

THE Pension Digest

ALSO IN THIS ISSUE –

No Life Insurance in an IRA,
Page 6

A Promissory Note as a Self-
Directed IRA Investment,
Page 7

IRA Contribution
Deductibility Chart for 2009,
Page 8

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The Coming Roth IRA Conversions

As of January 1, 2010, the two tax laws making many traditional IRA accountholders ineligible to convert funds within their traditional IRAs to a Roth IRA will no longer exist. Prior to January 1, 2010, an individual is ineligible to convert if his or her MAGI exceeds \$100,000, or if married, the individual does not file a joint federal income tax return. The repeal of these two laws was contained in the "Tax Increase Prevention and Reconciliation Act of 2005."

IRA Custodians should start to prepare for those individuals who will want to do "conversions" in 2010. Our guess is that many people will be in your institutions the first or second week of January. With numerous political fights currently occurring, we are assuming that the U.S. Congress and President Obama will not enact legislation repealing the 2005 law change.

The following material comes from CWF's brochures on Roth IRA conversions titled, "Why Should I Consider Converting My Traditional IRA in to a Roth IRA? New Rules Apply in 2010." You and your traditional IRA accountholders will benefit from understanding the rules and procedures applying to 2010 conversions. In order to induce individuals to convert in 2010, the tax law created a special tax incentive. Example, an individual who converts \$30,000 in 2010 will include \$15,000 (50% of the conver-

sion amount) in income on his or her 2011 tax return and the remaining \$15,000 (50%) on his or her 2012 return. Even though the conversion distribution occurs in 2010, no income tax is owed with respect to 2010 unless the converter chooses to not use this special tax rule.

In the following discussion, "you" and "I" means an individual who is a traditional IRA accountholder. All traditional IRA accountholders will consider converting all or some portion of their traditional IRA to a Roth IRA in 2010.

Purpose of a Roth IRA Conversion Contribution

If a person has a traditional IRA, federal income tax laws allow you to move all, or a portion, of your traditional IRA funds via "conversion" to a Roth IRA. This brochure discusses the benefits of converting traditional IRA funds to a Roth IRA, and the proper procedures for doing so.

Why convert my traditional IRA to a Roth IRA?

The income earned by the funds within a Roth IRA will be tax free to you or your beneficiaries when withdrawn as a qualified distribution. The income earned within your traditional IRA is always taxable when withdrawn.

Continued on page 2

**Roth IRA Conversions,
Continued from page 1**

Example: You have \$10,000 in your traditional IRA as of January 2007. You can certainly leave the funds within your traditional IRA and allow them to grow. Assume this \$10,000 grows in value to \$50,000 over the next 18 years.

The \$40,000 of income will be taxable whenever it is withdrawn from a traditional IRA. However, if you had converted or moved this \$10,000 to a Roth IRA, the \$40,000 of income will never be taxed if the funds are withdrawn as a qualified distribution.

No matter how great the income or how wealthy you are, it will be tax free if the distribution from the Roth IRA is a qualified distribution. As discussed below, you are generally required to pay income tax with respect to the \$10,000 for the year the conversion occurred.

Who is eligible to do a conversion for 2009?

If your Modified Adjusted Gross Income (MAGI) does not exceed \$100,000, and if you are married, you file a joint income tax return, you are eligible to do a conversion for 2009. However, a special rule provides that you are eligible for a conversion, even though you file a separate return, if you did not live with your spouse at any time during the year.

How do I determine my MAGI?

You should refer to IRS publication 590. In general, you start with your adjusted gross income on line 35 of Form 1040 or line 22 of Form 1040A, subtract the amount of income attributable to the conversion, subtract the amount of income attributable to a required distribution, subtract the income relating to a Roth IRA rollover from a qualified retirement plan, and then add certain amounts such as the amount of your traditional IRA deduction, any student loan interest deduction, any tuition and fees deduction and certain other deduction and exclusion amounts.

Who is eligible to do a conversion for years 2010 and subsequent years?

Beginning January 1, 2010, the conversion requirements, will be repealed, and anyone having a traditional IRA may convert funds from their traditional IRA to a Roth IRA.

How much may I convert from my traditional IRA?

There is no dollar limit on the amount which you may convert from your traditional IRA to a Roth IRA.

You must decide whether or not it is in your best interest to incur taxes on the conversion amount now, in order to receive the benefit of tax-free earnings, when the funds are converted to the Roth IRA.

Note that you are not required to convert the total amount of your traditional IRA in one year. It may be possible, depending on your income, to lessen the tax burden by converting only a portion of your traditional IRA balance over a period of a years.

