January 9, 2010

Re: ***Roth IRA Conversions***

Changes in federal law effective January 1, 2010 will give many taxpayers the first opportunity to convert an existing IRA or qualified retirement plan account into a tax-free Roth IRA account. Beginning in 2010, a taxpayer at any income level may undertake a conversion and the amount of the conversion is unlimited. Conversion may increase the after tax yield on retirement accounts to the owner-participant or to the account beneficiaries without changing an existing investment strategy.

A Roth IRA is an IRA account under federal law with custom features. These features make a Roth IRA particularly well-suited for estate planning transfers to younger generations. Contributions to a Roth IRA are not deductible, but distributions are generally tax free if the owner has held a Roth IRA account for at least five years. The account owner may continue contributions after reaching age 70 ½. No minimum distributions are required during the lifetime of the account owner or during the lifetime of a surviving spouse who elects to roll over the Roth IRA into the survivor's own account.

The twin features of tax-free distributions and permitted ongoing contributions are the primary benefits that give the Roth IRA its estate planning appeal. Taxpayers with an existing traditional IRA, or none at all, can create a Roth IRA and transfer property otherwise subject to income tax to younger generations at a potential reduced tax cost.

The owner-participant will be allowed to convert an existing retirement account to a Roth IRA. A non-spouse beneficiary may convert any qualified plan account but not an existing IRA. Conversion is accomplished by establishing a new Roth IRA account and requesting a trustee to trustee transfer from the existing retirement plan.

When an existing account is converted to a Roth IRA, the conversion is treated as a taxable distribution at ordinary income tax rates. Tax efficient planning would pay the resulting income tax from sources outside the Roth IRA. Under another upcoming change in federal law, a taxpayer may elect to pay the income tax on a year 2010 conversion in equal installments in years 2011 and 2012. Making this election may reduce the income tax liability on a 2010 conversion by spreading the income over several years, or deferring that income into a year when a taxpayer's income may be lower. A taxpayer may also include the full amount in income in year 2010. Paying the entire income tax on a year 2010 conversion without electing deferral may be a hedge against future increases in income tax rates. After 2010 any income tax liability would be payable in the same year as the conversion.

The longer that a converted Roth IRA account is held the greater the potential tax planning benefits. The greatest estate tax planning benefits occur by allowing the Roth IRA account to accumulate for younger generation beneficiaries with distribution over their life expectancies. The initial payment of the income tax on the converted account is effectively a "gift" to those beneficiaries, but no taxable transfer occurs because the owner-participant has the legal obligation to pay the income tax. The Roth IRA may be subject to federal estate tax, but generally no second level of income tax is imposed.

No right answer fits all possible Roth IRA conversions. Conversion must be weighed in light of the financial circumstances and planning goals of the account owner. The greatest tax benefits from conversion are generally achieved by allowing the Roth IRA to accumulate during the lifetime of the account owner for distribution to younger generations over an extended pay out. This approach is less advantageous if the account owner anticipates withdrawing the Roth IRA account during retirement. Paying the income taxes resulting from conversion out of the Roth IRA account is counterproductive to the potential tax benefits because that payment is deemed to be an immediate withdrawal subject to penalties.

Please feel free to discuss with me the upcoming changes in federal tax law, and whether a Roth IRA conversion makes sense for your estate planning.

Kind regards and best wishes for the New Year.

Very truly yours,

JOHN A. HARTOG, INC.