Saul Ewing LLP

PERSONAL WEALTH, ESTATES AND TRUSTS DEPARTMENT

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"What keeps you up at night?"

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Roth IRA conversions offer a valuable wealth transfer opportunity

By Robert H. Louis and Richard T. Frazier

A change in federal tax law that took effect in January of 2010 offers many people a technique for multi-generational wealth transfers that can offer benefits for 50 years or more into the future. It involves the conversion of individual retirement accounts (IRAs) and qualified retirement accounts into Roth IRAs.

WHAT IS A ROTH IRA?

Roth IRAs were the brainchild of former Delaware Senator William Roth. While a traditional IRA offers an income tax deduction for contributions and taxes distributions as ordinary income, a Roth IRA gives no income tax deduction for the contribution. However, once a five-year period has elapsed after setting up the Roth IRA, distributions of the amount contributed and the income earned by the Roth IRA (after age 59 1/2, death or disability) are free of federal income tax. Here is another benefit of Roth IRAs: while there are requirements that distributions from traditional IRAs and qualified plans begin shortly after the IRA owner reaches age 70 1/2, there are no distributions required from a Roth IRA to the individual who set it up. This means that an individual can establish a Roth IRA, make contributions to it, and allow the Roth IRA to grow for the rest of the owner's life, with nothing required to be paid out. The ability to accumulate wealth through a vehicle that grows on a tax-free basis for 30, 40 or 50 years is very valuable, perhaps unique in tax-planning techniques.

The ability of individuals to contribute to a Roth IRA phases out at various income levels, so for many people, it is not possible to establish a Roth IRA. It was possible to convert an existing traditional IRA to a Roth IRA, but that too was subject to an income phaseout, which meant that most people could not make such a conversion.

CONVERSION RULES CHANGE IN 2010

Starting in 2010, the conversion rules have changed. It is now possible to convert a traditional IRA or a retirement plan account to a Roth IRA without worrying about income limitations. When a traditional IRA or a retirement plan account is converted to a Roth IRA, the amount in the IRA or the account is taxed immediately. After that, once the waiting period has ended, distributions from the Roth IRA can be free from federal income tax. But, is it a good "deal" to pay tax now rather than later when distributions are made from the IRA or retirement account? As is often the case with tax planning, it is good for some people and not as good for others. Many articles have been written on this subject, and there are some guidelines as to when conversion might be a good idea.

WHO SHOULD CONVERT TO A ROTH IRA?

If you have sufficient other assets that you will not need the IRA or retirement account to live on during the rest of your life, you might benefit from a conversion. Alternatively, if you can identify a portion of the IRA or account that you will not need during life, you could convert that amount. The conversion amount would remain in the Roth IRA for life and continue to accumulate. Then, upon your death, the Roth IRA would pass to your beneficiary or beneficiaries. They would have to start taking distributions from the Roth IRA, which would continue to be tax-free, but they could stretch them out over their life expectancies. Consider the effect of naming, for example, a five-year-old child as the beneficiary of a portion of a Roth IRA. The child could take the funds out of the IRA for more than 70 years and, meanwhile, the funds would continue to grow on a tax-free basis. That multiplies the amount that will eventually be distributed into a much larger figure. Even if you will need some of the funds in later years, if you can postpone using them until later ages, that gives an advantage to conversion to a Roth IRA. And, by paying the income tax now on what beneficiaries will receive in later years, you are making a further transfer of wealth to them and reducing your taxable estate by the amount of tax you paid. If you can pay the tax on conversion from assets other than the IRA or retirement account, that is a further advantage for conversion.

Another factor to consider is income tax rates. If you believe that federal income tax rates you will pay in later years will be significantly lower than they are now, it is likely better to pay taxes later. On the other hand, if you think your tax rate will be about the same or only a little lower, or if you believe that Congress will increase income tax rates in the future, it might be better to pay taxes now and get the benefit of tax freedom in future years.

If Roth IRA conversion is in the federal tax law going forward, is there a reason to act this year? The answer is yes, for two reasons. First, investment values are still well below their peaks, and it is better to convert and pay tax now, when there is a smaller amount on which to pay tax. Second, the maximum federal income tax rate this year is 35 percent. Under current law, the maximum rate will rise to 39.6 percent next year. So, you will pay higher taxes on the same income next year. It is possible that Congress will extend the lower tax rates next year, but it is not certain. You can choose to pay tax on the conversion over the next two years, but that might not be beneficial if tax rates are increased next year.

In summary, those people with large IRA or retirement account balances and substantial other assets should certainly consider the advantages of conversion to a Roth IRA this year. This is a very valuable and effective tax-planning technique that, in the right circumstances, could create a stream of tax-free income flowing to children and grandchildren for many years.

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