

Roth IRAs, Capital Gains and Other 2010 Income Tax Planning Topics

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Background of Roth IRAs

- No deduction on contribution
- Tax free growth if there are no distributions until:
 - Roth IRA exists for 5 years, and
 - Distributions occur after:
 - Age 59½
 - Death or disability
 - First time homebuyers (\$10,000 limit)
 - No RMDs for participants
 - Can make contributions after age 70½
 - Excellent wealth transition tool

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Many taxpayers have not qualified for Roth IRAs

- No contributions because MAGI exceeds \$176,000
- No conversions because modified MAGI exceeds \$100,000
- Filing Status of MFS

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»» Law change for tax years after 2009

- Modified AGI limit on conversions is eliminated for 2010 and future years as well as disallowance for MFS
- For 2010 conversions only:
 - Conversion income taxed on 2010 return
 - OR
 - Conversion income can be deferred equally between 2011 and 2012 (Default unless elect to recognize all in 2010)
 - May be counter intuitive. Depends on tax provisions that may "Sunset" and rate increases in 2011 and 2012

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»» Reasons for converting to a Roth IRA

- Take advantage of favorable tax attributes
 - Charitable deduction carryforwards
 - Net Operating Loss carryforwards
 - Investment tax credits, etc.
- Suspension of the lifetime required minimum distribution (RMD) rules
- Payment of income tax prior to imposition of estate tax
 - Allows for greater wealth to be transferred to future generations

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»» Reasons for converting to a Roth IRA

- Greater growth potential
 - To the extent that outside asset resources are used to pay for the taxes due on the Roth IRA conversion
- Better utilize or arrange an IRA owner's use of their Estate Exemption
 - Effectively reduce the taxable estate of the IRA owner

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»» Four types of Roth conversions

1. Strategic Conversions
 - Long term wealth transfer objectives
2. Tactical Conversions
 - Short term income tax attributes
3. Opportunistic Conversions
 - Short term stock market volatility, take advantage of potential market rebound in tax free vehicle
4. Hedging Conversions
 - Projecting future events that result in higher future taxes

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»» Three critical factors that are a part of each type of conversion are:

1. Income tax bracket differential, current vs. future. Will you be in a higher tax bracket when you retire?
2. Ability to use outside assets to pay the income tax on conversion
3. Time Horizon-Can you live comfortably without using the funds for at least 5 but preferably 10 years, or best scenario is you don't need these funds at all.

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»» Strategic Conversions – Ideal Taxpayer is:

- One who has outside (non-qualified money) assets to pay taxes
- Does not need the money for annual income purposes
- Desires to leave value to children or grandchildren
- Expects to be in same or higher tax bracket in future years

This analysis is viewed more for wealth transfer planning. Although the next-generation beneficiaries are required to take RMD (required minimum distributions) over their lifetime, the RMDs are tax-free.

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»» Tactical Conversions – Ideal Taxpayer is:

- One who is faced with the possibility of losing a tax attribute
- Taxpayer needs to increase income to take advantage of favorable tax attributes
 - Net Operating Losses (NOL) carryforwards
 - Business and other ordinary losses
 - Deductions and exemptions in excess of income
 - Charitable contribution carryforwards
 - Non-refundable tax credits

This analysis is viewed more for tax planning to allow a taxpayer to take advantage of tax treatments. By doing a Roth conversion, a taxpayer will have leveraged their money by taking advantage of favorable tax attributes and paying little or no tax on the conversion.

»» Opportunistic Conversions – Ideal Taxpayer is:

- One who has an IRA portfolio that has declined recently due to market conditions
- One who has a stock or particular fund or asset class that is expected to have rapid growth within the near future

This analysis is intended to take advantage of economic and market conditions which are expected to reverse.

»» Hedging Conversions – Ideal Taxpayer is:

- One who is looking to hedge against an increase in income tax rates
- One who is looking to hedge against an increase in estate tax rates

This analysis is intended to hedge against higher income tax rates in the future. A part of this consideration involves the income tax tables for Married Joint vs. Single taxpayers. Regarding the estate tax, it can be much more effective to incur the deferred income tax on retirement assets while living. Doing so lowers the taxable estate, which saves Federal Estate tax and relevant State Estate or Inheritance taxes.

