IRAs and Roth Conversions

Rockland County Estate Planning Council

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Bruce D. Steiner

- Bruce Steiner has over 35 years of experience in the areas of taxation, estate planning, business succession planning and estate and trust administration.

- He is a frequent lecturer at continuing education programs for bar associations, CPAs and other professionals. He is a commentator for Leimberg Information Services, Inc., is a member of the editorial advisory board of *Trusts & Estates*, is a technical advisor for *Ed Slott's IRA Advisor*, and has written numerous articles for *Estate Planning*, *BNA Tax Management's Estates, Gifts & Trusts Journal*, *Trusts & Estates*, *Journal of Taxation*, *Probate & Property*, *TAXES*, *CPA Journal*, *CLU Journal* and other professional journals.

- Bruce has been quoted in various publications including *Forbes*, the *New York Times*, the *Wall Street Journal*, the *Daily Tax Report*, *Investment News, Lawyers Weekly*, *Bloomberg's Wealth Manager*, *Financial Planning*, *Kiplinger's Retirement Report*, *Newsday*, *New York Post*, *Naples Daily News*, *Individual Investor*, *Fox Business*, *TheStreet.com*, and *Dow Jones (formerly CBS) Market Watch*.

- Bruce has served on the professional advisory boards of several major charitable organizations and was named a New York Super Lawyer in 2010, 2011, 2012, 2013, 2014 and 2015.

Traditional IRAs

- Contributions are generally deductible
- Nondeductible contributions produce basis
- Income and gains in the IRA are generally not taxable
- Distributions are generally taxable

Roth IRAs

- Contributions are not deductible
- Income and gains in the IRA are generally not taxable
- Distributions are generally not taxable

Investment control

- With a few exceptions, you control the investments in an IRA
- In a profit-sharing or 401(k) plan, it depends on the plan

Contribution limits

- The IRA contribution limit is $5,500 per year ($6,500 if over age 50)
- The defined contribution limit is $53,000 per year
- The 401(k) plan limit is $18,000 per year ($24,000 if over age 50)

How to look at your qualified plan or IRA

- Your benefits are part yours (1 minus the tax rate) and part the government's (the tax rate)
- Your share grows tax-free

Your share is tax-free

- Assume a constant 40% bracket
- You contribute $5,500 to a traditional IRA. It grows to $55,000. You take it out, pay $22,000 tax, and keep $33,000
- If you didn't contribute the $5,500, you would pay $2,200 tax. You would have $3,300 left. It wouldn't grow to $33,000, since the income and gains would be taxable each year
- Your 60% share of the IRA ($3,300) grew to $33,000 tax-free

A Roth is equivalent to a larger IRA

- Suppose you contribute $5,500 to a traditional IRA. It grows to $55,000. You withdraw it, pay $22,000 tax, and have $33,000 left
- You could instead pay $2,200 tax up front and contribute $3,300 to a Roth IRA. It would grow to the same $33,000
- Suppose you contribute $5,500 to a Roth IRA
- That's equivalent to contributing $9,167 to a traditional IRA
- However, you can't contribute $9,167 to a traditional IRA

Comparing the traditional and Roth

- At a constant tax rate, the time value of money is not relevant
- There is an additional benefit if you convert or withdraw at a lower tax rate
- The benefit is reduced if you convert or withdraw at a higher tax rate

Converting to a Roth

- By paying the income tax on the conversion out of other assets, you are effectively making an additional contribution
- Assume you're in a 30% income tax bracket
- You have a \$100,000 traditional IRA and \$30,000 cash
- You convert. You now have a \$100,000 Roth IRA
- Your Roth grows to \$200,000 tax-free

If you don't convert

- Your $100,000 traditional IRA grows to $200,000. You withdraw the $200,000, pay $60,000 tax, and have $140,000 left

- Your $30,000 taxable account grows to less than $60,000, since the income and gains each year are taxable

When to convert

- It's more complicated if your tax bracket will decrease
- It's more complicated if converting all at once will bunch the income into a higher bracket
- Consider whether to convert all at once, or to spread the conversion over a number of years
- Moderate income IRA owners with large IRAs often spread the conversion over a number of years
- IRA owners who will always be in a high bracket may convert all at once

When to convert

- General rule: convert as much as you can each year as long as it doesn't put you into too high a tax bracket
- Many people convert up to the top of the 15% bracket
- There is often a window between retirement and age 70 (when Social Security benefits often begin) to convert in a low bracket

Miscellaneous factors affecting the tax on the conversion

- Taxation of Social Security benefits
- Medicare Part B premiums
- Phaseout of personal exemptions (PEP)
- Reduction of itemized deductions (Pease)
- The 10% of income floor on the deduction of medical expenses (7.5% in 2015 and 2016 if age 65 or over)

Additional factors affecting the tax on the conversion

- Other deductions and credits that are phased out based on income
- The alternative minimum tax. An IRA owner who would otherwise be in a higher bracket might convert within the 28% AMT tax rate
- The 3.8% tax on net investment income

