Can You Convert a Coronavirus-Related Distribution to a Roth IRA?

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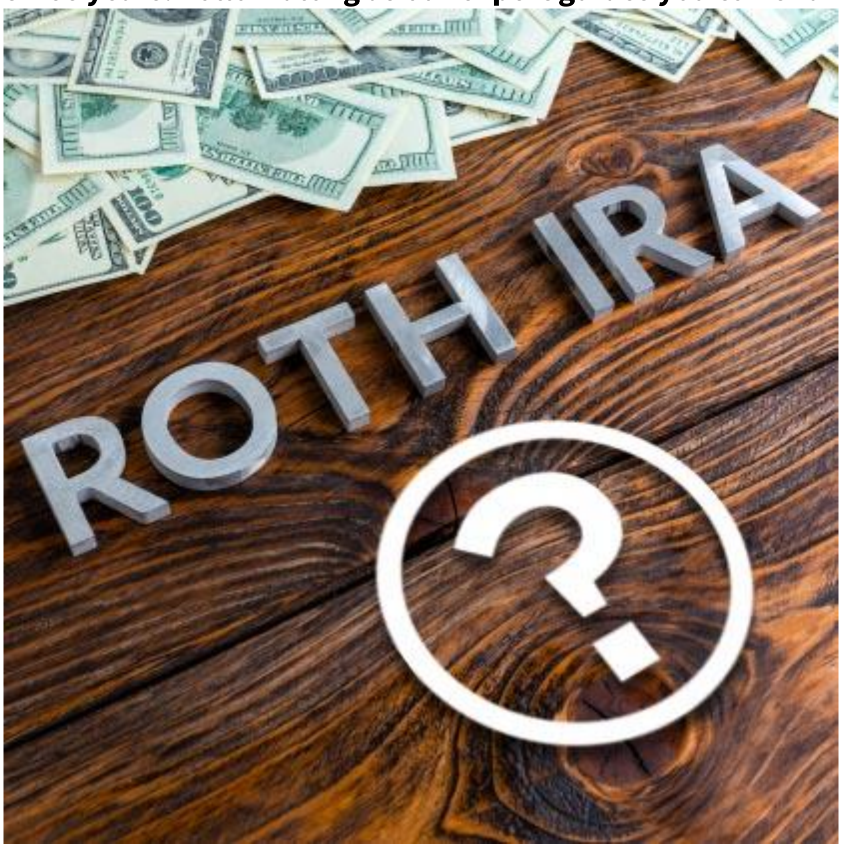
Can you do a Roth conversion of a coronavirus-related distribution? It would be nice if you could, as that would allow you to spread the income from the Roth conversion over three years. Follow along as our expert guides you to her answer.



The Covid-19 pandemic has wreaked havoc on the finances of many Americans. In response, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law, to provide relief for individuals and businesses.

One of the relief provisions relaxes the rules for distributions from retirement accounts through a coronavirus-related distribution provision, which allows taxpayers to (A) repay these distributions within three years, or (B) spread the income from the distribution over three years. One hot topic around this provision is whether a coronavirus-related distribution could be converted to a Roth IRA, thus allowing a taxpayer to benefit on both ends, in effect eating his cake and having it too.

Let us start with the basics

A. What is a coronavirus-related distribution?

A distribution is a coronavirus-related distribution if it meets all three of these requirements:

- It is taken at any time from January 1, 2020, through to December 31, 2020.
- It is taken from an eligible retirement plan.
- It is taken by a qualified individual, as defined in Section 1(B) of IRS Notice 2020-50: Guidance for Coronavirus-Related Distributions and Loans From Retirement Plans Under the CARES Act (Notice 2020-50).

Coronavirus-related distributions boast three attractive features that are not generally available to regular distributions:

1. They are exempt from the 10% early distribution penalty (additional tax) that applies to distributions made before the account owner reaches age 59½.
2. The income from the distribution may be included in income ratably over three years, whereas other distributions are generally required to be included in income the year in which the distribution occurs. If the taxpayer so elects, the total coronavirus-related distribution amount can be included in income for 2020.
3. The amount can be repaid to an eligible retirement plan within three years after the account owner received the distribution. Ordinally, distributions may be rolled over to an eligible retirement plan within 60 days of receipt, unless the account owner qualifies for a waiver or the 60-day period is postponed.

