Individuals

The rules are a little different for self-employed individuals who are taking money from their own plan.

Earlier we established that in order for a lump sum distribution to be an eligible rollover distribution, it had to be due to the employee's separation from service, attainment of age 59-1/2, or death or disability. In the case of self-employed individuals, the "separation from service" provision doesn't apply. In order to take a distribution and roll it over, a self-employed person must be over 59-1/2 or disabled.

Most eligible rollover distributions are made when an employee leaves the job, either at retirement or to change jobs. It may be possible for a person to get a distribution and roll it over to an IRA while he is still working, as long as he is over 59-1/2. The client should ask his employer if the plan allows "non-hardship withdrawals." If the plan doesn't specifically prohibit them, the client may be able to cash out his retirement account and roll the money to an IRA. Some people do this if they think they would have better investment options or lower fees with an IRA compared to leaving the money in the plan.

Types of Rollovers

Just to make sure we're covering all of our bases, let's take a quick look at the four basic types of rollovers:

- **Qualified plan to IRA.** This type of rollover is the main focus of this report.
- **Qualified plan to qualified plan**. This type is possible only if the plan accepts.
- **IRA to a qualified plan.** Again, only possible if the plan accepts.
- **IRA to IRA**.

Three Tax-free Ways to Move a Lump Sum Distribution

Again, This may sound fundamental, but we're covering the basics here just to make sure everyone's on the same page.

- ### Rollover

  A "rollover" is where the client takes receipt of the funds and deposits them to an IRA or qualified plan within 60 days. If the rollover is done this way, 20% will be withheld for taxes. If the client wants to roll over the entire amount, he will need to find other funds to make up the withheld amount until his tax refund comes. For example, if the lump sum distribution is $100,000, he will receive a check for $80,000. If he rolls over just the $80,000, he will have to pay actual taxes on the $20,000 not rolled over. Or he can find $20,000 from someplace else and roll over the entire $100,000 within 60 days. When he files his tax return, he'll report the $100,000 rollover and get back the $20,000 that was withheld.

- ### Direct rollover or transfer

  In this case the check is made payable to the new custodian, and the client delivers the check. The client touches the check but not the money. So there is no withholding.

- ### Trustee to trustee transfer

The third way is the easiest and safest. The assets are moved directly from one custodian to another. There is no distribution and no 1099R and no withholding. And no chance that the client will miss the 60-day window.

Rolling to a Qualified Plan

Although vast majority of your rollovers will be to an IRA, there may be times when a client will want to move money to another qualified plan.

For example, a client might retire, start a new business, and want to roll his 401k assets to his own company's profit-sharing plan instead of an IRA. Or maybe he's changing jobs and just wants to keep his assets in a qualified plan. As we mentioned earlier, the plan must agree to accept the assets. And the person must be an employee of the employer sponsoring the plan.

One advantage to rolling over to a qualified plan is that the client may be able to avoid required minimum distributions after age 70-1/2. However, this is far from a sure thing. If he were a 5% owner he would still have to take RMDs from the qualified plan. The new plan may require RMDs after 70-1/2—it just depends on the plan.

As I mentioned, after-tax money can be rolled to an IRA. When you're rolling to a qualified plan, any after-tax money must be moved by direct transfer.

Rollover to Solo 401(k)

Clients may see web advertising about rolling money to a solo 401k. Solo 401ks are great plans for self-employed individuals because they allow for higher contribution limits than for an IRA and also allow for loans. (Which, by the way, should never be encouraged since this money is supposed to be for retirement, after all!)

I can't see any advantage to rolling retirement money into a solo 401(k) except possibly for creditor protection. There's always more paperwork with qualified plans than with IRAs. A client can always roll it into an IRA and start a new solo 401(k) for new contributions.

Rollover as a Business Start-up

Another thing clients might see advertised on the Internet: rollover as business start-up, which the IRS affectionately calls ROBS.

Here, the client establishes a new corporation and qualified plan—the ROBS plan. The assets are rolled from the previous employer's qualified plan into the new ROBS plan. The ROBS plan uses rollover assets to purchase stock in the new business. Then the assets end up in the new business's checking account with no taxes due. The IRS has published their position on this: they don't like it, but apparently it is legal. Regardless, it will certainly invite scrutiny. Don't let your clients do it.

What’s Possible

Here's a table of all the possible rollovers.