State and local income taxes

- The top New York State income tax rate is 8.82%
- The top New York City income tax rate is 3.876%
- New York allows taxpayers over age 59 ½ to exclude $20,000 of qualified plan and IRA benefits.
- An IRA owner over age 59 ½ may wish to convert at least $20,000 a year to take advantage of the exclusion
- The top New Jersey income tax rate is 8.97%

Backdoor Roth conversions

- There are income limitations for contributions to a Roth IRA, or to deduct contributions to a traditional IRA
- If you can't contribute to a Roth, or deduct a contribution to a traditional IRA, you may be able to make a nondeductible contribution to a traditional IRA and then convert to a Roth
- This is called a "backdoor Roth conversion"

Proration of basis

- If you have other assets in a traditional IRA, the basis is prorated.
- If you have $45,000 in a traditional IRA with no basis and you make a $5,000 nondeductible contribution, you'll have a $50,000 traditional IRA with $5,000 of basis. If you convert $5,000, you'll only be able to apply $500 of basis
- You may be able to avoid this result by rolling your other traditional IRA assets into an employer plan

Mega backdoor Roth conversions

- Some employer plans permit nondeductible contributions
- You may be able to make nondeductible contributions to a profit-sharing plan, and roll them over into a Roth IRA
- This is knows as a “mega backdoor Roth conversion”

Proposal to eliminate backdoor Roth conversions

- The Administration has proposed to limit Roth conversions to pre-tax dollars
- This proposal would become effective in 2017
- In case this proposal is enacted, taxpayers may wish to make nondeductible contributions and roll them over in 2016

Additional benefits of the Roth conversion

- No required distributions after age 70 ½
- The spouse can roll it over into his or her own Roth IRA
- Increased creditor protection
  - More assets are in the (Roth) IRA, where they are or may be better protected against creditors
  - Example: before converting, an IRA owner has a $1 million IRA subject to 30% tax, and $400,000 of cash. After converting, the IRA owner has a $1 million Roth IRA and $100,000 of cash
  - The IRA is protected against most creditors in New York, New Jersey and Florida. However, the cash outside the IRA is not protected

Section 691(c) deduction for the estate tax on income in respect of a decedent

- The recipient of income in respect of a decedent gets an income tax deduction for the Federal estate tax
- This is intended to put the recipient in about the same position as if the decedent had received the income during lifetime
  - The decedent would have paid the income tax
  - The payment of the income tax would have reduced the estate, thereby reducing the estate tax
- However, the deduction is only for the Federal (but not the state) estate tax

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Estate tax on traditional IRA

- An IRA owner in New York dies with a $1 milllion traditional IRA
- The New York estate tax is $160,000 (16% of $1 million)
- The New York estate tax is deductible against the Federal estate tax
- The Federal estate tax is $336,000 (40% of $840,000)
- The total estate tax is $496,000

Income tax on traditional IRA

- The beneficiary gets an income tax deduction for the $336,000 of Federal estate tax
- The beneficiary has $664,000 of taxable income, and pays income tax of $265,600 (40% of $664,000)
- The total income and estate taxes are $761,600
- The beneficiary ends up with $238,400

The Roth conversion avoids this problem

- Suppose the IRA owner converted and paid $400,000 of income tax out of the IRA
- The IRA owner dies with a $600,000 Roth IRA
- The New York estate tax is $96,000 (16% of $600,000)
- The Federal estate tax is $201,600 (40% of $504,000)
- The total estate tax is $297,600
- The beneficiary ends up with $302,400 (instead of $238,400)
- The result is even better if the IRA owner can pay the income tax out of other assets

Trust tax rates

- The tradeoff for leaving retirement benefits in trust is that trusts are generally subject to income tax at higher rates
- For 2016, the 39.6% bracket begins at $12,400 of taxable income for trusts, but not until $415,050 (single) or $466,950 (joint) for individuals
- Trustees can avoid paying income tax at the trust rates by making distributions
- However, amounts distributed will be included in the beneficiary’s estate, and will be subject to the beneficiary’s creditors and spouses

The Roth conversion avoids the trust tax rates

- The Roth conversion avoids the tradeoff between the benefits of leaving assets in trust and the trust tax rates.
- Many IRA owners can convert at a tax rate less than 39.6%
- The trustees can retain the distributions from the Roth IRA in the trust without incurring additional income tax.

Deathbed conversions

- Removes the income tax from the estate
- Gets the other benefits of the Roth conversion
- If the IRA owner’s other assets are highly appreciated, they will get a basis step-up at death.
- The appreciated assets may be used to pay the tax on the conversion without incurring capital gains tax

Countervailing factors

- If you convert all at once, you may bunch the income
- You may be in a lower bracket at retirement
- You may move to a state with a lower state income tax, or with no state income tax
- The rollover and Roth conversion give up NUA treatment
- You may want to retain traditional IRA benefits to fill up your lower tax brackets after retirement
- Distributions from a traditional IRA may be offset by medical expenses

Recharacterizing

- You may recharacterize (unconvert) a Roth IRA back to a traditional IRA
- This gives you a free option. You can keep the Roth IRA if the value goes up, or recharacterize if the value goes down