B. What is a Roth Conversion?

Technically, a Roth conversion is also a rollover. It occurs when a distribution is made from a traditional account under an eligible retirement plan and rolled over to a Roth account—for example, from a traditional IRA to a Roth IRA.

What is the difference between a Roth conversion and other rollovers? With other rollovers, the amounts are rolled back to the same type of account from which the amount was distributed (traditional to traditional or Roth to Roth). This results in a nontaxable transaction. On the other hand, with a Roth conversion, the amount is distributed from a traditional account to a Roth account, and any pretax amount is taxable.

Conversion of a coronavirus-related distribution would be a bonus deal—if permitted

Roth accounts are more attractive than traditional retirement accounts because qualified distributions of earnings are tax-free, whereas, with a traditional account, distributions of earnings are taxable.

One of the ways to fund a Roth IRA without income and amount limitations is by converting amounts from a traditional retirement account. However, this is often seen as a deterrent for some because any pretax amount included in a Roth conversion is generally required to be included in the owner's income for the year in which the Roth conversion is done. One way to mitigate the taxes that would be due is to spread the conversion over multiple years.

If a coronavirus-related distribution could be converted to a Roth, the owner could get up to $100,000 into a Roth IRA for 2020 and spread the income ratably over three years—2020, 2021 and 2022. This could make the tax burden more manageable, and potentially reduce any income tax that would be owed should the lower income per year result in the individual being in a lower tax bracket than he would have been, had the $100,000 been included in income for only one year.

The reason some believe it is permitted

Under the CARES Act, a coronavirus-related distribution may be taken from an eligible retirement plan and may be repaid by the end of the 3-year period to an eligible retirement plan:

1. Of which the recipient is a participant, and
2. To which a rollover contribution of such distribution could be made.

For this purpose, the CARES Act's definition of an eligible retirement plan is consistent with the tax code, specifically IRC §402(c)(8)(B), which means:

i. An individual retirement account (IRA)
ii. An individual retirement annuity (IRA) other than an endowment contract
iii. A qualified trust (qualified plan, such as a defined contribution, defined benefit pension)
iv. A 403(a) annuity plan
v. An eligible deferred compensation 457(b) plan maintained by an eligible employer
vi. A 403(b) account or annuity

The only restriction on portability between these accounts is that any distribution made from a designated Roth account—such as a Roth 401(k)—must be rolled over to another designated Roth account or Roth IRA.

As such, those who believe a coronavirus-related distribution can be converted to a Roth IRA argue that:

A. The maximum period for the repayment is three years. Hence, there is nothing stopping someone from taking a coronavirus-related distribution from a traditional retirement account and repaying it within a short period—even the same day—to a Roth IRA.

B. A Roth conversion can be done indirectly, where the amount is paid to the participant, who then has 60 days to roll over the amount to the Roth IRA.

C. The definition of eligible retirement plan includes Roth IRAs, and the coronavirus—related distribution repayment option says that the amount can be repaid to an eligible retirement plan.

D. The only exception to rollovers between eligible retirement plans is that, under IRC §402(c)(8)(B), a rollover of a distribution that is made from a designated Roth account must be made to another designated Roth account or Roth IRA.

The question then becomes: If a coronavirus-related distribution may be repaid to an eligible retirement plan, and a Roth IRA is an eligible retirement plan, why can't a coronavirus-related distribution from a traditional retirement plan/account be rolled over to a Roth IRA?

Here is why it is not permitted

Recall from my explanation above, that a Roth conversion results in any pretax amount being included in income. This means that a Roth conversion of any pretax amount would be taxable; as opposed to a rollover between accounts of the same type (traditional to traditional or Roth to Roth) which would be nontaxable (tax-free).

The IRS has confirmed on more than one occasion that a repayment of a coronavirus-related distribution would be treated as a tax-free rollover—which means that it must occur between accounts of the same type—for example, traditional 401(k) to traditional IRA or Roth 401(k) to Roth IRA.

