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Elimination of Income Limits for Conversion to Roth IRAs in 2010

Traditional IRAs—with their tax deductibility and deferral of income tax on the earnings of the IRA—have long been an attractive vehicle for retirement savings. Traditional IRAs do have some drawbacks. The earnings will eventually be subject to income tax, perhaps at higher marginal rates than taxation at current rates. Also, there are rules that mandate when the owner must begin taking distributions and reporting income from a traditional IRA. These rules limit the effectiveness of traditional IRAs for deferring the income.

Roth IRAs are an attractive alternative to "traditional IRAs" for reasons that we will discuss in a moment. Until recently, the limits on the creation of a Roth IRA or the conversion of a traditional IRA to a Roth have meant that many taxpayers have been unable to take advantage of a Roth. With the beginning of the 2010 tax year, the income limits on a conversion have been eliminated. Many clients will be interested in exploring a conversion. We would like to offer some background as you consider the possibility of a conversion.

What is a conversion? Ignoring the mechanics, a conversion simply means transferring some or all of the assets in a traditional IRA to a Roth IRA and including the amount converted in taxable income.

There are some financial considerations to a conversion—for example, how to fund the tax liability—that we will not discuss here. Someone contemplating a conversion is well advised to take those considerations into account when making a decision.

Required Distributions

Unlike a traditional IRA, there are no required distributions while the owner of a Roth IRA is alive. On the death of the owner, if the surviving spouse is the designated beneficiary, then he or she can treat it as his or her own IRA by "rolling it over." If the survivor does the rollover, the surviving spouse would again have no required distributions.

Following the death of the "last" owner, a "designated beneficiary" (more on this below) must begin taking distributions no later than December 31 of the year following the year the owner died. So, if an owner of a Roth IRA died in 2015, then the designated beneficiary (other than the spouse) would have to begin taking distributions no later than December 31, 2016.

The distributions for that designated beneficiary will be calculated based upon his or her life expectancy. So, for example, if the designated beneficiary were age 40 with a life expectancy of 45 years, then in year one, the beneficiary would have to take 1/45th of the account balance; in year two, the beneficiary would have to take 1/44th of the account balance and so on. The beneficiary would be free to take a distribution more rapidly, but that is the minimum that he or she has to take.

Even if the designated beneficiary dies before the end of his or her life expectancy, the distributions to the next owner are calculated on the original schedule. There is no recomputation of the schedule if the next beneficiary is either younger or older than the deceased beneficiary.

In order to be able to use a life expectancy payout, the recipient must be a "designated beneficiary." There are special rules for qualifying a trust to be a designated beneficiary. The rules are quite complicated, and we will content ourselves simply to mention the issue in this LEGALcurrents.

It is possible to be a beneficiary of a Roth IRA but not be a designated beneficiary—which means that the distributions would have to be taken on a relatively short basis. Generally speaking, it would not make sense to convert a Roth without an ability to stretch out the distributions.

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Taxation on Distributions from a Roth

The rules on the taxation of distributions from the Roth IRAs distinguish between contributions and earnings. Contributions are the initial funding of the Roth; they may be withdrawn on a tax-free basis. The rule is that contributions are withdrawn first.

With respect to earnings, as long as that individual has had any Roth IRA for at least five years, then distributions of earnings after age 59½ are also free of income tax.

To illustrate these rules: suppose an individual established a Roth in 2006 with $10,000 and the account grew to $25,000 by 2009, at which point the beneficiary withdrew $20,000. The first $10,000 would be characterized as a return of the contribution and $10,000 would be characterized as earnings. Because the person had not waited the five years after the creation of the Roth, the earnings would be subject to income tax. There would, however, be no penalty.

As a practical matter, with a conversion of any size, the potential for tax on the earnings seems relatively small unless there are large distributions in the intervening five years.

Recharacterization: Changing One's Mind about a Conversion

An understandable concern is the possibility that the value of the Roth will decrease after a conversion, and so the taxpayer will report and pay tax on what is a phantom asset. There is a hedge against this, however. An owner is able to recharacterize the conversion, effectively treating it as a traditional IRA. There are time limits: a recharacterization has to occur by the time for the filing—including extensions-of that year's income tax returns. So, with a conversion in 2010, a taxpayer would have until October 15, 2011 to make the reconversion decision, assuming an extension of time to file.