Choices available to spouses

- A spouse may become an IRA owner
- A spouse may remain as a beneficiary
  - Avoids the 10% tax on withdrawals before age 59 ½
  - No required distributions until the deceased spouse would have reached age 70 ½.
  - May later decide to become an owner

Nonspousal rollovers

- Some qualified plans do not allow beneficiaries to stretch the benefits
- A nonspouse beneficiary may roll qualified plan benefits into an inherited IRA
- The inherited IRA may be an inherited Roth IRA

Spousal rollovers where the spouse is not the named beneficiary

- Default under the terms of the plan or IRA
- Disclaimers
- Elective share
- Community property
- Through an estate or trust

IRAs and ROTH IRA CONVERSIONS

ROCKLAND COUNTY ESTATE PLANNING COUNCIL

May 13, 2016

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ROTH IRAs and ROTH CONVERSIONS

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I. General Characteristics of Tax-Qualified Plans and IRAs.

A. Traditional IRAs.

1. Contributions are generally deductible.

2. It is often possible to make nondeductible contributions in excess of the amount that is deductible. These nondeductible contributions produce basis.

3. The income and gains within the plan or IRA are generally not taxable.

4. Distributions are generally taxable.

B. Roth IRAs.

1. Contributions are not deductible.

2. The income and gains within the plan or IRA are generally not taxable.

3. Distributions are generally not taxable.

C. Roth IRA conversions. The conversion is taxable except to the extent of any basis.

D. You have considerable investment control.

1. In an IRA, with a few exceptions, you have complete control over the investments.

2. In a profit-sharing or 401(k) plan, the degree of control that you have over the investments depends upon the plan.

   (a) Many plans offer a choice of mutual funds. The expenses of the funds will vary depending upon the funds in the plan, and the funds selected by the participant.

   (b) Some plans allow each participant to have a self-directed brokerage account.

   (c) A participant may be able to roll his or her benefits over to an IRA, whereupon he or she will have greater control over the investments.

3. In a defined benefit plan, you have no investment control or investment risk. You are guaranteed a defined benefit, which presumes a defined investment return.

E. Within certain limitations, you decide when to withdraw money from your IRA. Qualified plans limit when you may withdraw your money.

F. Basis step-up at death.

1. Traditional qualified plan and IRA benefits are income in respect of a decedent, so they do not receive a basis step-up at death.

2. Roth IRA benefits are generally not taxable, so their basis is irrelevant.

II. **Income Tax Benefits of Tax-Qualified Plans and IRAs.**

A. The investment income and gains in a tax-qualified plan or IRA are tax-free.

B. The limit on IRA contributions is $5,500 per year. A $5,500 IRA contribution at age 25 will grow to $115,513 by age 70, assuming a 7% return.

C. Contributions of $5,500 per year will grow to approximately $1.2 million in 40 years, assuming a 7% return.

D. There are income limitations on Roth and deductible contributions to traditional IRAs, but not to nondeductible contributions to traditional IRAs.

E. The annual defined contribution limit is $53,000 per year. Contributions of $53,000 per year (the current defined contribution limit) will grow to approximately $11 million over 40 years.

F. The limits on contributions are indexed for inflation. In addition, IRA owners over age 50 may contribute an additional $1,000 per year, and 401(k) plan participants over age 50 may contribute an additional $6,000 per year, so the eventual benefits may be even greater.

G. Although retirement benefits are taxable as ordinary income, with no basis step-up at death, you are not really "giving up" capital gains rates or basis step-up by making retirement plan or IRA contributions.

   1. If you contribute $5,500 to a traditional IRA and it grows to $115,513, and you withdraw it all at once, you will have $69,308 after income tax at 40%.

   2. If you did not contribute the $5,500 to an IRA, you would have $3,300 after income tax at 40%. At the same 7% return, assuming no income taxes at all (no interest or dividends and no capital gains at all), you would have the same $69,308. However, you would probably have some taxable interest or dividends or capital gains, and the yield on tax-exempt bonds is generally lower than the yield on taxable bonds.

H. At a constant 40% tax rate, you can view your IRA as being 60% yours and 40% as the government's.

I. When you withdraw money, it's 60% yours and 40% the government's.

J. The income and gains on your 60% share are tax-free, not tax deferred.

K. You get an additional benefit if your tax rate is lower when you withdraw money than when you contributed the money.

L. You may be able to contribute $5,500 to a Roth IRA instead of to a traditional IRA.

M. A 401(k) plan may allow participants to make all or some of their elective deferrals to a designated Roth account within the plan.

N. Contributions to a Roth IRA or a designated Roth account in a 401(k) plan appear to be the same as contributions to a traditional IRA or traditional account in a 401(k) plan.

   1. If you contribute $5,500 to a traditional IRA and it grows to $55,000, and you withdraw it and pay $22,000 tax, you have $33,000 left.

2. If you pay $2,200 tax up front and contribute $3,300 to a Roth IRA, and it grows to $33,000, you will have the same $33,000.

3. In the above example, the analysis involves comparing the tax rates upon contribution and upon withdrawal.

4. If you contribute $5,500 (rather than $3,300) to a Roth IRA, in a 40% bracket that is equivalent to contributing $9,167 to a traditional IRA.

