

Key Tax Planning Strategies for 2010 & Beyond

How can one soften the blow should tax rates be increased? That is the question on the minds of many investors, tax advisors and wealth managers. One possibility for consideration is conversion to a Roth IRA from a Traditional or Rollover IRA.

Why? Because starting in January 2010, the \$100,000 modified adjusted gross income (MAGI) limitation for Roth IRAs will vanish. As a result, individuals who previously were ineligible will be able to convert assets held in Traditional or Rollover IRAs, or qualified retirement plans, to a Roth IRA, regardless of how much they earn. Clients who expect their marginal tax rates in retirement to be higher than current rates may benefit by converting to a Roth IRA.

Of course, what the government gives with one hand it often takes back with the other. Thus, investors will be obligated to pay ordinary income tax on deductible IRA or 401(k) contributions that are converted to a Roth IRA. Under current law, to ease the pain, investors who convert in 2010 are allowed to spread the tax bill over the ensuing two years.

Investors should keep in mind that it is a virtual certainty that the highest tax brackets will be increased by 2011 and 2012, potentially making this feature unattractive. Therefore, it may be beneficial to opt out of this two-year spread.

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WHAT IS A ROTH IRA CONVERSION? A Roth IRA conversion takes place when an IRA (Traditional, Rollover, SEP, or SIMPLE) or qualified retirement plan (e.g., 401(k), 403(b)) is transferred (i.e., converted) to a Roth IRA. Income tax is due on the conversion amount by April 15th following the year of conversion. Unlike pre-tax IRAs and qualified retirement plans, qualified distributions from Roth IRAs are not taxed upon distribution.

misconception many wealth managers have is that paying tax early is a bad thing,” says Robert S. Keebler, a CPA and nationally recognized expert on family wealth preservation and retirement distribution planning at Baker Tilly in Appleton, Wisconsin. “I believe that Roth IRA conversions cannot be summarily dismissed. They have to be analyzed as part of every financial and estate plan.”

Ideal Candidate

Keebler shared his views, as well as several innovative Roth IRA conversion strategies, on a Webinar for estate planning attorneys and tax preparers hosted by TFC Financial Management in October. In his presentation, Keebler outlined several factors that may lead to identifying an ideal candidate for the Roth IRA conversion.

In summary, the ideal candidate for a Roth IRA conversion is an investor who:

- Has outside funds available to pay the income tax due
- Has favorable income tax attributes such

as net operating losses, charitable deductions, and/or AMT tax credits

- Will not immediately need the Roth IRA to meet annual retirement living expenses
- Anticipates not needing IRA required minimum distributions for living expenses
- Expects to be in the same or a higher tax bracket in the future
- Lives in a state which imposes a state death tax
- Has a long time horizon

The key to a successful Roth IRA conversion is to keep as much of the taxable income resulting from the conversion as possible in the investor's current marginal tax rate. In some cases, as Keebler points out, it makes sense to convert a larger amount and pay the current ordinary income tax rate on the conversion amount.

Earnings Taxed In the Future?

The wild card in this strategy is the chance that rules governing Roth IRA conversions could change. One possibility is that rules could change regarding the taxation of distributions for Roth IRAs (e.g., subject the Roth IRA to required minimum distributions, tax the earnings of the Roth IRA over a certain amount, or place special excise taxes on withdrawals).

If one believes that the previous examples are possibilities, they should also factor in the possibility that the rules governing Traditional and Rollover IRAs could be changed (e.g., accelerated required minimum distributions, loss of stretch IRA rules for beneficiaries forcing immediate or five-year distribution of inherited IRAs, special excise taxes for distributions, elimination of the Federal IRC 691(c) deduction for estate taxes paid).

The uncertainty in the tax code is the only certainty. Therefore, for the ideal Roth conversion candidate, tax diversification might

be the most prudent strategy. In other words, if one believes that investment diversification is a wise strategy for their assets, then one might also believe that tax diversification is a wise strategy for their current and/or future income stream.

The uncertainty of future tax laws relating to IRAs (both Roth and Traditional/Rollover) may be a reason to consider a partial Roth IRA conversion for the ideal candidate, rather than a reason to dismiss the strategy.

Fundamental Change in the Tax Code?

Would a major overhaul of the U.S. tax code change one's view on the potential advantages of a Roth IRA or, for that matter, on the advantages of a pre-tax IRA or other retirement plan?

Politicians have been discussing a major shift from the progressive income tax system whereby higher income earners have a larger tax burden than lower income earners for years. Many have stated that a simplification of the tax code is necessary. So, will the U.S. tax system be one of flat tax or consumption tax? This dramatic change is unlikely, at least, for our grandchildren's grandchildren.

It is recognized that eliminating the U.S. income tax is a hotly debated issue for those believers in a new political regime. We also recognize that a major shift in the progressive tax system would be stymied by the bureaucracy inherent in the political system. With two sides vehemently opposed to the issue of what a flat tax or consumption tax would mean (shifting of the tax burden from the wealthy to the not as wealthy) and the results that those taxes would create (economic growth or slower economic growth), it is difficult to imagine such a polar shift.

Online Roth Calculators, News Articles and Cocktail Conversation

Online Roth calculators, articles about Roth conversions and casual conversations about Roth IRAs, have one thing in common; they do not take each family's unique circumstances and objectives into consideration.

A recent online trade journal article attempted to "...dispel some of the common claims made about the advantages of the Roth." The author took findings from a so-called large, respectable investment firm and tested the scenarios in his own commercially available software. The problems that stood out were the fact that there was an axe to grind (selling his own software) and that he assumed that a Roth conversion was an all-or-nothing proposition; comparing results of "no conversion" with results of "conversion" which, of course, will skew results. At the very least, it will not provide sufficient data to make an educated decision.

