Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #549

Date: 09-Nov-10
From: Steve Leimberg's Employee Benefits and Retirement Planning Newsletter
Subject: **One Good Reason Not To Do a Roth IRA Conversion**

LISI has provided members with significant commentary on the topic of Roth IRA conversions. Now, **Alan Gassman**, **Kenneth Crotty** and **Christopher Denicolo** join together and provide members with their analysis of "one good reason" not to do a Roth IRA conversion.

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EDITOR's NOTE: Before we get to their commentary, **LISI** recently posted, courtesy of **Mike Nelson** of **Iowa Savings Bank**, The June 2010 Treasury/IRS draft of Form 8939, Allocation of Increase in Basis for Property Received from a Decedent. **LISI** heard from **Vince Lackner** of the **Lackner Group, Inc.** that the IRS intended to release the final form as soon as possible after receiving final guidance from the Office of Chief Counsel. However, the BNA Daily Tax Report announced that the Service was abandoning this version of Form 8939, and planned on distributing a substantially different version at some point before the end of 2010.

Now, here is their commentary:

EXECUTIVE SUMMARY:

Current legislation allows for the conversion of traditional IRA accounts and other traditional qualified retirement plan accounts into Roth IRA accounts in 2010 and in later years without any limitations on the client's adjusted gross income (AGI). Although many clients and advisors are jumping at this opportunity, there are a number of factors that must be examined, including the possibility that a client will have extraordinary home assistance and medical expenses that will, in effect, be payable from taxable retirement plan accounts on a tax-free basis.

A conversion from a traditional qualified retirement plans to a Roth IRA is not the right choice for every client. In analyzing the conversion, we feel many advisors are overlooking the possibility that the assets of a traditional qualified retirement plan can effectively be withdrawn tax-free if they are withdrawn for deductible medical expenses, and many clients incur such deductible medical expenses, especially later in life.

FACTS:

2010 has seen a change in legislation regarding the conversion of traditional retirement plan accounts into Roth IRAs. Before this year, only individuals with AGIs that did not exceed $100,000 were permitted to make such a conversion.[i] As a result of the Tax Increase Prevention and Reconciliation Act signed by President George W. Bush, this $100,000 AGI ceiling was eliminated for 2010 and later years making it possible for wealthier individuals to convert their traditional IRAs to Roth IRAs, if desired.

If such a conversion occurs, the conversion is treated as a taxable distribution from the traditional IRA to the taxpayer, and a subsequent non-deductible contribution to a Roth IRA. As a result of the conversion, “there shall be included in gross income any amount which would be includible were it not part of a qualified rollover contribution.[ii]”

Thus, for taxpayers in the highest income tax bracket, a 35% tax is levied on the monies currently in the IRA account, which may be paid with non-IRA funds. Additionally, for Roth IRA conversion that occurs in 2010, 50% of the conversion income could be taxed in 2011, and the remaining 50% could be taxed in 2012.[iii] However, if a taxpayer elects to pay all of the tax associated with a conversion in 2010, he or she may do so. While tax deferral is generally preferable in most cases, clients who would benefit from making a Roth IRA conversion in 2010 may want to consider paying income taxes in 2010 because of the potential for increases in income tax rates in future years.

After the funds have been converted to a Roth IRA, the assets in the account grow and can be withdrawn tax-free, once the holding period requirement is met and the taxpayer is over 59½. In addition there are no required minimum distributions from the Roth IRA. It is important to note that the 10% early distribution penalty tax does not apply to conversions of traditional retirement accounts to a Roth IRAs. However, this 10% early distribution penalty can apply to distributions that are made from a converted Roth IRA account within five years of the conversion, or if a distribution of earnings is made from the Roth IRA before the taxpayer attains the age of 59 1/2 and the distribution is not otherwise exempt from the early distribution penalty tax (such as if a distribution is made due to death, disability, or medical hardship).

COMMENT:

In theory, this new legislation regarding Roth IRA conversions works well mathematically for clients who will either (1) die and be subject to both federal estate tax and income tax on IRA or qualified retirement plan balances; or (2) who will pay more than a 35% income tax on the withdrawal of monies from an IRA or other qualified retirement account in the retirement years assuming that they are in the highest tax bracket when the conversion occurs.