5. But you may not contribute $9,167 to a traditional IRA.

6. Similarly, if you contribute $18,000 to a designated Roth account in a 401(k) plan, in a 40% bracket that is equivalent to contributing $30,000 to a traditional account in a 401(k) plan. But you may not contribute $30,000 to a traditional account in a 401(k) plan.

7. In other words, the Roth IRA or the Roth 401(k) effectively allows for a larger contribution than the traditional IRA or the traditional 401(k).

O. At a constant tax rate, time value of money is not relevant.

P. If your tax rate stays the same, contributing the same amount to a Roth is better, since it's effectively a larger contribution.

Q. At an increasing tax rate, contributing to a Roth is even better.

R. At a decreasing tax rate (*e.g.*, upon retirement), you have to weigh the decrease in tax rates against the benefit of having more money in a tax-free environment sooner.

III. <u>Converting a Traditional IRA to a Roth IRA.</u>

A. By paying the income tax on the conversion out of other assets, you are effectively making a substantial additional contribution to your IRA.

B. Example: an IRA owner in a 30% bracket has a $100,000 traditional IRA and $30,000 of other assets.

1. Suppose she converts. She now has a $100,000 Roth IRA. Over some period of time, it grows to $200,000.

2. Suppose she does not convert. Over the same time, her $100,000 traditional IRA will grow to the same $200,000, or $140,000 after tax. But her $30,000 taxable account will not double in the same period, since the investment income and gains in the taxable account will be subject to income tax each year.

C. The analysis is more complicated if the IRA owner's tax bracket will decrease (*e.g.*, following retirement), or if converting all at once will bunch the income into a higher tax bracket in the year of the conversion.

D. There is a tradeoff between converting all at once to get more money into a tax-free environment sooner, and spreading the conversion over a number of years to avoid bunching substantial taxable income in a single year.

E. Moderate income taxpayers with large IRAs often spread the conversion out over a number of years.

F. An IRA owner who expects to always be in a high income tax bracket may wish to convert all at once.

G. A general rule is to convert as much as you may each year so long as it doesn't put you into "too much higher" a tax bracket.

H. IRA owners with modest incomes often convert to the top of the 15% bracket.

I. Many IRA owners have a window between retirement and age 70 when Social Security benefits begin (if deferred to age 70) when they may convert in low brackets.

J. Miscellaneous factors may affect the tax on the conversion:

1. Taxation of Social Security benefits.

2. Medicare Part B premiums.

3. Phaseout of personal exemptions (PEP) based upon adjusted gross income.

4. The reduction of itemized deductions based upon adjusted gross income above a threshold (Pease).

5. The floor on the deduction of medical expenses (10% of adjusted gross income, except 7.5% of adjusted gross income before 2017 for taxpayers age 65 or over).

6. Other deductions and credits that are phased out based on income.

7. The alternative minimum tax. An IRA owner in the AMT who would otherwise be in the 33% or 35% or 39.6% bracket might convert to the extent he or she may do so within the 28% AMT tax rate.

8. The 3.8% net investment income tax.

9. State and local income taxes.

(a) The top New York State income tax rate is 8.82%.

(b) The top New York City income tax rate is 3.876%.

(c) New York allows taxpayers over age 59 ½ a $20,000 exclusion for tax-qualified pension income, including IRA benefits. An IRA owner over age 59 ½ may use this exclusion on Roth conversions. The beneficiaries of a deceased IRA owner may utilize this exclusion if the decedent would have been over age 59 ½.

(d) The top New Jersey income tax rate is 8.97%.

IV. Backdoor Roth Conversions.

A. If your income is too high to make a $5,500 annual contribution to a Roth IRA, you may make a nondeductible contribution to a traditional IRA and then convert it to a Roth IRA. This is commonly known as a backdoor Roth conversion.

1. If you have other traditional IRA assets, the conversion is taxable on a pro rata basis, which prevents the entire annual contribution from being converted into a contribution to the Roth IRA.

2. You may be able to avoid this result by rolling your other traditional IRA assets into a tax-qualified plan, if the tax-qualified plan so permits.

B. You may also be able to make nondeductible contributions to a 401(k) plan, and roll them over into a Roth IRA. This is commonly known as a mega backdoor Roth conversion.

C. The Administration's Revenue Proposals for Fiscal Year 2017 would limit Roth conversions to pre-tax dollars. https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf at 172.

1. This proposal would become effective in 2017.

2. In case this proposal is enacted, taxpayers may wish to make nondeductible contributions to traditional IRAs and roll them over to Roth IRAs in 2016.

V. Non-tax Benefits of the Roth Conversion.

A. There is no required beginning date during the IRA owner's lifetime, and therefore no minimum required distributions during the IRA owner's lifetime.

1. If the spouse is the beneficiary, he or she may roll it over into his or her own Roth IRA, and not have to take distributions during his or her lifetime.

2. This is a significant benefit. In the case of a traditional IRA, if the IRA owner (or his or her spouse) lives to life expectancy, a substantial portion of the IRA benefits must be distributed during lifetime.