The Roth IRA conversion is not an all-or-nothing proposition, even for someone who appears to be an ideal candidate for the strategy. In most cases for the ideal candidate, the amount to convert will be based on some combination of quantitative findings and their feelings about future circumstances and objectives.

There are also investment firms and/or software providers seemingly intent on demonstrating the rewards of the Roth conversion. These overzealous folks simply use marginal tax rates in their scenarios; skewing results in favor of a Roth conversion by simply considering that the top marginal tax bracket increases after the conversion year.

Like any financial planning issue, there are multiple variables that should be considered when analyzing a potential Roth conversion. TFC can assist in this planning, working along with

each family's tax advisor and estate planning attorney, to assure coordination with each family's financial and estate planning goals.

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Update on IRA Charitable Rollovers and Required Minimum Distributions

As we highlighted in last year's tax planning letter, IRA charitable rollovers were allowed for several years. These direct rollovers from IRAs to qualified charities allow an individual 70½ or older to donate a maximum of \$100,000 per year, expiring December 31, 2009.

The IRA charitable rollover satisfies the required minimum distributions (RMD) from IRAs, thus appealing to those taxpayers who did not need their RMD for immediate spending purposes. However, with the passing of H.R. 7327, the Worker, Retiree and Employer Recovery Act of 2008, RMDs have been suspended for 2009 reducing the appeal of the IRA charitable rollover.

Again, the IRA charitable rollover expires December 31, 2009, but the "Public Good IRA Rollover Act" has been introduced in both houses of Congress. This potential legislation would make the rollover permanent and decrease the eligible age of donors to 59½.

Planning Idea – Donate appreciated securities to qualified charities – If a taxpayer donates appreciated securities they may be able to take a charitable deduction equal to the current fair market value of the securities. The taxpayer will also avoid paying tax on the capital gains incurred if they were to sell security and donate

cash, rather than donating the appreciated security.

Retirement Plan Contributions & Roth IRA Conversions

As outlined above, the \$100,000 modified adjusted gross income limitation for Roth IRA conversions will vanish beginning in 2010.

Planning Idea - High-income taxpayers who do not qualify for Roth IRA contributions might benefit from making non-deductible contributions to a traditional IRA and then converting to a Roth IRA in 2010. The non-deductible contributions to an IRA will not be taxed as a result of the Roth conversion. However, income tax may be due if there are existing pre-tax IRA assets and/or earnings on the non-deductible contributions.

Gifts

For 2009, the annual exclusion for gifts to individuals is \$13,000 per donee, without paying gift tax on the amounts transferred. Married couples can gift \$26,000 per donee, per year without tax liability on the amounts transferred. The strategy not only removes the amount of the annual exclusion gift from an estate, but it removes future earnings on the gifts from an estate. The annual exclusion for gifts in 2010 will remain at \$13,000 (\$26,000 for married couples).

Planning Idea - Taxpayers may want to take advantage of the annual gift-giving limits to reduce future income and estate tax liabilities. Consider making 2010 gifts early in 2010, allowing for benefits of the gift to accrue sooner for all parties. Keep in mind, payments for qualified education expenses and medical expenses do not count toward the annual exclusion gift amounts.

Home Sale Capital Gains Exclusion Rules Changed in 2009

Prior to January 1, 2009, homeowners could sell their primary residence and exclude up to \$250,000 (or \$500,000 for married couples filing jointly) in capital gains as long as the homeowner(s) lived in the primary residence for at least two out of the last five years. The Housing Assistance Tax Act of 2008 changed these rules. As of January 1, 2009, homeowners are only allowed to exclude capital gains for the amount of time they actually used the home as a primary residence. For instance, under the new rules, if a married couple filing jointly bought a vacation home on January 1, 2009, moved into the home on December 31, 2011, and sold the home on December 31, 2013, they must pay capital gains tax on 60% of the gain (3 years of non-qualified use ÷ 5 years of ownership = 60%). The maximum exclusion remains at \$500,000.

Planning Idea - Homeowners that are considering moving into their vacation homes/second homes for future favorable capital gains purposes are advised to plan accordingly. The advice of moving into a second home for two out of five years in order to take advantage of the maximum capital gains exclusion will only result in a partial exclusion of the capital gain.

Final Note

Due to the complexity of the tax code, it is advisable to consult your wealth management team, including your tax advisor, prior to implementing the above-mentioned planning ideas. More specific details on the planning strategies and how they can be integrated with your plan will be discussed in the months ahead.

Key Tax Data for 2009 & 2010

Key Tax Data	2009	2010
Maximum Elective Deferral 401(k), 403(b), SARSEP & 457 Plans	\$16,500	\$16,500
Maximum Elective Deferral SIMPLE IRA & SIMPLE 401(k)	\$11,500	\$11,500
IRA Contribution Limits Traditional & Roth	\$5,000	\$5,000
Catch-Up Contribution Limit* 401(k), 403(b), SARSEP & 457 Plan	\$5,500	\$5,500
SIMPLE IRA & SIMPLE 401(k)	\$2,500	\$2,500
Traditional IRA	\$1,000	\$1,000
Defined Contribution & SEP IRA Limits		
Maximum Dollar Allocation	\$49,000	\$49,000
Maximum Considered Compensation	\$245,000	\$245,000
Federal Estate Exemption Amount	\$3,500,000	<i>Repealed**</i>
Gift Tax Unified Credit Amount	\$1,000,000	\$1,000,000
Gift Tax Exclusion (Individual)	\$13,000	\$13,000
Social Security Wage Base	\$106,800	\$106,800
AMT Exemption Amount		
Married filing jointly	\$70,950	<i>To Be Determined</i>
Single	\$46,700	

* Taxpayers age 50 and over

** As of December 17, 2009