Example: If you have \$50,000 in a traditional IRA, you may wish to convert \$10,000 a year for a period of 5 years, or \$5,000 a year for a period of 10 years.

When may I do a conversion during the year?

You may do it at any time. A conversion can be done for a given tax year as soon as January 1 of such year. For example, a person could convert his or her traditional IRA on January 1, 2009, for 2009. The last day to convert funds for a given year is December 31. However, see the later discussion of a failed conversion.

How do I convert my traditional IRA?

You can convert amounts from your traditional IRA to a Roth IRA by using any of the following three methods. The first method is the standard rollover. You can receive a distribution from a tra-

**Roth IRA Conversions,
Continued from page 2**

ditional IRA and roll it over (contribute it) to a Roth IRA within 60 days of the distribution. The second method is a trustee-to-trustee transfer. If permissible, you may direct the custodian/trustee of your traditional IRA to transfer an amount from the traditional IRA to the custodian/trustee of your Roth IRA. The third method is an internal movement. You direct the custodian/trustee of your traditional IRA to transfer an amount from your traditional IRA to your Roth IRA.

Whatever conversion method is used, the custodian/ trustee of the traditional IRA will prepare a Form 1099-R to report the distribution, and the custodian/trustee of the Roth IRA will prepare a 5498 to report the conversion contribution.

How do I convert my SEP-IRA or SIMPLE-IRA?

You would follow the same procedures which apply to converting funds from a traditional IRA. However, in the case of a SIMPLE IRA, you may convert such funds only after a 2-year period has expired since you first participated in your employer's SIMPLE IRA plan.

Do I need to execute a new Roth IRA plan agreement to receive the conversion contribution?

No. You could establish a new Roth IRA plan agreement if you wanted, but you would not need to. If you already have an existing Roth IRA, you could add the conversion funds to your existing Roth IRA.

What income tax will I owe because of a conversion made in 2009 or in a year after 2010?

You must include in your gross income (at the applicable marginal tax rate) distributions from a traditional IRA that you would have had to include in income if you had not converted them into a Roth IRA. That is, you are deemed to have received a distribution and you are required to pay tax on such amount. For example, assume your marginal tax rate is 15%. If you convert \$10,000 from your traditional IRA to a Roth IRA, you will pay tax of \$1,500 with respect to the \$10,000.

If the distribution includes any basis (i.e. nondeductible contributions), you do not include such after-tax amounts in your gross income.

What income tax will I owe because of a conversion made in 2010 or subsequent years?

As discussed above, you will still owe the applicable tax on the distribution from the traditional IRA. However, there is a special rule for conversions made in 2010.

If you make a conversion in 2010, you will be able to elect to include 50% of the conversion amount in income for income tax purposes in 2011, and the other 50% in 2012. No taxes will be owing in 2010 for conversions made in 2010. You do not have to use this option. If you desire, you may include all of a 2010 conversion amount in your income for 2010.

For conversions made after 2010, you will have to include the total conversion amount in your income.

If the distribution includes any basis (i.e. nondeductible contributions), you do not include such after-tax amounts in your gross income.

Should I wait until 2010 to convert my traditional IRA to a Roth IRA?

This is an individual decision. It will depend upon the facts and circumstances applying to each individual. There is no one right answer.

If you are now eligible to do a conversion, you will want to consider doing a conversion in 2009, versus waiting until 2010. Although waiting until 2010 to do a conversion will allow you to delay paying taxes on the conversion amount until 2011 and 2012, as discussed above, you may accumulate more tax-free income in the Roth IRA by converting the funds in an earlier year.

Will I owe the 10% additional tax for my conversion if I am under the age of 59½?

No.

**Roth IRA Conversions,
Continued from page 3**

Are there amounts in my traditional IRA which I am not eligible to convert?

Yes. You cannot convert any required distribution amount. You cannot convert amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you attain age 70½) under the required distribution rules.

Can I convert an IRA which I inherit from my spouse?

Yes. If you roll over your deceased spouse's IRA into your own traditional IRA, then you may convert it to a Roth IRA. In the same way, if you are eligible to elect to treat your deceased spouse's IRA as your own, then you may so elect and then convert it to a Roth IRA.

May I convert an IRA which I inherit from someone who is not my spouse?

No. If you inherited a traditional IRA from someone other than your spouse, then you are ineligible to convert such an IRA to a Roth IRA.

If I have set up a substantially equal periodic payment with respect to a traditional IRA, am I eligible to convert some or all of this IRA?

