

# Roth IRAs, Capital Gains and other 2010 Income Tax Planning Topics

**Presented by**

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## ROTH IRAS, CAPITAL GAINS AND OTHER 2010 INCOME TAX PLANNING TOPICS

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### I. *Roth IRA Conversions.*

#### A. Background of Roth IRAs:

- i. There is no income tax deduction on contribution to a Roth IRA.
- ii. A Roth IRA has tax free growth if there are no distributions until:
  1. Roth IRA exists for 5 years, and
  2. Distributions occur after:
    - a. Age 59½.
    - b. Death or disability.
    - c. First time homebuyers (\$10,000 limit).
- iii. There are no required minimum distributions (RMDs) for Roth IRA participants.
- iv. Contributions can be made by IRA owners after the IRA owner has reached age 70½.
- v. Distributions are first from basis and second from earnings.

#### B. Eligibility to contribute to a Roth IRA.

The table below shows the income limitations for contributions to Roth IRA's.

If your filing status is:	Your 2009 Roth IRA contribution is reduced if your MAGI is:	You can't contribute to a Roth IRA for 2009 if your MAGI is:
Single head of household	More than \$105,000 but less than \$120,000	\$120,000 or more
Married filing jointly or qualifying widow(er)	More than \$166,000 but less than \$176,000	\$176,000 or more
Married filing separately	More than \$0 but less than \$10,000	\$10,000 or more

- #### C. Eligibility for converting a traditional IRA to a Roth IRA. If you are married filing separately or your modified adjusted gross income (MAGI) exceeds

- \$100,000, you currently aren't allowed to convert a traditional IRA to a Roth IRA.
- D. The Tax Increase Prevention and Reconciliation Act of 2006 repealed the \$100,000 modified adjusted gross income limitation for the conversion of traditional IRAs to Roth IRAs and also allowed taxpayers filing married filing separately to convert traditional IRAs to Roth IRAs. These provisions are effective January 1, 2010.
  - E. For conversions completed in 2010, the taxable income on the conversion is deferred and one half is included as income in 2011 and one half is included as income in 2012. The taxpayer can elect, however, to treat all of the income as taxable in 2010. For conversions after 2010, the income is taxable in the year of conversion (i.e. no deferral).
  - F. A taxpayer may want to convert a traditional IRA to a Roth IRA to take advantage of favorable tax attributes such as charitable deduction carryforwards, net operating loss carryforwards and investment tax credits. This would allow the taxpayer to recognize taxable income and incur little or no tax. In addition, a Roth IRA is not subject to the lifetime required minimum distribution (RMD) rules that traditional IRAs are subject to. This allows for greater deferral of income inside the IRA. Another reason for conversion is that the payment of income tax prior to imposition of estate tax would allow for greater wealth to be transferred to future generations.
  - G. There are four types of Roth IRA conversions:
    - i. *Strategic Conversions*. This is where a conversion is done for wealth transfer planning. The taxpayer has outside (non-qualified money) assets to pay the tax on the conversion, does not need the money in the Roth IRA for annual income purposes, desires to leave value to children or grandchildren and expects to be in same or higher tax bracket in future years. Although the next-generation beneficiaries are required to take RMD (required minimum distributions) over their lifetime, the RMDs are tax-free.
    - ii. *Tactical Conversions*. This is where a conversion is done to take advantage of certain tax attributes such as net operating loss carryforwards, business or other ordinary losses, deductions and exemptions in excess of income, charitable contribution carryforwards or non-refundable tax credits. By doing a Roth IRA conversion, the taxpayer will have leveraged their money by taking advantage of favorable tax attributes and paying little or no tax on the conversion.
    - iii. *Opportunistic Conversions*. This is where a conversion is done to take advantage of economic and market conditions which are expected to reverse. A taxpayer who has an IRA portfolio that has declined recently due to market conditions and has the expectation that the IRA will experience rapid growth in the near future may want to consider a Roth IRA conversion.
    - iv. *Hedging Conversions*. This is where a conversion is done 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.

In each of these situations, the following factors must be considered:

- a. Income tax bracket differential, current vs. future. Will the taxpayer be in a higher tax bracket when they retire? If the taxpayer is in a lower income tax bracket in the future, the less attractive the conversion.
  - b. Ability to use outside assets to pay the income tax on conversion. If the tax on the conversion is paid with IRA money, the less attractive the conversion, especially if the 10% early distribution penalty is imposed.
  - c. Time Horizon-Can the taxpayer live comfortably without using the funds for at least 5 but preferably 10 years, or best scenario the taxpayer doesn't need the funds at all.
- H. If a taxpayer has multiple IRA accounts, the taxpayer can convert some accounts and not others. Likewise the taxpayer can convert a portion of the balance in one or more accounts. The conversion is not an all or nothing proposition. A taxpayer who is not in the highest tax bracket but would be by virtue of the income on the conversion may consider converting a portion of the balance each year based upon the amount of income that can be absorbed at the lower rate. Remember, however, that 2010 is the only year in which income on the conversion can be deferred.
- I. Nondeductible contributions must be allocated based upon the combined value of all of the traditional IRA accounts.
- For example*, a 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.
- J. Recharacterization. If a taxpayer converts a traditional IRA to a Roth IRA, the taxpayer may reverse the transaction. A conversion from a traditional IRA to a Roth IRA may be recharacterized, that is, reversed or cancelled. The taxpayer treats the conversion as if it had never been made by transferring the converted amount plus earnings or minus losses from the Roth IRA back to a traditional IRA. This is something the taxpayer may elect to do if the account value decreases after the Roth IRA conversion. The recharacterization must be done by the due date plus extensions of the taxpayer's return for the affected year. Thus the due date for recharacterization of 2010 conversions is October 15th, 2011.
- 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.