ROLLOVER CHART

6/7/2011

Roll From \ Roll To	Roth IRA	IRA (traditional)	SIMPLE IRA	SEP-IRA	457(b) (government)	Qualified Plan[1] (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b)[2])
Roth IRA	YES	NO	NO	NO	NO	NO	NO	NO
IRA (traditional)	YES[3]	YES	NO	YES	YES[4]	YES	YES	NO
SIMPLE IRA	YES,[3] after two years	YES, after two years	YES	YES, after two years	YES,[4] after two years	YES, after two years	YES, after two years	NO
SEP-IRA	YES[3]	YES	NO	YES	YES[4]	YES	YES	NO
457(b) (government)	YES[3]	YES	NO	YES	YES	YES	YES	YES,[3,5] after 12/31/10
Qualified Plan[1] (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES,[3,5] after 9/27/10
403(b) (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES,[3,5] after 9/27/10
Designated Roth Account (401(k), 403(b) or 457(b)[2])	YES	NO	NO	NO	NO	NO	NO	Yes, if a direct trustee to trustee transfer

[1]Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans
[2]Governmental 457(b) plans, after December 31, 2010
[3]Must include in income
[4]Must have separate accounts
[5]Must be an in-plan rollover
For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans Community.

Let's assume most of your clients will be rolling from a qualified plan.

Going down to the sixth row, we see all the different types of plans that qualified plan assets can be rolled to: Roth IRA. Traditional IRA. SEP-IRA. 457(b) government plan. Another qualified plan. 403(b). And Designated Roth Account within a 401(k), 403(b), or 457(b) plan.

This table is on the IRS website. If you think you might want to access it for various other types of rollovers, you might want to keep track of the URL: www.irs.gov/pub/irs-tege/rollover_chart.pdf.

The 60-day Rule

Continuing with our discussion of rollover basics, let's take a moment to mention the 60-day rule.

IRS publication 590 is very clear: You generally must make the rollover contribution by the 60th day after the day you receive the distribution from your IRA or qualified plan. Now, keep in mind that this 60-day rule only applies if the client is receiving the funds. If the assets are being moved by direct trustee-to-trustee transfer, or if the check is made out to the custodian so that the client never touches the money, there is no 60-day rule to worry about.

Still, you never know. Some clients might want to make a short-term loan, use the money for something else and then replace it within 60 days. Or maybe a client feels he has more control if he takes receipt of the money and deposits it himself into his IRA rollover account. In that case, the 60-day rule will apply.

Missing the 60-day deadline has pretty severe consequences. First of all, the rollover no longer qualifies for tax-free rollover treatment. It will be treated as a taxable distribution in the year it is distributed, even if the 60-day period expires in the next tax year. Plus, a premature distribution penalty may apply if the client is under 59-1/2. There could even be an excess contribution penalty. If funds go into an IRA that have no business being there, as a result of missing the 60-day deadline and the money now being after-tax funds, the client could be assessed a 6% excess contribution penalty.

How to circumvent the 60-day rule?

Just ask for a direct trustee-to-trustee transfer or a direct rollover where the check is made payable to the new custodian; it does not have to be delivered within 60 days.

There are a ton of horror stories about people missing the 60-day deadline for various reasons. Protect your clients by not letting it happen to them.

Waivers to the 60-Day Rule

A few years ago the IRS started relaxing its punishment a bit. If the delay is due to an error caused by the financial institution—say the bank put it into the client's taxable account instead of the IRA rollover account—the penalty will be waived. It’s also possible to get a private letter ruling waiving the penalty if the client has a good excuse. However, the cost of obtaining a private letter ruling is pretty steep. It makes most sense to just help your clients avoid the penalty in the first place.

Net Unrealized Appreciation

Net unrealized appreciation comes into play when the distribution includes employer stock.

It refers to the excess of the stock's fair market value at the time of the distribution over the plan's basis in the stock. The net unrealized appreciation is not taxable at the time of the distribution.

If it's rolled over, that net unrealized appreciation will ultimately be taxed as ordinary income when it comes out of the IRA. If the stock is not rolled over, the net unrealized appreciation will be taxed as a long-term capital gain whenever it is sold.

In most cases, clients will want to pay taxes on that net unrealized appreciation at long-term capital gains rates rather than ordinary income tax rates.

