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The Roth IRA: Should you convert?

These days, it seems you can't pick up a financial publication without reading about the benefits of converting a traditional IRA to a Roth IRA. One reason for the hoopla is that starting in 2010 anyone, regardless of income, can make the conversion.

A Roth IRA can offer income tax benefits as well as estate planning benefits, and it's important to consider both. But even though converting to a Roth IRA may present a golden opportunity for many taxpayers, it's not right for everyone.

Are you eligible?

Before 2010, Roth IRA conversions were limited to taxpayers with modified adjusted gross incomes (MAGIs) of \$100,000 or less. Starting this year, the income ceiling has been lifted — anyone with an eligible IRA account can convert

it to a Roth, even if their income is too high to make a Roth IRA contribution.

You can also convert a Simplified Employee Pension (SEP) IRA or a Savings Incentive Match Plan for Employees (SIMPLE) IRA. (But watch out for early distribution penalties for SIMPLE IRAs that are less than two years old.) You may also be able to roll over funds from a 401(k), 403(b) or 457 plan to a Roth IRA if your plan permits.

If you inherit an IRA (or, in some cases, an employer-sponsored plan) from your spouse, you can roll the funds into your own traditional IRA and then convert it to a Roth. If you inherit an IRA from someone other than your spouse, you're not eligible for a Roth conversion on those funds. But if you inherit an employer-sponsored plan from someone other than your spouse, you may be able to have those funds distributed directly to an *inherited* Roth IRA.

What's your tax outlook?

Roth IRAs work differently than traditional IRAs do. With a traditional IRA, contributions are tax deductible and earnings grow on a tax-deferred basis, but withdrawals are subject to ordinary income taxes. Roth IRA contributions aren't deductible, but qualified withdrawals are tax free.

Withdrawals from either type of IRA before age 59½ are subject to a 10% penalty (with certain exceptions), as are withdrawals from a Roth IRA that's less than five years old. With a traditional IRA, you must take required minimum distributions (RMDs) starting at age 70½,



but you can leave funds in a Roth IRA as long as you want.

From an income tax perspective, whether it makes sense to convert to a Roth IRA depends on whether you're better off paying the tax now or later. When you do a Roth conversion, you have to pay taxes on the amount you convert.

For conversions in 2010, however, you can defer the income and report half of it on your 2011 return and the other half on your 2012 return. If you expect your tax rate to be higher in retirement than it is now (because you'll be in a higher tax bracket or you believe tax rates will go up), then it may be advantageous to convert to a Roth, provided you can afford to pay the tax using funds from outside an IRA.

You may also be better off converting and paying the tax now if the value of investments in your IRA is depressed. That way, you'll minimize the current tax hit and avoid taxes on any future appreciation.

If you expect your tax rate to be lower in retirement, however, it may make sense to leave your savings in a traditional IRA or employer-sponsored plan. Under those circumstances, your overall tax liability will be lower if you pay the taxes later. And, presuming you're able to make the conversion in the future, you can do so in such a way as to minimize your tax burden and maximize the benefit of having the Roth IRA.

What if you don't need the money?

The previously discussed tax considerations assume that you'll need to tap your IRA funds during retirement for living expenses. But if that's not the case, converting to a Roth IRA may be your best bet even if you expect your tax rate to go down.

Roth IRAs aren't subject to RMDs, so they can make ideal estate planning vehicles. You can

Conversion factors

Whether converting to a Roth IRA is right for you depends on several factors. You should consider converting if:

- ⊙ You expect your tax rate to be higher in retirement or you don't think you'll need the money for living expenses,
- ⊙ Your investment horizon is long enough to benefit from a Roth IRA's tax-free growth, and
- ⊙ You can afford to pay taxes on the conversion using separate funds.

Converting may not be a good idea if:

- ⊙ You expect that your tax rate will be lower in retirement and that you'll need the funds for living expenses,
- ⊙ You lack separate funds to pay the taxes, or
- ⊙ You plan to donate the entire IRA to charity. (If you'd like to donate only a portion of the IRA to charity, you could split the IRA and convert only the noncharity bound portion.)

allow the funds to continue growing tax free until they pass to your children or other loved ones as part of your estate. Although your estate may be taxable (depending on its size and on what Congress decides to do about the estate tax), your beneficiaries will receive your Roth IRA income tax free. An inherited traditional IRA, in contrast, will come with a sizable income tax bill.

Hedging your bets

What if you're not sure what your financial future holds? One option is to hedge your bets by converting a portion of your traditional IRA or employer-sponsored plan into a Roth IRA. Also, keep in mind that you can "undo" a Roth IRA conversion up until your tax return due date, including extensions, for the year you make the conversion. So if the market takes a turn for the worse prior to the due date, you have the benefit of hindsight to undo the conversion, thus avoiding the unpleasant prospect of paying taxes on assets that have disappeared. ⊙

Making sense of multistate taxation

In today's digital age, most companies — even small ones — do business beyond their state's borders. It's critical, therefore, to review your business activities to evaluate the impact of multistate taxation. Paying attention to this issue is particularly important now, as cash-starved states eye out-of-state businesses as potential revenue sources.

