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Roth IRA Universe Widens


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New law to take effect in 2010.

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One major component of estate planning is not only making sure that appropriate documents are in place to maximize estate tax savings, but also ensuring all of the taxpayer's assets are coordinated with the estate plan.

While traditional IRAs commonly are an integral part of a client's estate—thereby necessitating a working knowledge of the traditional IRA rules—Roth IRAs typically have fallen below the radar because most taxpayers who take the time and incur the expense of estate planning do not own Roth IRAs in their estates due to the relatively low income limits required to establish them. However, beginning Jan. 1, 2010, this changes as new rules take effect, permitting taxpayers to convert their traditional IRAs to Roth IRAs without any income limitations. In this article, we will review Roth IRAs, in general, and summarize the new conversion rules.

Roth IRAs were created by the Taxpayer Relief Act of 1997. Unlike a traditional IRA where a taxpayer contributes tax-deductible dollars to an IRA account that grows tax-deferred until distributions are required to be made that are then subject to tax, beginning in 1998, taxpayers were able to contribute nondeductible dollars to a Roth IRA account and then allow the account to grow tax-free without taking distributions during life. In addition, when qualified distributions are made, the Roth IRA proceeds are withdrawn tax-free.

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Roth IRA eligibility is limited. In 2009, you are not eligible as a single filer to contribute to a Roth IRA if your modified adjusted gross income is equal to or in excess of $120,000. If you are married filing jointly, you are not eligible to contribute if your modified adjusted gross income is equal to or in excess of $176,000. The maximum amount that a taxpayer can invest in a Roth IRA in 2009 is $5,000 if the taxpayer is under age 50, or $6,000 if the taxpayer is 50 or over.

Unlike traditional IRAs which have required minimum distribution rules beginning April 1 of the year following a taxpayer's attaining age 70½, there are no required minimum distributions for a Roth IRA during a taxpayer's lifetime. Thus, a taxpayer who owns a Roth IRA is not required to begin to take distributions at age 70½, allowing the Roth IRA balance to continue to grow tax-free. In fact, a taxpayer is even permitted to contribute to a Roth IRA account after attaining age 70½, which is not permitted for a traditional IRA.

Rules Upon Death

At a taxpayer's death, the distribution rules for traditional IRAs apply to Roth IRAs in the following manner. At the taxpayer's death, he or she is deemed to have died prior to the required beginning date for minimum distributions, meaning that if the decedent taxpayer had a designated non-spouse beneficiary, the minimum distributions to said beneficiary must be made over the life expectancy of said beneficiary. If the beneficiary is the decedent's spouse, the spouse can roll over the Roth IRA to his or her own Roth IRA and continue the tax-free growth until the surviving spouse's death. If there is no designated beneficiary, the Roth IRA must be distributed no later than Dec. 31 of the year that contains the fifth anniversary of the decedent's death.

The important distribution rule for Roth IRAs during a taxpayer's lifetime is that it needs to be a qualified distribution. A qualified distribution is one that is both (i) made five years after the Roth IRA is created and (ii) made on or after the date on which the taxpayer attains age 59½. The five-year period begins Jan. 1 of the first year that the Roth IRA is created. There also is a qualified special purpose distribution for Roth IRAs for disability and for first-time home purchases up to $10,000. In the case of a qualified first-time home purchase or a distribution for disability, so long as the distribution is five years after the Roth IRA is created, the distribution will be tax-free.

The conversion rules currently in existence prior to Jan. 1, 2010, provide that married and/or single taxpayers with modified gross income of $100,000 or less can convert his or her traditional IRA to a Roth IRA. The amount transferred to the Roth IRA is included in the taxpayer's gross income. The income generated from the conversion of the traditional IRA to the Roth IRA is not factored into the taxpayer's modified adjusted income. Thus, if as a result of the conversion, a taxpayer's modified adjusted gross income exceeds $100,000, he or she will still not be disqualified from effectuating the conversion.

New Law

The new law, signed by President George W. Bush in 2006 and effective Jan. 1, 2010, permits taxpayers with incomes in excess of $100,000 to convert their traditional IRAs to Roth IRAs and spread the tax that would be due over two years—meaning that the conversion amount can be included as taxable income in 2011 and 2012. Basically, this opens the Roth IRA universe to an unlimited class of wealthy taxpayers with significant traditional IRA balances who deem it in their best interests to convert their IRAs to Roth IRAs, pay the tax over a two-year period, and enjoy the tax-free growth on their accounts.

The rule allowing taxpayers to defer their conversion income over two years only applies to conversions made in 2010. Bear in mind that if you pay the tax over the two-year period, 50 percent will be added to your income in 2011 and 2012. If tax rates increase in these years, or your income increases dramatically resulting in the taxpayer being in a higher tax bracket, the deferral over the two-year period may not be a prudent plan.