3. This benefit is only available to Roth IRA owners. A beneficiary of a Roth IRA (other than a spouse who rolls the Roth IRA over into his or her own Roth IRA) must take distributions over his or her life expectancy, in the same way as a beneficiary of a traditional IRA.

B. By not being compelled to take any distributions from a Roth IRA (other than an inherited Roth IRA), a tenant in a rent stabilized apartment may be able to keep his or her income under $200,000 and thereby continue to qualify for rent-stabilization.

C. Asset protection.

1. More assets are in the (Roth) IRA, where they are or may be better protected against creditors other than the IRS.

2. Example: an IRA owner has a $1 million traditional IRA subject to 30% tax on conversion and $400,000 of cash.

(a) The $1 million traditional IRA is protected against most creditors other than the IRS in many states, including New York, New Jersey and Florida, but the $400,000 of cash is not.

(b) The IRA owner converts to a Roth IRA and pays the income tax of $300,000. He or she now has a $1 million Roth IRA, all of which is protected in many states, including New York, New Jersey and Florida, and $100,000 in cash. Thus, most creditors other than the IRS may only reach $100,000.

VI. <u>Estate Tax Benefits of the Roth Conversion for Estates Subject to Federal Estate Tax</u>

A. You avoid the IRD problem on IRA distributions in states that have state estate or inheritance taxes because the income tax was already paid.

1. In a traditional IRA, the beneficiary gets an income tax deduction for the Federal (but not the state) estate tax. Section 691(c).

2. The Federal estate tax rate is 40%.

3. The top state estate tax rate is 16% in most states that have a state estate tax, including New York and New Jersey.

4. The state estate tax is deductible against the Federal estate tax, so the net cost in the top bracket is 9.6% (60% of 16%).

5. The total estate tax in New York in the top bracket (ignoring the notch) is 49.6%.

6. For example, suppose an IRA owner in New York, in the top estate tax bracket (16% above $10.1 million), dies with a $1 million traditional IRA. Assume a 40% income tax bracket.

   (a) The New York estate tax is $160,000 (16% of $1 million).

   (b) The Federal estate tax is $336,000 (40% of $840,000).

   (c) The total estate tax is $496,000.

   (d) The beneficiary gets an income tax deduction for the $336,000 of Federal estate tax, and pays income tax on $664,000. The income tax is $265,600 (40% of $664,000).

   (e) The total income and estate taxes are $761,600. The beneficiary ends up with $238,400 after income and estate taxes, ignoring the benefit of the stretch.

7. In the above example, assume that the IRA owner had converted to a Roth IRA and paid the $400,000 income tax on the conversion out of the IRA. The IRA owner then dies with a $600,000 Roth IRA.

   (a) The Roth conversion removes the income tax from the estate.

   (b) The New York estate tax is $96,000 (16% of $600,000).

   (c) The Federal estate tax is $201,600 (40% of $504,000).

   (d) The total estate tax is $297,600.

(e) The beneficiary ends up with $302,400 after income and estate taxes, ignoring the benefit of the stretch.

(f) The stretch is not affected by the conversion.

(g) The benefit is greater if the IRA owner has other assets with which to pay the tax on the conversion.

8. You could take distributions of the entire IRA during your lifetime and obtain the same income and estate tax benefits described above.

(a) That would prevent you and your beneficiaries from obtaining the benefits of the stretchout.

(b) Converting to a Roth get you the best of both worlds.

B. You can use a tax-paid Roth IRA to fund a credit shelter trust.

1. A Roth IRA is a more valuable asset than cash to fund a credit shelter or GST exempt trust, since it obtains income tax deferral, but is after-tax money.

2. Leaving a Roth IRA to a credit shelter trust provides a potential estate tax benefit, but at the cost of giving up a substantial amount of income tax deferral.

3. Credit shelter trusts are less important with portability.

C. You may use a tax-paid Roth IRA to fund a GST tax-exempt disposition.

D. You may minimize the impact of the income tax bracket compression for trusts.

VII. <u>Roth Conversions for Older Clients.</u>

A. There is a myth that Roth IRA conversions do not work well for older clients.

B. If a taxpayer leaves a $1 million Roth IRA to a trust for a grandchild, age 20, with a 61.9 year life expectancy, and the trust earns 10% within the Roth IRA and 6% on assets outside the Roth IRA, the trust will grow to $155 million over the grandchild's life expectancy. If the trust is GST exempt, the entire $155 million may pass free of transfer tax upon the grandchild's death.

C. If the trust earns 6% within the Roth IRA and 5% on assets outside the Roth IRA, the trust will grow to $28 million over the grandchild's life expectancy.

D. When Roth IRA benefits are distributed to beneficiaries, they are not subject to income tax.

E. If Roth IRA benefits are payable to a trust, they are not subject to income tax when the trust distributes them to the beneficiaries of the trust.

F. There are advantages to deathbed conversions.

1. The conversion gets the income tax out of the estate.

2. The conversion gets the other benefits of the Roth conversion.

3. If the IRA owner's other assets are highly appreciated, they will get a basis step-up upon death, so that they may be used to pay the tax on the conversion without incurring capital gains tax.