To get capital gains tax treatment of net unrealized appreciation, do not roll over employer securities. Instead, place them in a taxable account. This does mean that the client will owe income tax on the basis in the year of the distribution. The net unrealized appreciation and all future gains will be taxable at long-term capital gains rates.

Let’s look at an example: Bill retires and receives 10,000 shares of XYZ stock in a lump sum distribution. The stock is worth $50 per share at the time of the distribution, or $500,000. Let's say the plan's basis in the stock is $10 or $100,000. Bill places the stock in a taxable account and pays ordinary income tax on the $100,000 basis. He won't owe any tax on the $400,000 appreciation until he sells.

So what happens when Bill sells? If he sells the stock immediately for $500,000, he will report a $400,000 long-term capital gain. This is true even if he sells the stock the same day it goes into the account. Net unrealized appreciation always gets long-term capital gains treatment regardless of when the stock is sold.

Now let’s say Bill waits a few months but sells within the first year. If the stock appreciates to $600,000 and he sells within a year, he'll report a $400,000 long-term capital gain and a $100,000 short-term capital gain. Obviously, if he sells more than one year after the stock is placed in the account, all gains will be taxed at long-term capital gains rates.

Rolling Over Employer Stock

Holding out employer stock can be a great way to save clients taxes. However, there may be certain times when the client might want to roll over the stock. The main reason is to avoid current taxes. Remember, if he holds out the employer stock his basis in it will be treated as a taxable distribution. Plus, if he's under 59-1/2, he'll pay a premature distribution penalty in addition to ordinary income tax in the year of the distribution. But if he rolls it over, he can keep deferring taxes on the basis as well as the net unrealized appreciation.

Another reason you might go ahead and roll over the employer stock is if the net unrealized appreciation is an insignificant amount. If this is the case, the differential between long-term capital gains rates and ordinary income tax rates is such a small amount that it's not worth holding out the stock and paying taxes now on the basis.

A client might also want to roll over the employer stock if he plans to leave the money invested for many years. Say he puts the stock into a taxable account and sells it—now he has to reinvest the proceeds and pay taxes every year on the investment earnings because the assets are forever outside the tax-deferral umbrella.

But if he rolls over the stock, sells it and invests the proceeds, he can enjoy continued tax deferral on the investment earnings until the time comes to take distributions from the IRA. In this case it becomes necessary to analyze the tradeoff between long-term capital gains treatment and the tax deferral. The client's tax advisor can help with this.

Common NUA Mistakes

A very common NUA mistake is failing to hold out employer stock because of negligence or lack of understanding of the value of NUA tax treatment.

Most clients will not be aware of this. Unless they've been advised, it will never occur to them to hold out their employer stock in order to get favorable tax treatment.

Another big mistake is "temporarily" rolling over the employer stock.

Once that stock goes into an IRA, the net unrealized appreciation will never qualify for long-term capital gains tax treatment. That rollover election is irrevocable.

I noted earlier that when in doubt between the annuity and the lump sum, take the lump sum because you can always change your mind and buy an annuity later. But when it comes to employer securities, this option doesn't exist. You can't roll it over and then take it out later and get long-term capital gains tax treatment.

This is an election that must be made at the time of the rollover, so make sure your clients understand this.

Rolling to a Roth IRA

We saw earlier on the rollover table that qualified plan assets can be rolled directly to a Roth IRA.

Although the rollover is direct, for tax purposes, the assets are treated as a distribution and then as a rollover contribution to a Roth IRA.

Here's how the taxation works: Rolling qualified plan assets to a Roth is a little different than doing a regular conversion from a traditional IRA to a Roth.

First, of course, all pretax contributions, employer contributions, and earnings would all be taxable in the year of the distribution. If the distribution occurs in 2012 and the assets are not placed in the Roth IRA until 2013, the taxes are due for 2012, based on the date of the distribution.

Second, after-tax contributions may be rolled over tax free. This is a very good thing, to roll after-tax contributions to a Roth IRA. There will be no current taxes due on that money, since taxes have already been paid on it, and once they go into the Roth, there will never be any tax on the investment earnings generated by those assets. So if clients have retirement accounts with after-tax contributions, they should seriously consider rolling them to a Roth IRA.

Now, here's the catch. You can't cherry-pick the after-tax amount and roll over only that amount. If you're going to roll over an account that has after-tax contributions, you either have to roll over the entire account or, if doing a partial rollover, pay taxes on a portion of the distribution. I'll describe an example of this in a minute.