Partial Conversions

- If taxpayer has multiple IRAs, can convert some accounts and not others. Likewise can convert only a proportion of the balance in one or more accounts. Not an all or nothing proposition.

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Impact of nondeductible contributions

- Nondeductible contributions must be allocated based upon the combined value of all of the traditional IRA accounts.

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Impact of nondeductible contributions

- Example:
 - Taxpayer has two traditional IRAs worth \$50,000 each. The balance of IRA 1 is all from deductible contributions and earnings. The \$50,000 balance in IRA 2 consists of \$15,000 of nondeductible contributions and \$35,000 of deductible contributions and earnings. If the taxpayer converts IRA 1, the resulting \$50,000 deemed distribution will be 15% tax free ($\$15,000/\$100,000$). The same result will occur if IRA 2 is converted

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Multiyear conversion

- Consider converting a portion of the balance each year
- Avoid higher rates by targeting income on conversion each year
- Remember 2010 is the only year in which income on the conversion can be deferred.

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IRA account planning

- Split large IRA account into multiple accounts based upon asset class
- Reassess recharacterization based upon performance of each asset class
- Paperwork with IRA administrators may limit this???

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Recharacterization

- Undo prior conversion of traditional IRA to Roth IRA
- Due date for recharacterization of 2010 conversions is October 15th, 2011

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»» Roth IRA: Recharacterization

- **Example:** Assume you converted your \$100,000 traditional IRA to a Roth IRA in May 2010. By December 2010, your Roth IRA is worth only \$60,000--it has lost 40 percent of its value. Nevertheless, you'll pay income taxes based on the conversion date value of \$100,000. To get around this, you may be able to undo or recharacterize your Roth conversion. After the appropriate waiting period, you may be able to do a new conversion based on the new account value.

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»» Roth IRA: Recharacterization

- For example, assume you convert a traditional IRA to a Roth IRA in May of 2010. On August 6, 2010, you recharacterize that Roth IRA to a traditional IRA. You now want to reconvert to a Roth IRA. You won't be able to effect a reconversion until the later of:
 - January 1, 2011 (the beginning of the year following the year in which the amount was originally converted to the Roth IRA), or
 - September 6, 2010 (the end of the 30-day period following the day on which you recharacterized the Roth IRA to a traditional IRA)
- **Because the later of the two dates is what matters, you'll have to wait until at least January 1, 2011, to reconvert.**

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»» Sample Roth Conversion Timetable

- January 1, 2010 – First date in which income levels are lifted and a client can convert to a Roth IRA from a regular IRA
- December 31, 2010 – Last date in which a client can convert a regular IRA to a Roth IRA for the year 2010
- April 15, 2011 – Due date for the 2010 income tax return for the conversion if client chooses to pay the tax in one year. Otherwise, the default option is for taxpayer to report half the income in 2011 and half in 2012

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»» Sample Roth Conversion Timetable

- October 15, 2011 – Last date in which a recharacterization of a 2010 conversion may be made. Can undo a ROTH conversion for any reason by October 15th of following year.
- Reconversion of recharacterization timetable – Can take place only at the later of the following:
 - The tax year following the original conversion or
 - 30 days after the recharacterization

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»» Other Roth IRA points

- Cannot rollover RMDs
- Does not allow for conversion of traditional 401(k) to Roth 401(k).
- Although a taxpayer could roll a traditional 401(k) to a traditional IRA and then convert to a Roth 401(k), most plans do not allow a distribution to an IRA until the account owner retires or separates from service

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»» Capital Gains Tax Planning

- Current capital gains tax rate
 - 15% top rate with a 0% lower tier rate
- Future capital gains tax rate
 - Current law calls for the current 15% and 0% capital gains rates to go to 20% and 10% after 2010
 - Obama's plan calls for 20% tax rate for married taxpayers above \$250,000 or single taxpayers above \$200,000 for years after 2010

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»» Capital Gains Tax Planning

- Possible strategies in anticipation of higher capital gains tax rates
 - Acceleration of installment sale capital gains
 - Extract excess liquidity from closely-held corporations
 - Defer year-end security capital losses