Yes, but you must continue the periodic payments. The 10% additional tax on early distributions will not apply even if the distributions are not qualified distributions, as long as they continue to comply with the substantially equal periodic payment rules.

What tax reporting forms will be prepared by the one or two IRA custodians/trustees?

Regardless which of the three conversion methods is used, there is either an actual distribution which occurs or a deemed distribution which is deemed to have occurred. The custodian/trustee of the traditional IRA is to prepare a Form 1099-R to report the distribution. The IRS instructs the custodian/trustee to use a reason code "2" if you are not

yet age 59½ or older and a "7" if you are age 59½ or older. The custodian/trustee of the Roth IRA is to report the amount of the conversion contribution in box 3 of the Form 5498 for the year during which the conversion was made.

What income tax forms will I need to complete to properly reflect a conversion on my federal income tax return?

You will need to complete Form 1040 and Part II of Form 8606.

Is there an age limit imposed for doing a conversion?

No, a person is eligible to do a conversion at any age. However, as discussed previously, you are not eligible to convert any required distribution.

Is there any limit on the number of conversions I may do?

No. There is no limit as to how many conversions you may do.

What should I do if I make a failed conversion?

You will want to talk with your tax advisor, but most likely you will want to recharacterize your conversion contribution.

A failed conversion arises when you convert a portion of your traditional IRA to a Roth IRA early in the year because you thought you would be eligible, but later you become ineligible because you do not comply with the "less than \$100,000 of MAGI" requirement or because you do not file a joint income tax return when required to do so.

These reasons for a failed conversion will be eliminated beginning January 1, 2010, as discussed earlier.

A failed conversion also arises when you reconvert a portion of your traditional IRA to a Roth IRA during the same year as the prior conversion, or if later, during the 30-day period following a recharacterization. You must move, from the Roth IRA, by

a recharacterization, the amount you converted (including all of the earnings from the date of the conversion) into a traditional IRA by the due date (including extensions) for your tax return for the year during which you made the conversion. You will need to report the recharacterization on your tax return, but no portion will be required to be included in income. The net effect of a conversion and subsequent recharacterization is that a conversion never occurred.

If I convert some or all of my traditional IRA, do I have the right to change my mind and undo the conversion, or can I only undo it if I become ineligible?

You have the right to change your mind. You can undo it even though you were eligible to do the conversion. As discussed above, you must move the funds from the Roth IRA, by a recharacterization, into a traditional IRA, by the due date for your tax return for the year during which the conversion was made, including extensions. You may either recharacterize the entire conversion amount, or you may recharacterize only a portion of the conversion amount. You must also include the related earnings, from the date of the conversion. You will need to report the recharacterization on your tax return, but no portion will be required to be included in income. The net effect of a conversion and subsequent recharacterization is that a conversion never occurred.

What is a reconversion?

A reconversion is when you do a conversion, recharacterize it and then wish to do a second or a third conversion.

Is there a limit applying to reconversions?

Yes. You cannot reconvert an amount during the same taxable year or, if later, during the 30-day period following a recharacterization.

If I withdraw money from my Roth IRA a number of years after the conversion, will I have to pay a special 10% additional tax if I am younger than age 59½?

Unless you are exempt from the 10% special tax because you qualify for one of the exceptions, you will have to pay the 10% tax if, after applying the special tax-ordering rules, you are considered to have withdrawn your “conversion” funds, and you have not satisfied a special five-year rule. For this special rule, the five-year period starts on January 1 of the year during which you made the conversion contribution. A separate five-year period applies to each conversion you make.

You will NOT have to pay the 10% tax even if, after applying the special tax-ordering rules, you are considered to have withdrawn your “conversion” funds after you have satisfied a special five-year rule. Once you attain age 59½ or older, you may withdraw these conversion funds and not owe the special 10% tax.

Are there any other tax situations of which to be aware?

There is a situation in which an individual may have to pay additional taxes that they may not be aware of when making a conversion to a Roth IRA.

Example: You are age 48 and you withdraw \$10,000 from your traditional IRA and convert it to a Roth IRA. Because the \$10,000 is taxable to you, it is calculated that you owe \$800 of income tax on this \$10,000. You do not have resources to cover this income tax amount, so, instead of converting the entire \$10,000, you only convert \$9,200, and use the additional \$800 to pay the income tax on the conversion amount. This is certainly permissible. The law expressly provides that the 10% additional tax does not apply to any conversion amount. However, only \$9,200 was converted. The \$800 which was used to pay the income taxes was not converted and must be included in your income for income tax purposes. In addition, you will owe an additional \$80 (\$800 x 10%) in taxes which you probably had not planned on owing

Continued on page 6

**Roth IRA Conversions,
Continued from page 5**

because the 10% does apply to the \$800 which was not converted.