They made a point of reminding us six times in Notice 2020-50, by using language that indicates that the option for spreading the income over three years applies only to amounts that would have been tax-free if rolled over. For example, in the Purpose section, they state the following:

> "…and, *to the extent the distribution is eligible for tax-free rollover treatment* and is contributed to an eligible retirement plan within a 3-year period, will not be includible in income."

The full list of occurrences is:

1. The Purpose Section on Page 1
2. Section 1. Coronavirus-Related Distributions: Part A. Special Tax Treatment for Coronavirus-Related Distributions
3. Section 1. Coronavirus-Related Distributions: Part D. Certain Coronavirus-Related Distributions Are Permitted to Be Recontributed

4. Section 3. Guidance for Eligible Retirement Plans Making or Accepting Recontribution of Coronavirus-Related Distributions: Part B. Accepting Recontributions of Coronavirus-Related Distributions
5. Section 4. Guidance for Individuals Receiving Coronavirus-Related Distributions Under Section 2202 of the CARES Act.
6. Section 4. Guidance For Individuals Receiving Coronavirus-Related Distributions Under Section 2202 of the CARES Act: Part C. Tax Treatment of Recontributions of Coronavirus-Related Distributions

Remember, one of the requirements of a coronavirus-related distribution is that a repayment of the amount must result in tax-free rollover treatment, causing the repaid amount to be excluded from income. Therefore, a coronavirus-related distribution cannot be converted to a Roth, because a Roth conversion is not tax-free, and is includible in income.

There is more: the tax reporting forms

According to the IRS, a qualified individual receiving a coronavirus-related distribution claims the favorable tax treatments by reporting the distribution on the individual's federal income tax return for 2020 and Form 8915-E, *Qualified 2020 Disaster Retirement Plan Distributions and Repayments (or if there is no federal income tax return for 2020, by filing just Form 8915-E).*

At the time of writing this article, Form 8915-E was not yet available. However, we can refer to previous versions of Form 8915, that were used to report Disaster Retirement Plan Distributions and Repayments.

According to the instructions, there are two options for these distributions:

1. The amount is included in income for the year in which the distribution is made, and
2. The amount is spread in income ratably over three years.

Amounts that are repaid are excluded from the equation used to figure out how much to include on the tax return. According to the instructions, the equation is:

(Taxable portion of coronavirus-related distribution amount / 3)	–	any amount repaid before filing the 2020 tax return	=	amount to be included on return as taxable income

This excludes a Roth conversion from the repayment formula. If it is included, it would incorrectly show that the conversion amount is nontaxable. The IRS would find this problematic.

Consider this demonstration:

Assume a coronavirus-related distribution of a pretax amount of $100,000 and an election to spread the amount over three years.

Assume also, that $10,000 is rolled over in 2020

(Taxable portion of coronavirus-related distribution amount / 3)	–	any amount repaid before filing the 2020 tax return	=	amount to be included on return as taxable income
$100,000/3	–	$10,000	=	
$33,333	–	$10,000	=	$23,333

This shows that the rollover of the $10,000 should result in a tax-free rollover, and therefore cannot be a Roth conversion, as a Roth conversion is not tax-free.

Could this change?

Maybe, but I doubt it!

Generally, the IRS provides exceptions to certain general rules to help taxpayers who face adverse tax consequences for reasons beyond their control. For instance, the IRS will waive the 60-day deadline for rollovers, where the deadline is missed due to hardship or certain reasons beyond the control of the taxpayer—like a pandemic.

Most, if not everyone, would agree that a Roth conversion does not fall into a category of hardship—and is more of a tax strategy for taxpayers who are on the opposite of the spectrum from financial hardship.

Could the IRS somehow provide an exception that permits the conversion of a coronavirus-related distribution? It is not impossible, but I think it is unlikely.

So, for now, if anyone takes a distribution from a traditional retirement account and decides to roll over any portion of that amount to a Roth IRA or designated Roth account, the amount must be included in income for the year in which the conversion occurs—and 2020 is no exception.

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