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»» Capital Gains – Acceleration of Installment Sale Capital Gains

- Normal rule on installment sale-recognize gain on sale as principal payments are received.
- IRC Section 453(d)(1) allows a taxpayer to elect out of installment sale treatment in the year in which the sale occurs
- Election not to use installment sale treatment is made by simply reporting all of the gain on a timely filed tax return including extensions

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»» Capital Gains - Acceleration of Installment Sale Capital Gain

- Present value analysis is needed to determine tax benefit of electing out
- Generally, the longer the term of the contract, the less likely the acceleration of the tax results in savings. Deferral of income tax outweighs the increase in the tax rate
- Note in a real estate transaction that the unrecaptured Section 1250 gain is taxed first

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Capital Gains - Acceleration of Installment Sale Capital Gain

- Don't forget to look at AMT when looking at the installment sale election analysis
- May be beneficial if taxpayer has existing capital losses to offset acceleration of gain
- Acceleration of pre-2009 installment sale capital gains can be accomplished
 - Gift or sale of installment obligation
 - Substantial modification to the note with the lender

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Capital Gains – Closely Held Corporations

- C corporations with accumulated earnings and profits could issue a dividend which would be taxed at capital gains rates (qualified dividend income)
- S corporations with accumulated c corporation earnings and profits could make an actual dividend or make a deemed dividend election

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Capital Gains – Closely Held Corporations

- IRC Section 1368(e)(3) allows election to distribute AE&P before AAA
- AE&P in an S corporation that no longer operates an active trade or business could subject the corporation to a 35% tax on excess passive net investment income and termination of S corporation status

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»» Capital Gains – Defer Year End Losses

- Save capital losses until 2011 when the losses are more beneficial, especially if client already has capital loss carryforward or no gains to offset

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»» Cancellation of Indebtedness Income

- Normal Rules
 - Generally taxable unless excludable under IRC Section 108(a)
 - Discharge in bankruptcy
 - Taxpayer is insolvent
 - Qualified farm indebtedness
 - Qualified real property business indebtedness
 - Principal residence debt up to \$2 million

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»» Cancellation of Indebtedness Income

- Normal Rules
 - Reduction of tax attributes when an exclusion under IRC Section 108(a) applies
- New Legislation
 - Election to defer COD income from the reacquisition of an applicable debt instrument during 2009 and 2010.
 - COD income can be deferred to and included in taxable income ratably over a five year period beginning with:
 - For reacquisitions occurring in 2009, the fifth tax year following the year in which the reacquisition occurs or
 - For reacquisitions occurring in 2010, the fourth tax year following the year in which the reacquisition occurs
 - Thus, COD income would begin being taxed in 2014

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»» Cancellation of Indebtedness Income

- Applicable debt instrument is debt issued by a C corporation or any other person including a pass through entity in connection with the conduct of a trade or business
- Reacquisition includes:
 - Debt for debt exchanges
 - Repurchase of debt for cash
 - Modification of debt treated as an exchange
 - Exchanges of equity for debt
 - Contribution of debt to capital
 - Complete forgiveness of the debt instrument

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»» Cancellation of Indebtedness Income

- Election is made on a debt by debt basis
- Election is irrevocable
- In the case of a partnership, S corporation or other pass through entity, the election is made by the entity
- Cessation of business activities, sale of business assets of the business or liquidation of the business causes acceleration of the recognition of the deferred COD income

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»» Cancellation of Indebtedness Income

- Election is made by including a statement that clearly identifies the debt instrument and includes the amount of income to be recognized and deferred over the five year period with the income tax return in the year of discharge
- No use of the IRC Section 108(a) exclusions if the election is made

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»» Cancellation of Indebtedness Income

- Analysis of income deferral versus exclusion under IRC Section 108(a)
 - For example a taxpayer may choose to not make the deferral election if it has a NOL carryover that it can use to offset the debt discharge income and that otherwise would expire unused
 - Also, a taxpayer may choose to not make the deferral election if the COD income qualifies for one of the exclusions under IRC Section 108(a) and that the exclusion, with the required tax attribute reduction, is more beneficial than the deferral