The main factor that we believe many advisors are not thinking about is that IRA and other traditional qualified retirement plan funds may, in effect, be withdrawn tax-free if used for "deductible medical and care expenses" of an elderly client.

When a distribution is made from a traditional IRA, the value of the distribution is generally taxed to the recipient as ordinary income to the extent of the portion of the distribution that does not represent a return of the taxpayer's previous contribution to the IRA.[iv] Under current law, medical and healthcare expenses are deductible to the extent that they exceed 7.5% of the taxpayer's AGI, or to the extent that they exceed 10% of the taxpayer's AGI if the taxpayer is subject to the alternative minimum tax.[v]

In other words, when we are all hopefully and happily living in our late 80's and early 90's (or 100's) and need personal care helpers (like live-in maids) and things that Medicare will not pay for, these expenses will still be tax deductible and can thus be paid for on a tax-free basis from a "taxable IRA" to the extent the expenses exceed 7.5% of the taxpayer's AGI.

Therefore, we have seen a number of clients spend down relatively large IRAs during their last years on a "tax-free basis" Some of these clients would have run out of money during their lifetime if they had given away 35% of the value of their IRAs by converting to a Roth IRA if the option had been available.

If you consider your IRA and qualified retirement plan monies as "later in life reserves" that might be used for health care and living assistance expenses, then paying 35% of this amount now to the government or reducing your net worth by 35% if you pay the tax that results from the conversion from assets outside the IRA and pension may not be a good idea.

In any event, there is no hurry to effectuate a Roth IRA conversion before year-end 2010 because current law allows clients to convert their traditional retirement accounts to Roth IRAs after 2010, without regard to the client's AGI. Therefore, clients and their advisors can deliberate as to whether a Roth IRA is appropriate for the client's situation. Clients who wait until after 2010 to effectuate a Roth IRA conversion would only miss out on the ability to pay the income taxes associated with the Roth IRA conversion in the 2011 and 2012 tax years. The money set aside to pay these taxes is not expected to earn any significant interest in our present economy, so what is the hurry?

Another consideration is whether our United States tax system will ever evolve into a European- style value added tax (VAT) system. Paying tax now at 35% may turn out to be a "faux pas" if effective United States tax rates go down into the 15%-20% range because of the implementation of a value added tax system.

While the opportunity to discuss Roth IRA conversions gives us the ability to review client assets and motivations, the vast majority of clients and sophisticated advisors seem to be advising against Roth IRA conversions, or at least not advising that all IRA and qualified retirement plan accounts be converted to Roth IRAs.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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Kenneth Crotty
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TECHNICAL EDITOR: BARRY PICKER

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[i] P.L. 109-222, §512(a)(1), repealing former IRC § 408A(c)(3)(B).

[ii] IRC Section 408(d)(3)(A).

[iii] P.L. 109-222, Section 512(b), amending IRC Section 408A(d)(3)(A).

[iv] IRC Section 408(d)(1).

[v] IRC Section 213(a). However, for tax years beginning after December 31, 2012, the 7.5% floor on deductible medical expenses will be increased to 10% for all taxpayers other than individuals who have attained the age of 65 before the end of the tax year or individuals whose spouses have attained the age of 65 before the end of the tax year, provided that the taxpayer is not subject to the alternative minium tax. For tax years ending after December 31, 2016, the floor on deductible medical expenses will be increased to 10% for all taxpayers.

P.S. **Barry C. Picker**, of **Picker & Auerbach, CPAs, P.C**. is the author of the terrific "Barry Picker's Guide to Retirement Distribution Planning." **Bob Keebler** and **Barry Picker** have just released a new book entitled, 100+ Roth Examples and FlowCharts. It contains Roth IRA Contribution Limitations, Recharacterizations, Taxability of Distributions, 10% Early Withdrawal Penalty, Asset Protection Issues, and Post-Mortem Roth Distributions. Bob and Barry's book can be ordered through an order form on Barry's website, www.pwacpa.com, or via phone at 1-800-809-0015.