- K. Reconversion after recharacterization. Once a Roth IRA conversion has been recharacterized, the IRA cannot be converted back to a Roth IRA until the later of:
- i. The beginning of the year following the year in which the amount was originally converted to the Roth IRA, or
  - ii. The end of the 30-day period following the day on which you recharacterized the Roth IRA to a traditional IRA.
- 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:
- a. January 1, 2011 (the beginning of the year following the year in which the amount was originally converted to the Roth IRA), or
  - b. 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.
- L. Specific dates related to Roth IRA conversions:
- i. January 1, 2010 – First date in which income levels are lifted and a client can convert to a Roth IRA from a regular IRA.
  - ii. December 31, 2010 – Last date in which a client can convert a regular IRA to a Roth IRA for the year 2010.
  - iii. 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.
  - iv. 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.
- M. Planning point. A taxpayer could split a large IRA account into multiple accounts based upon asset class and reassess recharacterization of each IRA based upon the performance of each asset class. It is uncertain how IRA account managers will react to this as this could create a lot of additional paperwork and reporting.
- N. A traditional 401(k) cannot be converted to a Roth 401(k). In addition, 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.

## II **Capital Gains Tax Planning.**

- A. The current capital gains tax rate is 15% for capital gains in the ordinary income rate brackets of 25% or above and a 0% tax rate for capital gains in the ordinary income rate brackets of 10 and 15%.
- B. Current law calls for the current 15% and 0% capital gains rates to go to 20% and 10% after 2010. The Obama administration's plan calls for 20% tax rate for married taxpayers above \$250,000 or single taxpayers above \$200,000 for years after 2010.
- C. Possible strategies in anticipation of higher capital gains tax rates:
  - i. Acceleration of installment sale capital gains.

- ii. Extract excess liquidity from closely-held corporations.
  - iii. Defer year-end security capital losses.
- D. Acceleration of Installment Sale Capital Gains. Under IRC Section 453, the gain on an installment sale may be recognized as principal payments are received. However, IRC Section 453(d)(1) allows a taxpayer to elect out of installment sale treatment in the year in which the sale occurs. The election not to use installment sale treatment is made by simply reporting all of the gain on a timely filed tax return including extensions. If an increase in the capital gains tax occurs, it may be advantageous to elect out installment sale treatment and record all of the gain in 2009 or 2010. A present value analysis is needed to determine tax benefit of electing out. Generally speaking, the longer the term of the contract, the less likely the acceleration of the tax results in savings as the deferral of income tax outweighs the increase in the tax rate. Another factor that may influence the taxpayer's decision to elect out of installment sale treatment is the existence of capital loss carryforwards. Do not forget to calculate the impact of alternative minimum tax (AMT) on the election out of the installment sale. If the taxpayer has significant capital gains and minimal ordinary income, AMT may apply and, therefore, influence the decision to elect out of installment sale treatment.
- E. Acceleration of pre-2009 installment sale capital gains can be accomplished by gifting or selling the installment obligation or substantially modifying the note with the lender. This is treated as a disposition of the installment contract which triggers the taxation of the remaining gain.
- F. 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). After 2010, qualified dividend income will be taxed at ordinary income rates and not at capital gain tax rates. S corporations with accumulated C corporation earnings and profits (AE&P) could make an actual dividend or make a deemed dividend election. IRC Section 1368(e)(3) allows the corporation to make an election to distribute AE&P before AAA. The distribution of AE&P for an S corporation maybe beneficial for the reason listed above. In addition 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. The removal of AE&P at the current 15% dividend rate can eliminate this issue for the S corporation. This could be especially important if the entity has appreciated real estate trapped within the S corporation and its active business operations are diminishing.
- G. Defer Year End Losses. Taxpayers could save capital losses until 2011 when the losses are more beneficial, especially if the taxpayer already has capital loss carryforward or no gains to offset.

### **III Cancellation of Indebtedness Income.**

- A. Normal Rules. Cancellation of indebtedness income (COD) is generally taxable unless excludible IRC Section 108(a). These exclusions are:
  - i. Discharge in bankruptcy.
  - ii. Taxpayer is insolvent.
  - iii. Qualified farm indebtedness.
  - iv. Qualified real property business indebtedness.

- v. Principal residence debt up to \$2 million.
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- B. Tax attributes such as loss carryovers, credit carryovers or basis in property must be reduced by the amount of the COD income when an exclusion under IRC Section 108(a) applies.
  - C. The American Recovery and Reinvestment Act of 2009 added IRC Section 108(i), which allows for the 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:
    - i. For reacquisitions occurring in 2009, the fifth tax year following the year in which the reacquisition occurs, or
    - ii. 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.
  - D. An 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. The term “debt instrument” is defined broadly to include a bond, debenture, note, certificate or any other instrument constituting indebtedness.
  - E. 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 and complete forgiveness of the debt instrument.
  - F. Election is made on a debt by debt basis and is irrevocable. In the case of a partnership, S corporation or other pass through entity, the election is made by the entity. The 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.
  - G. 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.
  - H. If the election to use IRC Section 108(i) is made, the taxpayer is precluded from using any of the exclusions of IRC Section 108(a)(1)(A)-(D). Therefore, an analysis of the income deferral under IRC Section 108(i) versus income exclusion under IRC Section 108(a) must be made. For example, 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. Even if the taxpayer does not qualify for one of the income exclusions under IRC Section 108(a), the taxpayer may choose to not make the deferral election under IRC Section 108(i) if it has a NOL carryover that it can use to offset the debt discharge income and that otherwise would expire unused.