THE ROTH IRA BACKDOOR THAT CONGRESS TOOK AWAY

By Caitlin Sawyer, Tax Associate at Hunton & Williams LLP

In collaboration with Hunton & Williams LLP, STRATA Trust Company brings you this whitepaper to help make sense of the latest Tax Reform impact on Roth IRAs, so that you can better navigate the opportunities and challenges that these changes present.

On December 22, 2017, President Trump signed into law H.R. 1, known as the Tax Cuts and Jobs Act (the "Act"), which makes widespread changes to the Internal Revenue Code (the "Code"). Among other things, the Act eliminates the ability to recharacterize (i.e., undo) Roth IRA conversions. This change could have a significant impact on your financial planning and how you manage your Roth IRA.

ROTH IRA CONTRIBUTIONS: BACKGROUND

There are three general methods to transfer funds to your Roth IRA: direct contributions, rollovers, and conversions. To make direct contributions to a Roth IRA, you must make such contribution on or before the date that your tax return for that year is due. However, an annual contribution limit applies to direct contributions. The aggregate amount that you can contribute to all of your IRAs (traditional and Roth) during a taxable year is the lesser of a maximum dollar amount (for 2017 and 2018, $5,500, and $6,500 if you are age 50 or older) and your compensation for that year (taking into account your spouse's compensation if you file jointly). Note that your ability to directly contribute to a Roth IRA phases out once your compensation exceeds certain amounts. In 2018, your ability to contribute to a Roth IRA begins to phase out if you earn at least $120,000 per year and is eliminated if you earn $135,000 ($189,000 and $199,000, respectively, for taxpayers filing jointly).

You can also "rollover" (i.e., move) funds from a qualified plan (such as a 401(k) plan or a 403(b) plan) into your Roth IRA. The Code does not limit the amount that you can rollover into a Roth IRA in a particular year. In addition, the phase out amounts that apply to direct contributions to a Roth IRA do not apply to rollovers. However, be aware that the terms of a 401(k) plan or a 403(b) plan could limit the amount that you are able to rollover to a Roth IRA.

Finally, you may transfer funds to a Roth IRA by converting a traditional IRA or a qualified plan into a Roth IRA (a "Roth Conversion"). A Roth Conversion occurs either with a trustee-to-trustee transfer of an amount from the traditional IRA or plan to the Roth IRA, or with a distribution out of the traditional IRA or plan followed by a contribution to the Roth IRA within 60 days. The amount converted to a Roth IRA is taxable to you as if you had withdrawn those funds. If you want to use a Roth Conversion for a particular taxable year (and thus include the contributed amount in income in that taxable year), you must do so by December 31 of that year (even though you may not know your tax liability until you prepare your tax return).

A Roth Conversion may make sense if your annual compensation exceeds the Roth IRA phase out amounts that apply to direct contributions to a Roth IRA. Unlike direct contributions, Roth Conversions are not subject to these phase out amounts (hence the reason that a Roth Conversion is often referred to as a "backdoor" Roth IRA). Therefore, Roth Conversions are a useful alternative to direct contributions for taxpayers that are not eligible to contribute funds directly to a Roth IRA. Also, a Roth Conversion essentially allows you to change when the amounts held in the IRA or qualified plan are subject to tax. After the Roth Conversion, these amounts will not be subject to tax when they are withdrawn.

ROTH CONVERSIONS UNDER PRIOR LAW

Prior to the Act, you could recharacterize (i.e., undo) a Roth Conversion as long as you elected to do so on or before the due date for your tax return for the year of the original conversion. As a result, the Roth Conversion would be treated as if it had never occurred (i.e., the money would stay in your traditional IRA or qualified plan) and you would not owe the income taxes on the amount that may have been owed as a result of the Roth Conversion.

There are a few reasons that you might choose to undo a Roth Conversion. For example, suppose immediately after the Roth Conversion, market prices drop such that the tax liability arising from the Roth Conversion will be more than you anticipate having to pay in the future. In that situation, you might consider undoing the Roth Conversion with the intent to convert the IRA or qualified plan at a later date to take advantage of the market adjustments. In addition, a reversal of a Roth Conversion may make sense to help you manage your tax liability if you anticipate being in a higher income tax bracket, whether as a result of the Roth Conversion or otherwise.

TAX REFORM: ROTH CONVERSIONS GOING FORWARD

The Act eliminates your ability to undo any Roth Conversions made on or after January 1, 2018. If you engaged in a Roth Conversion during 2017, you can recharacterize that conversion if you do so by October 15, 2018 (i.e., the extended date for filing your tax return). If you are considering a recharacterization for a Roth Conversion during 2017, be sure to extend the due date for your 2017 tax return to provide yourself with the maximum amount of time to consider whether to recharacterize. It is unclear whether or not you can amend a previously filed 2017 tax return to recharacterize a Roth Conversion, even if that amendment is filed by October 15, 2018.