But unlike with IRAs, you do not have to aggregate all qualified plan assets when determining the ratio of after tax money. If there is more than one qualified plan account you can choose the account with the most after-tax money in it and roll over that one account.

Here's our example: Linda has an IRA worth $50,000 and two 401(k) accounts with a former employer valued at $100,000 and $150,000 respectively. The

$100,000 account consists of $30,000 in after-tax contributions. If Linda converts the $100,000 account, the tax-free portion will be $30,000.

Now, let's say Linda wants to roll over $30,000 to a Roth IRA. She can't just pick out the $30,000 after-tax portion and roll that amount without paying current taxes. Rather, any amount she does convert would be tax-free in the same ratio as the total account: $30,000 to $100,000, or .3. So if she converts $30,000, the tax-free portion would be $9,000, which is the $30,000 after-tax portion multiplied by .3.

Why Would a Client Want to Roll Retirement Plan Assets to a Roth IRA?

The analysis is basically the same as a regular conversion of a traditional IRA to a Roth IRA.

Yes, you have to pay taxes on the distribution now. But this may be a wise move in the long run if you expect higher taxes in the future, have a long investment time frame and can pay taxes on the conversion with outside funds. You'll be glad later on when you have withdrawal flexibility with no required minimum distributions and want to pass the assets tax-free to heirs.

I believe that everyone should have *some* money in a Roth IRA, just because you never know what can happen to taxes in the future. And now we're seeing that Medicare premiums and the new Medicare surtax starting in 2013 are determined by adjusted gross income—clients will be looking for ways to keep income off their tax return in the future. Rolling or converting to a Roth early on is a good way to do this.

Just be aware that if the client is taking a big distribution and rolling it to a Roth, he'll have a bump in income for that year which will affect his Medicare premiums two years down the road. The ideal time to do this is before the client turns 63. However, even if the client is already on Medicare, it may be worth it to pay the higher premiums for a year in order to get the tax benefits later on.

You can always spread the conversion over several years in order not to give the client excessive income in any one year. Just roll the assets to an IRA and convert later.

Roth Caveats

There are a few things to watch out for.

Roth Caveat #1

If you are anticipating a Roth conversion this year or in the future, and if the lump sum distribution consists of after-tax money, you have to be careful.

Let's say a client has two qualified plan accounts, one with a substantial amount of after-tax contributions. After-tax contributions are great for Roth rollovers because the client doesn't have to pay taxes on that money—it's already been taxed. That means it can go right into a Roth IRA and forever escape taxation for the rest of the client's life—and the lives of his beneficiaries. If you roll both qualified plans into a traditional IRA with the idea of converting to a Roth later, you'll have to aggregate all the IRAs for the purpose of determining the tax-free amount.

The better thing to do is roll the account with the after-tax contributions directly into a Roth. Then the ratio of tax-free to taxable assets will be more favorable.

Let’s look at an example: Steve has a contributory traditional IRA worth $100,000. He also has two qualified plan accounts.

Account A is worth $150,000 and consists of $60,000 in after-tax contributions.

Account B is worth $200,000 and is all pretax money.

If Steve rolls Accounts A and B into an IRA, he will have IRAs totaling $450,000 with $60,000 basis.

So, of any partial conversions he might do, only 13% would be tax free ($60,000 ÷$450,000). If he converts $150,000, only $19,500 would be tax free ($150,000 x .13). However, if he keeps Account A intact, he can convert the entire $150,000 account with his full $60,000 basis converted tax free.

Roth Caveat #2

If a client has a nondeductible IRA and will be converting it to a Roth sometime this year, you do not want to roll qualified plan assets into an IRA in the same year because it will dilute his basis.

The aggregation rule is based on IRA values at the end of the year. If you convert a client’s IRA now, and then, before the end of the year, roll a big chunk of retirement plan assets into an IRA, that new IRA rollover will be included in the aggregation.

Here's an example of this: Christine has a $30,000 nondeductible IRA with $23,000 basis.

She also has $300,000 in a qualified retirement plan that is rollover eligible.

If she converts the $30,000 IRA without rolling over the $300,000, the tax-free portion of the Roth conversion will be $23,000.

But if she rolls over the $300,000 to an IRA, the tax-free portion of the $30,000 conversion will be just $2,100.

