Estate Planning Insights

A Quarterly Publication of

Karen S. Gerstner & Associates, P.C.

Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
(713) 520-5205

Vol. 6, No. 4 October 31, 2009

SHOULD YOU CONVERT YOUR TRADITIONAL IRA TO A ROTH IRA?

Soon, the opportunity for a participant (listed owner) of a traditional IRA (or participant of certain qualified plans) to convert such IRA (or plan) to a Roth IRA will be expanded. Is this something you should do? Also discussed in this newsletter are two estate plans involving disclaimers.

Expanded Conversion Opportunity Available in 2010. Up until now (and through December 31, 2009), only a taxpayer with modified Adjusted Gross Income (AGI) not exceeding $100,000 (excluding the taxable amount of the conversion and any MRD) could convert a traditional IRA to a Roth IRA. However, beginning January 1, 2010, *any* taxpayer can convert a traditional IRA (and certain employer-sponsored retirement accounts) to a Roth IRA, even if he has modified AGI above $100,000. In other words, there will no longer be an income limit for making a Roth conversion.

Some Aspects of Roth IRAs. Although contributions made to Roth IRAs are not tax-deductible, distributions from Roth IRAs are tax-free if they are *Qualified Distributions*, meaning, they are (1) made after the 5-tax-year period that begins to run on January 1 of the first year for which a contribution (including a conversion) was made to *any* Roth IRA maintained for that participant *and* (2) made to a participant who is at least 59½ years old (or disabled) or to the participant's beneficiary on account of his death. Further, the participant of a Roth IRA does not have to take minimum required distributions (MRDs) from the Roth IRA upon reaching age 70½, as must be done with a traditional IRA. In addition, there is no age limit on making a contribution to a Roth IRA as there is for a traditional IRA.

Spouse as Beneficiary. If a Roth IRA passes to the participant's spouse on his death, many Roth IRA Agreements are set up for an *automatic* spousal IRA rollover, meaning that the surviving spouse becomes the new participant of the Roth IRA (if the spousal rollover is not automatic, most surviving spouses opt to do the rollover). The benefit of the spousal rollover is that no MRDs have to be taken from the rolled-over Roth IRA during the surviving spouse's lifetime (same as for the original participant). Further, Qualified Distributions to the surviving spouse will be income tax-free.

Community Property Considerations. Don't forget that, as with all assets acquired during marriage by a married couple living in Texas (other than gifts and inheritances), a Roth IRA is presumed to be community property, owned ½ by each spouse. This is true even though the Roth IRA is titled in the name of just one spouse–the participant–and even though only that spouse has "control" over the Roth IRA.With such "sole management community property", the spouse whose name is on the account is the *manager* of the account on behalf of both spouses (but not the sole owner). Since the funds in a married participant's Roth IRA are community property, when completing the beneficiary designation form, the participant should name his spouse as the beneficiary of *at least* ½ of the Roth IRA (because she already owns half under community property law). Otherwise, the result will be potential adverse gift tax consequences for the spouse and possibly even litigation (for fraud on the community).

Non-Spouse Beneficiaries. If a Roth IRA passes on the participant's death to non-spouse designated beneficiaries and if separate inherited Roth IRA accounts are timely created, each beneficiary can use his/her own life expectancy for calculating MRDs from his/her inherited Roth IRA. MRDs from an inherited Roth IRA must commence by December 31 of the year following the year of the Roth IRA participant's death. Unlike with traditional inherited IRAs, however, Qualified Distributions from an inherited Roth IRA are tax-free.

Estate Tax Considerations. For federal estate tax purposes, the participant's interest in a Roth IRA is included as an asset of his estate (the same as a traditional IRA) at its fair market value on the participant's date of death (or, if it will save estate taxes to value all of the decedent's assets 6 months after the date of death, then on the alternate valuation date). If the participant's interest in the Roth IRA passes to his U.S. citizen spouse on death, estate taxes will be deferred because of the unlimited marital deduction (if the participant's spouse is not a U.S. citizen and the marital deduction is desired, the Roth IRA would need to be placed in a QDOT). If the Roth IRA participant is not married, then estate taxes could be imposed on the Roth IRA (and his other assets)

if the decedent's entire estate is large enough to be taxable (over $3.5 million under current law).