BOTTOM LINE: ACTION ITEMS

Based on the changes made by the Act to Roth Conversions, consider the following:

Recharacterize as soon as possible

If you engaged in a Roth Conversion during 2017 and it becomes clear that doing so will subject you to unfavorable tax consequences, be sure to:

- Undo the conversion by October 15 (and to extend the due date for your 2017 tax return to October 15).
- Keep in mind that undoing a 2017 Roth Conversion may make sense because the tax arising from such conversion will be subject to the 2017 tax rates. Because the Act lowered tax rates across the board, a Roth Conversion in 2018 may be subject to a lower tax rate than a Roth Conversion made in 2017.
- Consider undoing a 2017 Roth Conversion and then reconverting in a subsequent tax year to take advantage of the lower tax rates.

However, note that certain waiting periods apply before you are able to reconvert – if you convert and then undo, you cannot reconvert until 30 days after you undo the Roth Conversion or one year after the Roth Conversion itself (whichever is later).

Carefully consider any Roth Conversion

Roth Conversions made after January 1, 2018 are essentially irrevocable. Going forward, you must carefully consider any Roth Conversion before you actually decide to use this method to transfer funds to a Roth IRA. Be sure to estimate your tax liability for the year and the amount of income tax that will be due as a result of the Roth Conversion.

Don't rule out Roth Conversion

Because the Act lowered tax rates, it may be a good time to consider a Roth Conversion. In a Roth Conversion, any untaxed amounts that are contributed the Roth IRA via such conversion are taxable. With low tax rates, it may make sense to convert a traditional IRA or plan to a Roth IRA in 2018.

Consider different strategies to transfer funds to your Roth IRA

As explained above, there are various methods of transferring funds to your Roth IRA. You can make a direct contribution to a Roth IRA, roll over funds, or use a Roth Conversion. Consider transferring funds using a direct contribution or a rollover to avoid the new recharacterization rule (which only applies to Roth Conversions).

Consult with a Tax Advisor or Legal Counsel

We recommend you consult with a qualified tax advisor or tax attorney regarding whether recharacterizing a Roth Conversion or making any other elections with respect to Roth IRAs, traditional IRAs or qualified plans is right for you.

ABOUT THE AUTHOR

Caitlin Sawyer, a Tax Associate at Hunton & Williams LLP, helps clients navigate complex federal income tax issues. She focuses on corporate mergers, acquisitions and reorganizations, fund formation, and transactions involving partnerships, limited liability companies, and other pass-through entities. Caitlin assists clients with tax issues involved in mergers, acquisitions and other complex transactions. She has significant experience regarding the tax aspects of corporate mergers, acquisitions and reorganizations (including transactions involving banks and S corporations) and drafting tax provisions in partnership and limited liability company (LLC) agreements. She also has extensive experience calculating Section 280G payments and drafting 280G shareholder vote documents in connection mergers and acquisitions. Caitlin also has experience with drafting tax provisions in a variety of disclosure documents, including proxy statements and prospectuses. She regularly advises clients regarding the Foreign Account Tax Compliance Act (FATCA) as well as the Bipartisan Budget Act of 2015 (the New Partnership Audit Rules).

ABOUT HUNTON & WILLIAMS LLP

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ABOUT US

STRATA Trust Company has quickly catapulted to become a premier national custodian for alternative assets and non-exchange traded investments in self-directed IRAs. Formerly known as Self Directed IRA Services, Inc., STRATA has been helping investors use their retirement account funds to invest in real estate and other alternative investments since 2008. STRATA currently serves over 33,000 individuals nationwide with over $1.8 billion in assets under custody.

With offices in Waco and Austin, Texas, our team's vast experience in handling the details and complexities that real estate transactions require is unrivaled. Our seasoned team's experience in the custody of alternative assets spans over 350 years. With a well-established reputation for honesty and integrity, STRATA is committed to delivering responsive, flexible and innovative solutions.

At STRATA, we work to ensure that the highest standards for safety and soundness are met. As a subsidiary of Horizon Bank, SSB, STRATA is a Texas-chartered trust company regulated by the Texas Department of Banking, which has long set the benchmark among state banking regulators. Strict controls are in place to ensure the safety of uninvested cash, and independent auditors are retained to conduct regular audits of our operations.

STRATA
TRUST COMPANY

7901 Woodway Drive,
STE 200, Waco, TX 76712

866.928.9394
512.637.5739

info@StrataTrust.com
www.StrataTrust.com