VIII. <u>Countervailing Factors.</u>

A. If you convert a large IRA at once, you will bunch the income into a higher income tax bracket for a single tax year.

1. You may spread the conversion out over a number of years.

2. You may convert each year the amount that will fill up the desired income tax bracket.

3. Consider the consequential effects, such as the various tax benefit and deduction phaseouts.

B. If you will be in a lower income tax bracket upon retirement, you may want to postpone the conversion until you retire.

C. If you intend to move to a state with a low income tax, or with no income tax, you may want to postpone the conversion until you move to that state.

D. If your spouse is likely to survive you, and is likely to be in a lower income tax bracket upon your death, you may want to postpone the conversion. On the other hand, if your spouse will be in a higher income tax bracket upon your death, due to not being able to file a joint return, you may want to convert during your lifetime.

E. If you transfer employer stock with net unrealized appreciation (NUA) in the process of converting to a Roth IRA, you give up the opportunity to take advantage of the special rules for NUA.

F. An IRA owner may want to keep sufficient traditional IRA benefits so as to fill up his or her lower income tax brackets after retirement.

G. Distributions from a traditional IRA may be offset by medical expenses.

H. If you have a taxable estate, the benefits of using the taxable account to make annual exclusion gifts (and perhaps making larger gifts) may outweigh the benefits of the Roth conversion.

IX. <u>Recharacterizing (Unconverting).</u>

A. You may recharacterize (unconvert) a Roth IRA back to a traditional IRA by the due date of your income tax return (with extensions); *i.e.*, by October 15^{th} of the following year.

B. An IRA owner might recharacterize (unconvert) a Roth IRA if the value of the IRA went down after the conversion. This allows the IRA owner to convert again at a lower value.

C. An IRA owner might recharacterize a Roth IRA if he or she had unexpected income in the year of the conversion, and as a result was in a higher income tax bracket than expected.

D. If you recharacterize, you may not reconvert until the following year, or for 30 days, if later.

E. You may put different asset classes in different Roth IRAs and recharacterize the ones that went down in value.

F. An executor may recharacterize a conversion made by a decedent. However, unless the IRA passes to the surviving spouse, there will not be another opportunity to convert.

X. <u>Inherited or Beneficiary IRAs.</u>

A. The person who established the IRA is the "IRA owner."

1. An IRA owner may make additional contributions to the IRA.

2. An IRA owner need not take distributions until the required beginning date.

3. An IRA owner may convert to a Roth IRA.

B. A beneficiary other than the spouse may maintain the IRA as an inherited or beneficiary IRA.

1. A beneficiary may not make additional contributions to an inherited or beneficiary IRA.

2. A beneficiary must take distributions beginning in the year after the IRA owner's death.

C. A surviving spouse may become an IRA owner:

1. By designating himself or herself as the IRA owner.

2. By rolling the IRA over into his or her own IRA.

3. By making contributions to the inherited IRA.

4. By failing to take a required distribution from the inherited IRA.

D. A surviving spouse may remain as a beneficiary.

1. Distributions from an inherited IRA are not subject to the 10% tax on withdrawals before age 59 ½.

2. A surviving spouse under age 59 ½ is likely to remain a beneficiary.

3. The surviving spouse need not take distributions from an inherited IRA before the deceased spouse would have reached age 70 ½.

4. If the surviving spouse dies before the deceased spouse would have reached his or her required beginning date, the surviving spouse's beneficiaries may stretch the IRA as if the spouse had been the IRA owner.

5. If the surviving spouse is older than the deceased spouse, the surviving spouse might want to remain as a beneficiary until the deceased spouse would have reached age 70 ½.

E. A spouse who remains as a beneficiary may later decide to become an owner.

XI. <u>Transfers by Nonspouse Beneficiary from Tax-Qualified Plans to Inherited IRAs.</u>

A. Under the Worker, Retiree and Employer Recovery Act of 2008, tax-qualified plans must permit nonspouse beneficiaries to transfer their benefits to an inherited IRA.

B. Before that, plans could choose whether to permit such transfers.

C. Notice 2008-30 says that the inherited IRA may be an inherited Roth IRA.

1. That allows a beneficiary to transform a beneficiary interest in a tax-qualified plan into a beneficiary interest in a Roth IRA.

2. This caught everyone by surprise.

3. Since a nonspouse beneficiary may roll tax-qualified plan benefits (but not IRA benefits) over to an inherited IRA, this complicates the decision as to whether a retiree not converting to a Roth should

keep his or her money in the plan instead of rolling it over to an IRA.

XII. The Spouse May Complete the Roth Conversion.

A. Benefits payable to the spouse from a tax-qualified plan or IRA qualify for the estate tax marital deduction.

B. A spouse may roll the tax-qualified plan benefits over into an IRA. Sections 402(c)(9) and 408(d)(3)(c)(ii)(II).

C. The spouse may name new beneficiaries.

D. The spouse may select a new payout method.

E. The spouse may defer both income and estate taxes.

F. The spouse may be able to convert to a Roth IRA.

G. Any income taxes payable during the spouse's lifetime will reduce the spouse's estate.

H. While naming a QTIP trust as a beneficiary provides control, and may facilitate a reverse QTIP election for GST purposes, the cost of such control is the loss of substantial income tax deferral. If the benefits are instead left to the spouse as the beneficiary, the spouse may roll the benefits over into his or her own IRA, name new beneficiaries, possibly convert to a Roth IRA (immediately, at a later time, all at once, or over a number of years) and obtain a greater stretchout.