A traditional IRA has an *overstated* value for federal estate tax purposes because it is a "pre-tax" asset (i.e., it has a built-in income tax liability that artificially increases its value for estate tax purposes). Further, the transfer of a traditional IRA results in double taxation–it is subject to estate taxes in the participant's estate and income taxes as the funds are withdrawn by the beneficiaries. Sometimes the double tax applies in the same year (where all or a portion of the IRA has to be liquidated and withdrawn to pay the decedent's estate taxes). With a 45% estate tax rate and a 35% top income tax rate, the combined tax rate can be substantial. Fortunately, there is an income tax deduction (but not a tax credit) to help alleviate this double taxation on traditional IRAs. Some researchers believe that if the beneficiary of a deceased participant's traditional IRA utilizes the stretch option (only takes the MRD each year) and takes the allowable income tax deduction (with respect to the estate taxes caused by inclusion of the IRA in the participant's estate), the net result to the beneficiary, long term, is comparable to the net result of the beneficiary inheriting a Roth IRA. As noted, the Roth IRA is subject to estate tax in the participant's estate just like a traditional IRA. A converted Roth IRA will have a lower value for estate tax purposes than the traditional IRA from which it came (and, further, the participant's estate will be smaller due to the income taxes paid on the conversion). The conversion might lower the value of the participant's estate enough to avoid estate taxes. Obviously, however, in view of the expanded conversion opportunity, some Roth IRA participants will still have taxable estates at death. While the Roth IRA may incur estate taxes in the participant's estate, assuming all distributions from the Roth IRA to the participant's beneficiaries are Qualified Distributions, there will not be an income tax deduction for the estate taxes paid on the Roth IRA because there aren't any income taxes on the post-death distributions in that case.

Considerations Regarding the Conversion. There are many articles that discuss the pros and cons of converting a traditional IRA to a Roth IRA. There isn't just one correct answer–everyone's situation is different. However, a consensus that keeps appearing is that, for the most part and for most people, the conversion is not a "slam dunk". The end result may be pretty close to neutral–slightly better or slightly worse than not converting. Keep in mind that one reason the federal government removed the income limitation in 2010 is to raise revenue (that should indicate something).

There are certain factors that weigh *against* doing the conversion:

1. The participant must use funds from the IRA (or another retirement fund) to pay the income taxes caused by the conversion.
2. The participant is likely to begin needing to spend retirement funds soon.
3. The beneficiaries of the participant's IRA are not likely to utilize the "stretch" distribution method after the participant's death.
4. The participant is likely to be in a lower income tax bracket in the future compared to now.

On the other hand, a single participant with a sizeable IRA and a *taxable* estate (over $3.5 million) could reduce his estate below $3.5 million by converting. Also, since the values of securities held in IRAs are low right now, the income taxes on conversion would be less now than when asset values are high. Further, if you expect to be in a higher income tax bracket later (which might be the case for all of us), the conversion may make sense. Income taxes on the Roth conversion will be due ½ in 2011 and ½ in 2012, *unless you make the election to pay all of the tax in 2010.*

Contact your CPA or Financial Planner. To see if the Roth IRA conversion is appropriate for you, we highly recommend that you contact your CPA or financial advisor (or both). They can help you analyze the potential results based on your particular situation and "show you some numbers" to help you decide.

ESTATE PLANNING IDEAS

Disclaimer Estate Plan #1. While three major (and some lesser) estate tax bills have been pending since early this year, it looks like Congress probably won't have time to make any comprehensive changes to the estate tax laws before year end. If Congress does nothing, then the law already on the books provides that there is no estate tax for persons who die in 2010. While the "no death taxes in 2010 provision" (if retained) would be advantageous for beneficiaries of extremely large estates, for beneficiaries of moderately sized estates, not obtaining the usual "tax-free step up in basis" for the inherited assets (another 2010 feature) would be disadvantageous. The latest we hear from Washington, however, is that Congress is likely to pass a one year "patch", making the estate and gift tax laws for 2010 the same as 2009. Basically, this means that the estate tax exclusion amount would remain at $3.5 million, the estate tax rate would remain at 45% and the lifetime gift tax exemption amount would remain at $1 million. Married couples who want two exemptions from the estate tax (and not just one) would still need a Bypass Trust in their Wills or Living Trust Agreement because there is no *portability of exemptions* between spouses under current law.

As a reminder, most clients who create a Bypass Trust appoint their spouse as the sole Trustee and name their spouse as the primary beneficiary of the trust. Thus, the surviving spouse has control over the trust assets and can use them for her health, support and maintenance, to maintain her accustomed standard of living. If the trust is so written, distributions can also be made from the trust to children and grandchildren while the spouse is living. Thus, placing assets in a Bypass Trust is very close to giving the assets to the spouse, but with the tax benefit of allowing couples to obtain 2 exemptions from the estate tax (doubling the amount that can eventually be passed on to children, free of estate tax).

Current law will "sunset" at the end of next year. Thus, unless changed by Congress, for 2011 (and thereafter), the estate tax exemption amount will drop back to $1 million and the top estate tax rate will go back up to 55%. Some in Congress want to make the current $3.5 million exemption permanent and index it for inflation. Others want the exemption to be reduced to $2 million. So far, the majority want to keep the estate tax rate at 45%. One provision in all of the pending bills that is *not part of current law* is portability of exemptions between spouses. *If* portability passes, married couples would no longer have to include a Bypass Trust in their Wills to obtain 2 exemptions from the estate tax. Again, we don't have portability now, so married couples without a Bypass Trust only get one $3.5 million exemption per couple, resulting in a 45% estate tax on everything above that amount on the second spouse's death.