This was determined by first dividing the $23,000 basis by the $330,000 in total

IRAs to get .07 as the tax-free multiplier. Then, to determine the tax-free portion of any amount that Christine converts after rolling the $300,000 to an IRA, multiply the converted amount by .07 to get $2,100.

Roth Caveat #3

If there's any chance that a non-spouse beneficiary of a qualified plan might want to convert those assets to a Roth IRA, either now or in the future, do not roll them into an IRA. This will immediately disallow the conversion, since inherited IRAs may not be converted.

Advisors have long advocated IRA rollovers for inherited plan assets as a way to give beneficiaries more control over the investments. But with Roth conversions now taking center stage as a viable financial planning strategy for clients at all income levels, it makes sense to preserve inherited plan assets for potential conversions. In fact, beneficiaries of qualified plans may be seen as prime prospects for your Roth conversion conversations. Make sure they understand the benefits of converting to a Roth and also warn them that rolling the assets to an IRA would make them ineligible for a Roth conversion at a later date.

The Best Ways to Name Beneficiaries

These guidelines apply to all IRAs, not just IRA rollovers, but since the money going into IRA rollovers can be very substantial, you want to make sure clients name the right beneficiaries.

Rule #1: Name a Beneficiary

The first rule is simple: name a beneficiary. If a client doesn't name a beneficiary, the assets will go into his estate and be distributed according to the terms of his will. There are a few major problems with this.

First of all, the assets may go to the wrong people. If the client hasn't updated his will, or worse, doesn't have a will, the IRA could be inherited by an estranged spouse or a spendthrift child.

Secondly, the assets might have to go through probate, which is an expensive and time-consuming process. With a designated beneficiary, the assets go straight into an inherited IRA controlled by the named beneficiary.

Third, and most important, if the IRA assets go to the estate, distributions are accelerated and can't be stretched over the beneficiary's life expectancy.

Rule #2: Name a Spouse as Beneficiary

This won't work if the client isn't married, of course, or if the client really wants the assets to go straight to his kids from a former marriage. But a spouse is the only one who can take the IRA as her own. This means distributions don't have to start until she turns 70-1/2, and there is no estate tax due at the time of the client's death. Naming a spouse as beneficiary just defers taxes that much longer.

Rule #3: Name a Young Person as Beneficiary

This is simply to keep the tax deferral going since distributions can be stretched over a long period of time. You have to look at the client's overall family situation and estate plan and coordinate the beneficiary designation with that.

Rule #4: Split the IRA Among Beneficiaries

Rather than having one IRA with several beneficiaries, a client can split the IRA and make a separate IRA for each beneficiary.

The reason for this is that when you have one account, the distributions must be stretched over the oldest beneficiary's life expectancy. With multiple IRAs, each beneficiary can use his or her own life expectancy.

Rule #5: Educate the Beneficiaries

Sometimes spouses and kids have no idea the lengths to which the client went to preserve assets from taxes.

He may have paid taxes earlier than he needed to in order to convert the assets to a Roth and give his loved ones many years of tax-free income. He may have paid high-priced attorneys to design a carefully constructed estate plan. If the beneficiaries don't know what they have to do to keep deferring the taxes, all of this could go to waste.

Young people with little awareness of financial matters may think it makes no difference to just cash out the IRA and spend it or invest it in something else. They have no idea how much this may be costing them in taxes. They're probably not aware of the distribution rules for inherited IRAs.

If they fail to take the first distribution on time, they'll have to drain the account within five years. This can be a tragedy, especially for Roth IRAs, which otherwise would have many years of tax-free growth in them.

Common Beneficiary Mistakes

One key mistake commonly made by beneficiaries is failing to coordinate the beneficiary designation with wills, trusts, and other dispositions. The beneficiary designation trumps these other documents in case of conflict, and that may not be what the client wants. We've all heard stories of an ex-spouse inheriting an IRA because the client didn't update his beneficiary designation form—not to mention the confusion in the family caused by conflicts in the decedent's wishes.

Another mistake is naming one's estate as beneficiary. This is slightly different from not naming a beneficiary. Some clients may want to save time and trouble by simply writing "my estate" on their beneficiary designation form. An estate is not a designated beneficiary in the legal sense of the word and has no life expectancy on which to base future distributions. This means the IRA must be drained sooner than it needs to be.