Must I take a required minimum distribution from my conversion Roth IRA?

No. A Roth IRA accountholder is not subject to any required distribution rules.

Will my beneficiary(ies) be required to take required distributions after I die?

Yes. Your beneficiary will be required to take required distributions. However, if your spouse is your beneficiary, and he/she decides to treat the Roth IRA as their own, distributions may not be required. Your beneficiary(ies) will want to discuss their options with their tax advisor.

Summary. An IRA custodian wants to start now on preparing for the 2010 Roth conversion activity. Time will tell how many people will convert some or all of their traditional IRAs. The lure of tax-free income from the Roth IRA is very alluring to those individuals who have high incomes and who pay substantial income taxes. You may well benefit by contacting certain traditional IRA accountholders first before they ask. The best result will be - you move traditional IRA funds at another institution to being Roth IRA funds with your institution. ♦

No Life Insurance in an IRA

This article is meant to remind self-directed IRA custodians that IRA funds cannot invest in any life insurance.

Are life settlement contracts life insurance? CWF believes they are and an IRA's purchase of such contracts would disqualify the IRA.

Code section 408(a)(3) clearly provides that "no part of an IRA will be invested in life insurance contracts." Such an investment is not a prohibited transaction as defined in Code section 4975. The investment of IRA funds in impermissible life insurance means the account fails to qualify as an IRA.

There would be a deemed distribution of the entire account as of the date of purchase.

The statutory language does not mention or require the life insurance be on the life of the IRA accountholder.

People sell viatical settlement contracts and life settlement contracts. Others buy these contracts. The topic being discussed is whether a self-directed IRA may buy such a contract as an investment.

Some parties argue that fully paid-up viatical settlement contracts and life settlement contracts are not "life insurance" since no premiums remain to be paid. Purchasing such a contract is not the purchasing of life insurance as is normally meant, but it is the purchase of an "investment."

The primary difference between a life settlement contract and a viatical settlement is that in a life settlement contract the insured does NOT have a life-threatening or catastrophic disease, illness or condition as is the case with a viatical contract situation.

Certainly, the most conservative approach is that a life settlement contract and /or a viatical contract is life insurance and that IRA funds must not be invested in such contracts.

A less conservative approach is that the self-directed IRA custodian will allow the individual to furnish it with a legal opinion that the specific contract being purchased is not life insurance as referenced in Code section 408(a)(3) and he or she assumes responsibility and holds the IRA custodian harmless if the IRS would conclude otherwise.

CWF certainly advises an IRA custodian to inform the individual of the risk and the unsettled legal status of the life settlement contracts as being a qualifying IRA investment. ♦

A Promissory Note as a Self-Directed IRA Investment

CWF recently had a self-directed IRA custodian pose the following question. How long should a nonperforming or delinquent loan remain in an IRA. This IRA could either be a trust IRA or a self-directed custodial IRA.

Here are CWF's general thoughts on promissory notes as an IRA investment.

1. The most conservative approach is to always keep the loan in the IRA even if the loan has been in default for a long time. Unless the debtor has gone through bankruptcy, there would always be a legal claim to seek repayment. Situations change. In most cases there is no need to rush to eliminate the note from the list of IRA assets unless the administrative fees for such note would induce one to eliminate the note. If the loan has no value, the IRA custodian will use zero as the fair market value in its accounting and determination of fair market value of the entire IRA. An IRA may need to have a special fee for "defaulted loans."

2. If an asset decreases significantly in value, it can be advantageous from a tax planning standpoint to distribute the asset in-kind to the IRA accountholder. This is especially true if the individual believes the value of the asset will increase after being distributed.

The fair market value of the asset at the time of the in-kind distribution will be required to be included in the individual's taxable income. There is the "valuing" issue. We are not sure if there are loan appraisers, but a good faith effort should be made by an accountant or bank personnel to determine the current discounted value of a loan which might not be repaid. There should be a write-up setting forth the determination of the value. Under the federal tax rules, We believe the IRA custodian has the primary duty to determine FMV and this duty cannot be delegated to another party.