State of uncertainty

There's a great deal of uncertainty about the application of state taxes. To trigger a state's income or sales and use taxes, a business must have a substantial connection — or nexus — with that state. Historically, that meant a physical presence in the state, such as retail stores, offices, sales reps or manufacturing facilities. But states have become increasingly aggressive in pushing the boundaries of nexus.

Some states define “physical presence” to mean even the most minimal contact. Others have attempted to do away with the requirement altogether, imposing their taxes on out-of-state

businesses with an *economic* presence in the state. These ever-changing rules make it difficult to predict the tax consequences of your business activities in other states and increase the risk that multiple states will attempt to tax the same income.

There's a great deal of uncertainty about the application of state taxes.

Service providers and others at risk

There are still some limits on a state's ability to extend the reach of its taxes, though many states are pushing to have these restrictions relaxed. The U.S. Supreme Court, for example, continues to require a physical presence before an out-of-state business can be required to collect sales and use taxes.

Also, a federal law enacted more than 50 years ago (Public Law 86-272) prohibits states from levying income taxes on businesses whose only activity in the state is the solicitation of orders for tangible personal property that are approved and filled outside the state.

Unfortunately, this leaves a gaping hole for certain types of business. In recent years, several states have successfully imposed their income taxes on out-of-state providers of services or intangible property — such as credit card companies and trademark licensors — with no physical presence in



the state. Neither of these activities is protected by Public Law 86-272.

What you should do

To avoid unpleasant tax surprises, review your activities in each state for potential tax liability. Whenever possible, structure your activities so that you avoid triggering taxes in other states. And if that's not possible, find out whether there are

mechanisms — such as credits for taxes paid — that allow you to avoid double taxation.

Also, keep an eye on Congress. Proposed legislation would eliminate much of the uncertainty over multistate taxation by prohibiting states from taxing businesses that lack a physical presence in the state and by providing a uniform definition of “physical presence.” ☺

Cause and effect

The estate tax repeal also modifies carryover basis rules

After spending a lifetime building your wealth, you look forward to sharing it with family members. But did you know that *how* you transfer assets can affect the recipient's income tax liability because of the basis he or she receives? And did you realize that the 2010 estate tax repeal has temporarily modified the carryover basis rules?

Basis: A primer

Basis is the cost associated with an asset. It's used to measure your gain or loss when you dispose of the asset. If the asset is used in your business, it's used to determine the amount of depreciation, depletion or amortization deductions.

When you sell an asset, your gain or loss is determined by taking the sale proceeds and subtracting your adjusted basis. So, for example, if you purchase stock for \$175,000 and sell it for \$225,000, you'll realize a \$50,000 gain. On the other hand, if you sell the stock for \$150,000, you'll have a \$25,000 loss.

The starting point for calculating an asset's basis is the price you pay for it (including the amount of any existing debt you agree to assume in connection with the purchase). But depending on the nature of the asset, your basis may be adjusted



to reflect changes that increase or decrease your investment in the asset.

Basis and your estate plan

From an estate planning perspective, basis is important because it affects the amount of taxable gain or loss your beneficiary will realize should he or she sell the asset. And your beneficiary's basis



in an asset depends on the manner in which you transfer it.

Generally, when you transfer an asset at death, your beneficiary receives a “stepped-up” basis equal to the asset’s fair market value on that date, assuming the fair market value of the asset is greater than its adjusted basis. If you transfer an appreciated asset by gift, however, your adjusted basis in the asset “carries over” to your beneficiary.

At first glance, it would seem that transfers at death are preferable because a stepped-up basis minimizes the gain on a sale of the asset. But it’s not that simple. To determine the best strategy for transferring assets you need to look at the big picture.

State of basis

As of this writing, the estate tax repeal is in effect, and the automatic step-up in basis is eliminated. Your estate can allocate only up to \$1.3 million to increase the basis of certain assets plus up to \$3 million to increase the basis of assets you leave to your surviving spouse. As a result, if you hold substantial amounts of appreciated assets and die this year, the potential income tax liabilities imposed on your beneficiaries may offset some — or even all — of the estate taxes saved because of the repeal.

So should you revise your estate plan? If you have highly appreciated assets, consider leaving them to your spouse or donating them to a favorite charity. Then you can bequeath your less highly appreciated assets to other family members.

But also keep in mind that the repeal and the changes to the basis rules are only temporary: The estate tax is scheduled to return in 2011, and Congress may act sometime this year to reinstate the estate tax for 2010 (perhaps even by the time you’re reading this), and, in turn, reinstate the automatic step-up in basis. (For more information on estate tax uncertainty, see “Tax Tips” on page 7.)

Even when the automatic step-up at death *is* in effect, it shouldn’t necessarily preclude you from making lifetime gifts. If an asset’s value hasn’t appreciated significantly — so that its fair market value isn’t substantially higher than your basis — then the manner in which you transfer the asset won’t have a big tax impact on your beneficiary. Also, if your beneficiary plans to hold onto the asset rather than sell it, the income tax implications may not even be an issue that factors into your decision.

