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## Endnotes

1. Internal Revenue Code Section 4943 and Treasury Regulations Section 53.4943-6(b)(1).
2. IRC Sections 4943(c) and 4946.
3. IRC Section 4941.
4. IRC Section 4941(d).
5. Treas. Regs. Section 53.4941(d)-(b)(3).
6. Treas. Regs. Section 53.4941(d)-2(c)(1).
7. IRC Section 4941(d)(2)(F) and Treas. Regs. Section 53.4941(d)-3(d).
8. Treas. Regs. Section 53.4941(d)-(b)(3)(i)(c).

## RETIREMENT BENEFITS

# Roth Conversions Are More Attractive Under ATRA

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Converting traditional individual retirement accounts to Roth IRAs can benefit clients in several ways, including making the IRA tax-free, effectively resulting in additional contributions to the IRA. And now, with the increased top income tax rates for trusts under the American Taxpayer Relief Act of 2012 (ATRA),<sup>1</sup> this conversion is even more attractive.

## History

The Roth conversion first became available in 1998. However, until 2010, an IRA owner whose modified adjusted gross income (AGI) was over \$100,000 was unable to convert. Under the Internal Revenue Service Restructuring and Reform Act of 1998, required distributions from IRAs didn't count toward the \$100,000 AGI cap beginning in 2005.<sup>2</sup> Under the Tax Increase Prevention and Reconciliation Act of 2005, the \$100,000 AGI cap was eliminated, effective beginning in 2010.<sup>3</sup>

## Benefits

There are several benefits to converting to a Roth IRA. Since a Roth IRA is tax-free, the principal benefit is

that, to the extent the IRA owner can pay the tax on the conversion out of other assets, converting has the effect of making a substantial additional contribution to the IRA.

*Example:* Assume a constant 25 percent income tax bracket. An IRA owner has a \$100 traditional IRA and \$25 in a taxable account. If he converts, he has a \$100 Roth IRA. Over some period of time, it grows to \$200, all of which is tax-free. Over the same period of time, if the IRA owner doesn't convert, his traditional IRA will grow to \$200, or \$150 after income tax. His \$25 taxable account will grow to less than \$50, since the income and gains on the taxable account will be taxable each year. Because the \$200 Roth IRA is tax-free, it's more valuable than the after-tax value attained without the Roth IRA conversion.

Other benefits of the Roth conversion include:

- There are no required minimum distributions from a Roth IRA during the IRA owner's lifetime. This can provide a significant benefit, especially if the IRA owner or his spouse lives for a long time and has other assets available to cover living expenses.
- The Roth conversion increases the level of asset protection. As shown in the above example, by paying the income tax on the conversion out of other assets, converting has the effect of making a substantial additional contribution to the IRA, which is better protected against creditors than a taxable account. The extent of this protection varies from state to state. IRAs are also generally protected from creditors under federal bankruptcy laws.
- A Roth IRA is a more valuable asset to fund a credit shelter or generation-skipping transfer (GST) tax-exempt disposition. An IRA is valued for estate and GST tax purposes without regard to income taxes payable.<sup>4</sup> However, distributions from a Roth IRA are generally tax-free, while distributions from a traditional IRA are generally subject to income tax. Leaving an IRA to a credit shelter trust limits the stretchout to the spouse's life expectancy. However, there's no similar tradeoff to leaving an IRA to a grandchild, more remote issue or a GST tax-exempt trust.
- A Roth IRA avoids double tax in a decoupled state. To mitigate the double tax (since traditional IRA benefits are subject to estate tax and then to income

tax), Internal Revenue Code Section 691(c) allows an income tax deduction to the recipients for the federal estate tax payable with respect to income in respect of a decedent, such as IRA benefits. However, this provision doesn't allow an income tax deduction for state estate or inheritance taxes. By converting to a Roth IRA, the income tax is removed from the estate.

## Income Tax Tradeoff

There can sometimes be an income tax tradeoff in converting to a Roth IRA. As a general rule, the Roth conversion makes sense to the extent the tax rate on the conversion is less than, equal to or not too much higher than the tax rate that would otherwise apply to distributions from the IRA.


There are benefits to providing for children and grandchildren in trust, rather than outright. Assets passing in trust aren't included in the beneficiary's estate for estate tax purposes and are better protected against the beneficiary's potential creditors, including spouses. The same reasons for leaving other assets in trust, rather than outright, apply to IRA benefits. However, in the case of a traditional IRA, there's an income tax tradeoff. Trusts reach the top income tax bracket at \$11,950 of taxable income.<sup>5</sup> If the beneficiary is in a lower income tax bracket, there's an income tax cost to obtain the estate tax and asset protection benefits of leaving IRA benefits in trust. While the trustees can make distributions to beneficiaries in lower income tax brackets, these distributions will defeat the estate tax and asset protection benefits of the trust.

The income tax cost of leaving assets in trust has increased as a result of ATRA.<sup>6</sup> ATRA increased the top income tax rate for trusts, applicable to taxable income over \$11,950, from 35 percent to 39.6 percent. At the same time, ATRA made the 2001 and 2003 tax rate reductions permanent for individual taxpayers with taxable income up to \$400,000 (single) or \$450,000 (joint). In addition, the 35 percent bracket only applies to taxable income between \$398,350 and \$400,000 (single) and between \$398,350 and \$450,000 (joint and surviving spouses). These reductions will permit many IRA owners to convert at tax rates below 35 percent. By converting to a Roth, IRA owners can leave their IRA benefits to their children and grandchildren in trust, rather than outright, without subjecting the IRA benefits to tax at 39.6 percent or giving up the estate tax and asset protection benefits of the trust.

## Timing

To avoid bunching the income from the conversion into a single year, many IRA owners should spread the conversion out over a number of years. IRA owners who are in a high income tax bracket, but who expect to be in a lower income tax bracket upon retirement, may wish to wait until retiring before converting or beginning to convert if they want to spread the conversion out over a number of years.

IRA owners who are married should consider the possible change in tax brackets on the death of one spouse.

IRA owners who don't have enough other income to fill up their 15 percent and lower brackets may wish to retain a sufficient amount of traditional IRA benefits to take advantage of these brackets. 

## Endnotes

1. American Taxpayer Relief Act of 2012 (P.L. 112-240, H.R. 8, 112th Cong., 2d Sess.).
2. Public Law 105-206, Section 7004.
3. P.L. 109-222, Section 512.
4. *Estate of Smith v. United States*, 391 F.3d 621 (5th Cir. 2004); *Estate of Doris F. Kahn*, 125 T.C. 227 (2005).
5. Income tax brackets are indexed for inflation. The \$11,950 figure applies for 2013.
6. *Supra*, note 1.



## SPOT LIGHT

### Sitting on the Dock of the Bay

"Untitled" (13 in. by 16<sup>7</sup>/<sub>8</sub> in.) by Hale Woodruff, sold for \$10,200 at Swann Auction Galleries' recent African American Fine Arts Sale in New York on Feb. 14, 2013. Woodruff is best known for his three panel mural depicting the mutiny on the *Amistad* and the ensuing trial.