XIII. Getting the Benefits to the Spouse for a Rollover and Roth Conversion Where the Spouse is Not the Named Beneficiary.

A. If someone other than the spouse is the beneficiary, it is sometimes possible for the spouse to become a beneficiary, so that the spouse may do a rollover. Bruce D. Steiner, "IRA Rollovers: Making This Option Possible for a Spouse Who's Not the Named Beneficiary," Trusts & Estates (June 2015) at 41, http://kkwc.com/wp-content/uploads/2015/08/IRA-Rollovers-Making-this-option-possible.pdf; Bruce D. Steiner, "Postmortem Strategies to Shift Retirement Benefits to the Spouse," 24 *Estate Planning* 369 (1997), http://www.kkwc.com/docs/AR20050125164755.pdf.

1. Default provisions of the plan or IRA.

2. Disclaimer.

3. Intestacy.

4. Elective share.

5. Community property.

6. Through an estate or trust.

B. The financial institution that is the IRA trustee or custodian may require a private letter ruling.

XIV. Self-Directed Roth IRAs.

A. A self-directed Roth IRA facilitates investing in illiquid assets since there are no required distributions during the IRA owner's lifetime.

B. Since a Roth IRA is tax-exempt, it can be a good place for assets that are expected to increase in value if they might be sold during the IRA owner's lifetime.

C. Be careful of the self-dealing rules.

1. Section 4945 prohibits direct or indirect self-dealing.

2. The penalty for a prohibited transaction in an IRA is that the IRA ceases to be considered an IRA.

XV. Unrelated Business Taxable Income.

A. While tax-qualified plans and IRAs are generally tax-exempt, a tax-qualified plan or IRA is taxable on unrelated business taxable income (UBTI). Thus, a Roth IRA may be subject to income tax.

B. UBTI includes income from a business and debt-financed income. However, there is an exception for purchase money debt in a tax-qualified plan.

BDS:jlf

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Endnotes

1. Internal Revenue Code Section 4943 and Treasury Regulations Section 53.4943-6(b)(1).
2. IRC Sections 4943(c) and 4946.
3. IRC Section 4941.
4. IRC Section 4941(d).
5. Treas. Regs. Section 53.4941(d)-1(b)(3).
6. Treas. Regs. Section 53.4941(d)-2(c)(1).
7. IRC Section 4941(d)(2)(F) and Treas. Regs. Section 53.4941(d)-3(d).
8. Treas. Regs. Section 53.4941(d)-1(b)(3)(i)(c).

RETIREMENT BENEFITS

Roth Conversions Are More Attractive Under ATRA

By Bruce D. Steiner, an attorney with Kleinberg, Kaplan, Wolff & Cohen, P.C., in New York

Converting traditional individual retirement accounts to Roth IRAs can benefit clients in several ways, including making the IRA tax-free, effectively resulting in additional contributions to the IRA. And now, with the increased top income tax rates for trusts under the American Taxpayer Relief Act of 2012 (ATRA),[1] this conversion is even more attractive.

History

The Roth conversion first became available in 1998. However, until 2010, an IRA owner whose modified adjusted gross income (AGI) was over $100,000 was unable to convert. Under the Internal Revenue Service Restructuring and Reform Act of 1998, required distributions from IRAs didn't count toward the $100,000 AGI cap beginning in 2005.[2] Under the Tax Increase Prevention and Reconciliation Act of 2005, the $100,000 AGI cap was eliminated, effective beginning in 2010.[3]

Benefits

There are several benefits to converting to a Roth IRA. Since a Roth IRA is tax-free, the principal benefit is that, to the extent the IRA owner can pay the tax on the conversion out of other assets, converting has the effect of making a substantial additional contribution to the IRA.

Example: Assume a constant 25 percent income tax bracket. An IRA owner has a $100 traditional IRA and $25 in a taxable account. If he converts, he has a $100 Roth IRA. Over some period of time, it grows to $200, all of which is tax-free. Over the same period of time, if the IRA owner doesn't convert, his traditional IRA will grow to $200, or $150 after income tax. His $25 taxable account will grow to less than $50, since the income and gains on the taxable account will be taxable each year. Because the $200 Roth IRA is tax-free, it's more valuable than the after-tax value attained without the Roth IRA conversion.

Other benefits of the Roth conversion include:

- There are no required minimum distributions from a Roth IRA during the IRA owner's lifetime. This can provide a significant benefit, especially if the IRA owner or his spouse lives for a long time and has other assets available to cover living expenses.

- The Roth conversion increases the level of asset protection. As shown in the above example, by paying the income tax on the conversion out of other assets, converting has the effect of making a substantial additional contribution to the IRA, which is better protected against creditors than a taxable account. The extent of this protection varies from state to state. IRAs are also generally protected from creditors under federal bankruptcy laws.