The IRA custodian wants to be careful in the situation involving the in-kind distribution of a loan. A taxpayer could easily try to abuse the situation to his or her personal benefit. It is unclear if the IRS will look to the IRA custodian to try to limit such abuse. We expect the IRS will adopt the approach of expecting the IRA custodian to have procedures to limit such abuse. For example, an IRA accountholder has \$100,000 of fully taxable funds within a traditional IRA. He loans \$90,000 to a third party in early 2008. The third party defaults on the loan in 2009, such loan is distributed in-kind in December of 2009 with a zero or \$1.00 value, but the borrower ends up repaying the loan in 2011.

Note the individual would include in his or her 2009 taxable income the amount of \$0 or \$1.00. How will the individual reflect the repayment of the \$90,000 loan amount and the payment of the accrued income on his or her 2011 tax return?

We will need to do research to determine the tax consequences - is the repayment of the loan amount non-taxable, might the entire payment qualify as capital gain income or might the entire amount be taxed as ordinary income?

3. An IRA custodian and an IRA accountholder need to have a written understanding covering all subjects with respect to promissory notes. This topic needs to be covered by a special addendum to the IRA plan agreement. Some of the subjects to be covered:

- a. what percentage of the IRA may used to make such loans;
- b. what loan documents will be used;
- c. what collateral will be given for the loan by the borrower;
- d. what interest rate will apply;
- e. when is a default defined to occur so that the collection action will commence;

**Promissory Note,
Continued from page 7**

- f. when will collection action be deferred or suspended and for what reasons; and
- g. the IRA custodian should be authorized to hire an attorney to collect the delinquent debt.

We've heard that many IRA custodians of self-directed IRAs require the use of a Note Servicing Agent. Does the Servicing Agent have the duty to collect with respect to a defaulted note?

Some IRA self-directed custodians have adopted a business model where they want to severely limit their collection activity and may try to contractually remove themselves from performing this duty.

The other approach is to have the IRA custodian perform the collection duty by having the IRA plan agreement or addendum expressly authorize the hiring of a collection attorney and the paying of his or her fee.

There is one more issue to be mentioned. Under federal income tax laws, income arises when one party forgives or cancels a legal debt. We have paraphrased an IRS summary on this issue. The tax impact of debt forgiveness or cancellation depends on the facts and circumstances of each particular situation. Generally, if a person or party borrows money from a commercial lender and the lender later forgives the debt, the person or party most likely will need to include the cancelled amount in income for tax purposes. The lender is usually required to report the amount of the cancelled debt to the third party and the IRS on Form 1099-C, Cancellation of Debt. In some limited situations, the amount forgiven is not required to be included as income.

The IRA, as a lender, most likely will be required to prepare the Form 1099-C in a defaulted note situation. There could also be prohibited transaction issues arising from a loan forgiveness situation if the IRA accountholder would personally benefit from the forgiveness.

In summary, a self-directed IRA may certainly have as an investment, a loan or loans to third par-

ties. There are special concerns and tasks associated with loans. ♦

**IRA Contribution Deductibility Chart
for 2009**

(for participants and/or spouses in
employer-sponsored retirement plans.)

Amount of Modified AGI - (Combined modified AGI if married)

Single

Below \$55,001	Entitled to full deduction
\$55,001-\$64,999.99	Entitled to prorated deduction amount - use special formula**
\$65,000 or over	No deduction permissible

**Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$55,000/\$10,000. This will give you a ratio that determines the amount you cannot deduct.*

Married - joint return, both are covered

Below \$89,001	Entitled to full deduction
\$89,001 - \$108,999.99	Entitled to prorated deduction amount - use special formula**
\$109,000 or Over	No deduction permissible

**Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$89,000/\$20,000. This will give you a ratio that determines the amount you cannot deduct.*

Married - joint return, but only you are covered

Below \$89,001	Fully Deductible
\$89,001-\$108,999.99	Entitled to prorated deduction amount - use special formula**
\$109,000 or over	No deduction permissible

**Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$89,000/\$20,000. This will give you a ratio that determines the amount you cannot deduct.*

Married - joint return, but only your spouse is covered

Below \$166,001	Fully Deductible
\$166,001-\$175,999.99	Entitled to prorated deduction amount - use special formula**
\$176,000 or over	No deduction permissible

**Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$166,000/\$10,000. This will give you a ratio that determines the amount you cannot deduct.*

Married Filing Separately

Below \$10,000	Entitled to prorated deduction amount - use special formula**
\$10,000 or Over	No deduction permissible

**Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$0/\$10,000. This will give you a ratio that determines the amount you cannot deduct.*

*Any amount determined under this formula which is not a multiple of \$10 shall be rounded to the next lowest \$10.

However, an IRA accountholder will be able to deduct a minimum of \$200 as long as his or her AGI is not above the phase-out range (base amount plus \$10,000).