The starting point for calculating an asset’s basis is the price you pay for it.

Seek counsel

The basis rules have always complicated estate planning, and uncertainty surrounding the estate tax can make it even more difficult. When is the best time for you to transfer appreciated assets? The answer is that every person’s situation is unique; thus, you should seek the counsel of your tax advisor. ☺

tax TIPS

Have you reviewed your estate plan?

The estate and generation-skipping transfer (GST) taxes (but not the gift tax) disappeared on Jan. 1, 2010. Unless lawmakers act, these taxes will return in 2011 to levels prescribed by pre-2001 law — with a top estate tax rate of 55% and a \$1 million estate tax exemption.

As of this writing, the repeal remains in effect, but Congress might reinstate the 2009 estate tax regime (or something like it), possibly retroactively to Jan. 1 — it may even have done so by the time you're reading this. Check with your tax advisor for the latest information, and review your estate plan to ensure it continues to achieve your objectives.

During the repeal, some plans may not work as expected. For example, if you die while the repeal is in effect and your plan uses a formula to allocate wealth between family and marital trusts, you could inadvertently disinherit your spouse. (For information about another important estate tax law change, see “Cause and effect” on page 5.) ☺

Courts give LLCs a boost

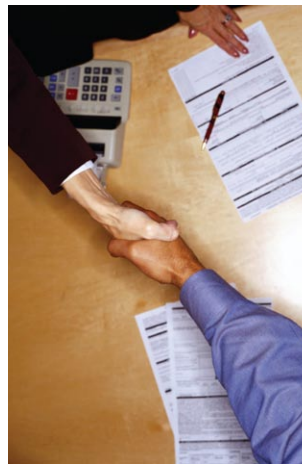
Limited liability companies (LLCs) — which combine the tax advantages of a partnership with the liability protection of a corporation — have become one of the most popular forms of business entity. However, the IRS has taken the position that LLC members should be treated like limited partners for purposes of the passive activity loss rules, regardless of their level of involvement in management. That meant an LLC member can't deduct business losses against “active income,” such as wages, interest and dividends.

Fortunately, in cases decided last year and this year, the U.S. Tax Court and the Court of Federal Claims rejected the IRS position. They found that an LLC member can offset business losses against active income provided the member “materially participates” in management of the LLC in the manner of a general partner. ☺

Now's the time to restructure loans

The struggling economy has made it difficult for many businesses to keep up with their debt obligations. Often, it's in the best interest of both borrower and lender to restructure a loan, with the lender forgiving a portion of the debt

or adjusting the terms to reduce the borrower's monthly payments. Many business owners are surprised to discover, however, that — with certain exceptions — restructuring a loan can result in taxable cancellation of debt (COD) income.



If you're considering restructuring a loan, now may be time to do it. Under last year's stimulus legislation, you can defer certain business-related COD income realized in 2009 and 2010 and pay the tax in equal installments from 2014 to 2018. ☺



Since the income limitations that had previously governed those who can make a Roth IRA conversion have been eliminated, all individuals can now convert all or a portion of their traditional IRAs into a Roth IRA. This is a very significant change and all individuals with traditional IRAs or qualifying employer retirement plans that can be converted into an IRA should consult with their tax and investment advisors to determine whether converting would be beneficial given their specific circumstances.

There are tremendous benefits to having some or a portion of your retirement assets in a Roth IRA. However, Roth conversions trigger a current tax cost. The tax cost is dependent upon the mix of your deductible and nondeductible IRAs. In many cases, you will have more funds at death if you convert your traditional IRAs into a Roth even though there is an immediate income tax on the conversion. This is primarily because unlike traditional IRAs, you do not have to start taking distributions from a Roth IRA at age 70½, therefore the entire balance within the Roth IRA continues to grow on a tax-free basis.

Roth IRAs also provide a great deal of flexibility in your estate planning. While the value of your Roth IRA will be includable in your taxable estate, specific bequests of a Roth IRA to your children or grandchildren gives them an asset that will be tax-free to them for life.

Generally, ideal candidates for Roth conversions are:

- individuals who do not expect to use their traditional IRAs in retirement;
- individuals who can pay the conversion tax with other assets; and
- individuals who will have a taxable estate.

It is highly recommended that all individuals with traditional IRAs consult with their tax and investment advisors to illustrate the benefits of converting.

Your ODMD tax advisors have significant experience with the tax laws regarding conversions and can prepare financial projections to illustrate the effects of converting. You owe it to yourself and your family members to determine if a Roth conversion is right for you.

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Joe Bodan is the Director of Tax Services for ODMD. He has 27 years of experience providing federal, state and local, and international tax compliance and planning services for closely-held businesses and their owners, and high net worth individuals. He has been a member of the New York State Society of CPA's tax committees for state and local taxation, and closely-held and S corporations. Joe has been a featured speaker at seminars and has authored several tax articles affecting closely-held businesses and individuals.



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