A well-meaning mistake is writing "all my children, equally." Whenever a beneficiary designation refers to a class of people who are not in a custodian's records, a payer may decide that the participant did not make a beneficiary designation. Or, the payer may require the client to name every person in the class and prove that there are no others. Since it is difficult to prove the nonexistence of an unidentified person, even the opportunity to correct such a beneficiary designation would result in significant frustration and delay.

Another mistake is naming a minor without considering the minor's guardian. For example, a divorced parent might not want to name a young child as beneficiary if doing so might put the money into the hands of the child's other parent. Instead, the client might name a suitable trustee or custodian.

Finally, clients need to be careful of failing update the beneficiary designation. This should be done at least once a year or whenever a significant life event occurs, such as a marriage, divorce, birth, or death.

One of your most important functions as a financial advisor is to stay on top of family events and remind clients to review their beneficiary designations.

How Rollovers are Treated in Divorce

Sometimes divorce settlements call for one spouse's retirement assets to be split between both spouses. When this happens, the spouse who is receiving a share of the other spouse's assets can roll them into her own IRA.

The two main conditions for a divorce rollover are that the distribution must be an eligible rollover distribution, just as if it had been made to the employee; and that it is made under a qualified domestic relations order, or QDRO.

QDROs

A QDRO is a judgment issued under the domestic relations law of a state. It gives to an alternate payee, such as a former spouse, the right to receive all or part of the benefits that would be payable to a participant under the plan. It requires certain specific information and cannot alter the amount or form of the benefits of the plan.

You will really not have much to do with the legalities of the QDRO. Your job is to understand that a distribution to a divorced spouse is subject to a QDRO and to handle the rollover as usual.

However, if the spouse receiving qualified retirement assets under a QDRO needs some money, and if she's under 59-1/2, be sure to take it out before doing the rollover. She will have to pay taxes on it, but there will be no premature distribution penalty. This doesn't apply to assets coming from an IRA, just a qualified retirement plan.

How Rollovers are Reported

Let’s wrap up by touching on how rollovers are reported to the IRS.

Form 1099-R is used to report pension distributions to the IRS. The client will receive his copy in January. He should take a look at it and make sure it's correct. If it isn't, he can notify his employer and have it corrected.

VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution $	OMB No. 1545-0119 **2012** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2a Taxable amount $		
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy 1 For State, City, or Local Tax Department**
PAYER'S federal identification number	RECIPIENT'S identification number	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	
RECIPIENT'S name		5 Employee contributions /Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.)		7 Distribution code(s) — IRA/ SEP/ SIMPLE ☐	8 Other $ %	
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions $	
10 Amount allocable to IRR within 5 years $	11 1st year of desig. Roth contrib.	12 State tax withheld $ $	13 State/Payer's state no.	14 State distribution $ $
Account number (see instructions)		15 Local tax withheld $ $	16 Name of locality	17 Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

Form 1099-R

Box 1 will show the gross distribution. Box 2a will show the taxable amount. If the money was moved by direct transfer, this box should be zero. If the client took receipt of the funds, there will be a dollar amount in Box 2a. Box 4 will show the amount of federal income tax that was withheld. However the client has his taxes done, either the tax preparer or Turbotax will know what to do with this form.

Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7
	8a	**Taxable** interest. Attach Schedule B if required	8a
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.	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
If you did not get a W-2, see instructions.	14	Other gains or (losses). Attach Form 4797	14
	15a	IRA distributions . 15a — b Taxable amount	15b
	16a	Pensions and annuities 16a — b Taxable amount	16b
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17
Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	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

Form 1040

This is the income section on page 1 of form 1040. The amount of the gross distribution from Box 1 on the 1099-R would go on line 16a. Then the client would subtract out any after-tax contributions and any amounts rolled over and enter the taxable amount on line 16b. If the client did a full rollover of the entire taxable amount, he would write zero on Line 16b and write the word "rollover" next to it.

To recap: Enter the full amount of the distribution on line 16a to match the amount in Box 1 of the 1099-R.

Subtract any after-tax contributions and any amounts rolled over and enter the remaining amount on line 16b. Write the word "rollover" next to line 16b.

If you have questions about IRAs and IRA rollovers, you can to straight to the source, Publication 590. The URL is www.irs.gov/pub/irs-pdf/p590.pdf.