In the event of recharacterization, a taxpayer is not eligible to make another Roth conversion for what is likely to be a relatively short time (technically, until the later of the first day of the following tax year or 30 days after a transfer from the custodian of the Roth IRA to the custodian of the traditional IRA).

Timing of Reporting Income from a Conversion

If a taxpayer makes a conversion, then he or she will have a choice of taking all the income in 2010 or dividing the income between 2011 and 2012.

The taxpayer effectively will have until the due date for his or her 2010 returns (October 15, 2011 if the returns are extended) to decide whether it makes sense to report the income for 2010 or defer it to 2011 and 2012. A taxpayer may need to adjust his or her estimated tax payments so as to avoid penalty if, in fact, he or she sought to report the income in 2010.

Charitable Planning

If a taxpayer is contemplating substantial charitable gifts as part of his or her estate planning, a good source of funding the gifts is a traditional IRA. Why? Any taxable income on the use of the IRA can be offset by an income tax charitable deduction. Put another way, if possible, traditional IRAs—and not Roth IRAs—should be used to fund charitable dispositions.

If a taxpayer is inclined to use some part of a traditional IRA money to fund some or all of the charitable gifts and he or she is willing to do so now, then the donor can take advantage of the rule that allows for tax-free distributions from traditional IRAs to fund charitable contributions if made directly to public charities. Under current law, the ability to do so ends December 31 of this year. It is not clear if Congress will extend the law.

So, in contemplating a conversion, it probably does not make sense to convert the portion that will be given to charity.

Even if a donor will not use the traditional IRA as a source of funding, a donor might wish to accelerate charitable gifts in the year of a conversion. The charitable deduction from such gifts will reduce the income tax with a conversion. Also, the conversion should reduce the effect of the income tax limitations on deductibility of charitable gifts, if enacted.

Update on Federal Estate Tax Legislation

Under the 2001 federal tax legislation, the exemption against the federal estate tax is $3.5 million in 2009; there is only one tax rate—45%. Under current law, the federal estate tax is to be repealed for decedents dying after December 31, 2009. If Congress does not reaffirm the repeal by the end of 2010, however, the federal estate tax reverts to its pre-2001 provisions, most prominently, an exemption of only $1 million and a marginal rate structure with a top rate of 55%.

Besides the estate tax provisions, one other component of the 2001 legislation has caused uncertainty. Under current law, effective until December 31, 2009, the basis for most assets changes to the value of the assets for estate tax purposes. IRAs, qualified plans, and annuities are the exceptions. In effect, any appreciation in the value of an asset up to the owner's death is sheltered from capital gains tax when the heirs or estate sells the asset.

After December 31, 2009, there is to be no automatic change in basis. Rather, under a quite complicated provision, an executor was allowed to allocate basis to certain assets in an estate.

On December 3, the House of Representatives voted 225-220, with nine abstentions, to enact the "Permanent Estate Tax Relief for Families, Farmers and Small Businesses Act of 2009," H.R. 4154. The measure effectively would (1) roll the $3.5 million exemption forward (albeit without indexation), (2) maintain the marginal rate at 45%, and (3) maintain the step-up in basis for most assets includible in a decedent's estate. [The exemption against the gift tax would remain at $1 million.]

The bill is significant as it is the first estate tax legislation to be voted on by either the House or Senate in 2009.

The prospects in the Senate are uncertain. The Senate Finance Committee is considering a bill, the "Taxpayer Certainty and Relief Act of 2009," S. 722, that differs from the House bill in several significant aspects.

At present, the Senate is concentrating on health insurance legislation. Given that and the lack of legislative days left on the 2009 calendar, it is not clear whether the Senate will vote on the House bill, vote on its own bill and have the respective bills proceed to committee to resolve the differences, or do nothing at all.

Our advice: stay tuned. ■

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