- A Roth IRA is a more valuable asset to fund a credit shelter or generation-skipping transfer (GST) tax-exempt disposition. An IRA is valued for estate and GST tax purposes without regard to income taxes payable.[4] However, distributions from a Roth IRA are generally tax-free, while distributions from a traditional IRA are generally subject to income tax. Leaving an IRA to a credit shelter trust limits the stretchout to the spouse's life expectancy. However, there's no similar tradeoff to leaving an IRA to a grandchild, more remote issue or a GST tax-exempt trust.

- A Roth IRA avoids double tax in a decoupled state. To mitigate the double tax (since traditional IRA benefits are subject to estate tax and then to income tax), Internal Revenue Code Section 691(c) allows an income tax deduction to the recipients for the federal estate tax payable with respect to income in respect of a decedent, such as IRA benefits. However, this provision doesn't allow an income tax deduction for state estate or inheritance taxes. By converting to a Roth IRA, the income tax is removed from the estate.

Income Tax Tradeoff

There can sometimes be an income tax tradeoff in converting to a Roth IRA. As a general rule, the Roth conversion makes sense to the extent the tax rate on the conversion is less than, equal to or not too much higher than the tax rate that would otherwise apply to distributions from the IRA.

There are benefits to providing for children and grandchildren in trust, rather than outright. Assets passing in trust aren't included in the beneficiary's estate for estate tax purposes and are better protected against the beneficiary's potential creditors, including spouses. The same reasons for leaving other assets in trust, rather than outright, apply to IRA benefits. However, in the case of a traditional IRA, there's an income tax tradeoff. Trusts reach the top income tax bracket at $11,950 of taxable income.[5] If the beneficiary is in a lower income tax bracket, there's an income tax cost to obtain the estate tax and asset protection benefits of leaving IRA benefits in trust. While the trustees can make distributions to beneficiaries in lower income tax brackets, these distributions will defeat the estate tax and asset protection benefits of the trust.

The income tax cost of leaving assets in trust has increased as a result of ATRA.[6] ATRA increased the top income tax rate for trusts, applicable to taxable income over $11,950, from 35 percent to 39.6 percent. At the same time, ATRA made the 2001 and 2003 tax rate reductions permanent for individual taxpayers with taxable income up to $400,000 (single) or $450,000 (joint). In addition, the 35 percent bracket only applies to taxable income between $398,350 and $400,000 (single) and between $398,350 and $450,000 (joint and surviving spouses). These reductions will permit many IRA owners to convert at tax rates below 35 percent. By converting to a Roth, IRA owners can leave their IRA benefits to their children and grandchildren in trust, rather than outright, without subjecting the IRA benefits to tax at 39.6 percent or giving up the estate tax and asset protection benefits of the trust.

Timing

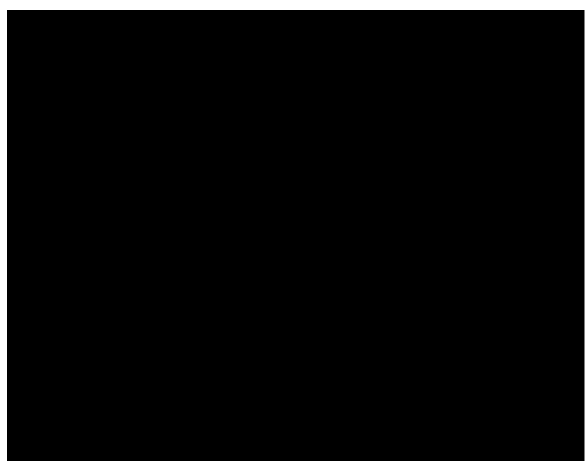
To avoid bunching the income from the conversion into a single year, many IRA owners should spread the conversion out over a number of years. IRA owners who are in a high income tax bracket, but who expect to be in a lower income tax bracket upon retirement, may wish to wait until retiring before converting or beginning to convert if they want to spread the conversion out over a number of years.

IRA owners who are married should consider the possible change in tax brackets on the death of one spouse.

IRA owners who don't have enough other income to fill up their 15 percent and lower brackets may wish to retain a sufficient amount of traditional IRA benefits to take advantage of these brackets.

Endnotes

1. American Taxpayer Relief Act of 2012 (P.L. 112-240, H.R. 8, 112th Cong., 2d Sess.).
2. Public Law 105-206, Section 7004.
3. P.L. 109-222, Section 512.
4. *Estate of Smith v. United States*, 391 F.3d 621 (5th Cir. 2004); *Estate of Doris F. Kahn*, 125 T.C. 227 (2005).
5. Income tax brackets are indexed for inflation. The $11,950 figure applies for 2013.
6. *Supra*, note 1.



SPOT LIGHT

Sitting on the Dock of the Bay

"Untitled" (13 in. by 16 1/8 in.) by Hale Woodruff, sold for $10,200 at Swann Auction Galleries' recent African American Fine Arts Sale in New York on Feb. 14, 2013. Woodruff is best known for his three panel mural depicting the mutiny on the *Amistad* and the ensuing trial.