Since we don't know what the future holds, for couples who would prefer not to have a Bypass Trust unless it's needed to avoid estate taxes, there is a type of Will that is very flexible. It's generally referred to as a "Disclaimer Will" because of the mechanism that causes assets to pass into a Bypass Trust (versus a "formula Bypass Trust Will"). I like to call this the "optional Bypass Trust Will". This Will is more valuable than a simple Will because it allows a couple to avoid future estate taxes but still lets the surviving spouse use and control all the assets. Basically, the Will says (translating to non-technical language), "I leave everything I own at my death to my spouse, but if my spouse decides it would be better to put all or some of what I own in a Bypass Trust, I give my spouse the option to do that." If a Bypass Trust is not needed because the combined estate is less than the exemption amount (with or without portability, if applicable), the spouse can do nothing (not exercise the option) and everything will belong to her (just as with a simple Will). If a Bypass Trust *is* needed to avoid future estate taxes, the spouse can exercise the option. Further, with the Disclaimer Will, the surviving spouse can tailor the size of the trust to exactly what is needed to keep her estate below the exemption amount.

Only a *qualified* disclaimer (one that meets all IRS requirements) will avoid gift tax treatment for the spouse when she makes the disclaimer. There are some things the surviving spouse can do that will foreclose the disclaimer option, so the downside of this very flexible estate plan is that people who rush out and act too quickly when their spouse dies (and without good legal advice) often end up "shooting themselves in the foot". The biggest restriction is that you can't use the assets you intend to disclaim as if they were your own or re-title them into your own name. Doing so will foreclose the option–it's as if you've already made the decision to keep the assets. So this type of plan requires *heightened caution* upon the first spouse's death. We always recommend to our clients with this type of plan that they call us right away when their spouse dies and ask us to remind them what they can and cannot do prior to making their decision regarding the disclaimer option. The Disclaimer Will is very popular right now and works well for couples having a total estate between $1 - $4 million.

On the other hand, some couples who already have a Bypass Trust in their Wills might still want the trust, even if it's not needed to avoid estate taxes. Here are some of the non-tax reasons why someone might want to stick with their formula Bypass Trust Will:

1. The person is concerned that, if she dies first, her spouse will remarry and leave her assets to a new spouse (or to someone other than her children or desired beneficiaries).
2. The person has significant liability exposure (perhaps a retired doctor) and likes the fact that the assets in the Bypass Trust are protected from the claims of creditors.
3. The person likes having additional income tax options with respect to the income earned by the assets held in the Bypass Trust.
4. The person wants a professional Trustee to manage his assets for the benefit of his spouse after death.

Disclaimer Estate Plan #2. For clients with large, taxable estates, in addition to utilizing various lifetime planning techniques to avoid death taxes, those with a charitable intent often leave a portion of their estate to one or more qualified charities at death. Unlike with charitable gifts made during life, there are no percentage limitations for qualified gifts made to charity at death. In other words, there is an unlimited charitable deduction at death. Sometimes wealthy clients may not have a strong charitable intent themselves, but recognize that their children may be interested in giving to charity. A really neat option that I heard about recently from my friends at

the Houston Christian Foundation is a twist on the usual making of charitable gifts at death. A very wealthy person might give each of his children the option to disclaim all or any portion of the share of the client's estate passing to that child at death. Per the Will or Trust, the disclaimed assets are distributed to a donor-advised fund at one of the three local community foundations. The Will's tax payment clause would need to be written so that each child who disclaims to charity gets the advantage of that charitable deduction (reducing the estate taxes on that child's share of the estate). Thus, the children determine how much estate tax is paid by their parent's estate.

Further, while the parent's estate obtains the charitable deduction in time to reduce federal estate taxes (because the disclaimer has to be made within 9 months of death–the due date for paying estate taxes), each child has unlimited time after that to make recommendations regarding which particular public charities ought to receive distributions from his/her donor-advised fund. Thus, the portion of the estate the child doesn't keep himself can be paid out by the community foundation to various charities the child recommends as time goes by.

HAPPY HOLIDAYS. Our office will be closed November 26 & 27 for Thanksgiving and December 24 & 25 for Christmas. We will also be closed Friday, January 1, 2010 for New Year's Day. We are grateful for the work that has come our way this year through our clients and colleagues. We wish everyone Happy Holidays!

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

You can also reach us by e-mail addressed to:

Karen S. Gerstner* karen@gerstnerlaw.com

Jill Gary Hughes jill@gerstnerlaw.com
Heather J.E. Laureles heather@gerstnerlaw.com
Lynn Brooks lynn@gertnerlaw.com
Biljana Salamunovic biljana@gerstnerlaw.com
General delivery gerstnerlaw@yahoo.com

*Board Certified, Estate Planning & Probate Law, Texas Board of Legal Specialization

KAREN S. GERSTNER & ASSOCIATES, P.C.
A Professional Corporation
Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

Telephone (713) 520-5205
Fax (713) 520-5235

PRSRT STD
U.S. POSTAGE
PAID
PERMIT NO. 600
HOUSTON, TX

CHANGE SERVICE REQUESTED

PRINTED ON RECYCLED PAPER

To download back issues and learn more about estate planning, visit our web site at **www.gerstnerlaw.com**