In actuality, the Roth IRA concept has been available to a larger universe of taxpayers for a few years now. Since 2006, participants of 401(k) plans have had the ability to elect to have their tax-deferred contributions to their 401(k) plan be made with after-tax dollars to a designated Roth 401(k) plan account, and have the account grow tax-free.

Any participant in a 401(k) plan is eligible to make a Roth 401(k) plan contribution so long as the 401(k) plan has been amended to provide for it. Unlike Roth IRAs, there are no income limitations as to who can make such a contribution. The contribution limits for a regular 401(k) and Roth 401(k) are aggregated, meaning you are not permitted to contribute the maximum amount to both accounts. In 2009, the maximum amount a taxpayer can contribute to his or her regular 401(k) account and Roth 401(k) combined is $16,500, or $22,000 for taxpayers aged 50 or older.

As mentioned in the introduction to this article, it is critical for the taxpayer's assets to be coordinated with his or her estate plan. The beneficiary designation for the newly created Roth IRA must be reviewed to ensure that the proceeds will pass in a manner that is consistent with the estate plan. If, after the conversion, the Roth IRA makes up a large portion of the married taxpayer's estate and this asset is needed to fully fund the taxpayer's applicable exclusion amount ($3.5 million in 2009), the taxpayer will want to make sure via his or her beneficiary designation that this asset can be utilized to fund said exclusion amount.

A typical scenario is designating the surviving spouse as the primary beneficiary, but giving the surviving spouse the ability to disclaim the proceeds, in which case the disclaimed proceeds pass to a special trust, which utilizes the applicable exclusion amount of the first spouse to die. This gives the surviving spouse the flexibility to do post-mortem estate planning and to use the Roth IRA proceeds to fully fund the first spouse's exclusion amount if the Roth IRA is needed.

> The **new law**, effective Jan. 1, 2010, permits taxpayers with incomes in excess of $100,000 to **convert** their **traditional** IRAs to **Roth** IRAs and spread the tax that would be due over two years—meaning that the conversion amount can be included as taxable income in 2011 and 2012.

Generally speaking, IRAs and Roth IRAs for that matter are not the best assets to utilize when funding the exclusion amount of the first spouse to die because it will accelerate the payment of the IRA. If the surviving spouse remains as the beneficiary, as opposed to the trust for the spouse's benefit, the surviving spouse will be able to roll over the IRA and be able to treat it as his or her own IRA. In the case of a Roth IRA, the surviving spouse will not be required to take distributions during his or her life, thus enhancing the tax-free growth of the Roth IRA.

If trusts are utilized for children at the second spouse's death, the Roth IRA beneficiary designation should designate such trusts to again ensure consistency among the assets passing under a taxpayer's will and the taxpayer's non-probate assets, such as the Roth IRA. If the trust is the designated beneficiary, minimum distributions will be required to be made after the taxpayer's death based on the life expectancy of the oldest beneficiary of the trust.

The decision to convert your traditional IRA to a Roth IRA is not irrevocable. If a taxpayer makes the conversion decision and then in the same year watches his new Roth IRA decline significantly due to market conditions, absent a decision to undo the conversion, the taxpayer will pay tax on the amount of the IRA on the date the IRA is converted. In this case, the taxpayer could recharacterize the Roth IRA to a traditional IRA by the extended due date of his tax return for the year of the conversion.

Factors to Consider

What should you do regarding conversion? As we move closer to 2010, there will be a plethora of commentary on both sides of the issue. Each taxpayer's situation is different, but the factors to consider are tax rates, age and expected life expectancy, expected need in retirement of the IRA, the client's belief that tax rates will increase and/or decrease, and whether or not he or she believes there is a chance the law for Roth IRAs would ever be changed to tax Roth IRA distributions. Certainly one argument in favor of converting a traditional IRA to a Roth IRA is the ability to pay the tax due from assets outside the traditional IRA, leaving the newly converted Roth IRA intact to grow tax-free.

One other point to consider is the fact that most taxpayers' investment accounts have declined somewhat dramatically during these difficult economic times. If the client and his or her financial adviser believe the market is at or near its bottom, then absent other factors, a decision to convert to a Roth IRA would mean the client would pay income tax on the depressed value of his or her IRA account, leaving the future appreciation within the newly converted Roth IRA free from tax. Any decision to convert should be discussed with a financial adviser.

It is fairly evident that beginning in 2010, Roth IRAs will become more commonplace in the estates of wealthy taxpayers. As a result, now is the time to become familiar with them and the advantages and disadvantages of owning them.