

continued from front page

Importantly for some planning purposes, it does not include (a) income derived from an active trade or business, (b) distributions from IRAs or other qualified plans, (c) any income taken into account for self-employment tax purposes, (d) gain on the sale of an active interest in a partnership or S corporation or (e) items which are otherwise excluded or exempt from income, such as interest from tax exempt bonds or the income earned in a life insurance policy or the life insurance proceeds. The threshold amount is \$200,000 for single taxpayers, \$250,000 for married taxpayers filing jointly or \$125,000 for married taxpayers filing separately, and approximately \$12,000 for trusts. Some examples may help illustrate how and when the new surtax will apply, beginning in 2013:

- Abe, a single taxpayer, has \$250,000 of net investment income and no other source of income, resulting in MAGI of \$250,000. The new 3.8% surtax would apply to \$50,000, which is the lesser of (1) investment income of \$250,000 or (2) the excess MAGI of \$250,000 over the \$200,000 threshold amount.
- Bob and Cindy, a married couple each age 50 and filing jointly, have combined salaries of \$300,000, but no investment income. The 3.8% surtax will not apply since they have no investment income.
- Dave and Ellen, another married couple filing jointly, have \$400,000 of salaries and \$50,000 of net investment income, for a combined MAGI of \$450,000. The 3.8% surtax would apply to the \$50,000 of investment income, which is less than the excess of MAGI over the \$250,000 threshold amount.
- The Frank Smith Trust has investment income of \$50,000 and no distributions. The amount over the threshold, approximately \$38,000, will be subject to the 3.8% surtax.

Potential Planning Opportunities

Although it is still quite early in our analysis of the Act and the impact of its new taxes, a few potential planning opportunities suggest themselves. For instance, the new 3.8% surtax does not apply to distributions from IRAs and other qualified retirement plans. Thus, you may wish to begin increasing your contributions to those types of retirement plans now. Understand, however, that distributions from traditional IRAs do have the effect of increasing MAGI, which could move you over the threshold for paying the surtax on investment income.



The 3.8% surtax will not apply to distributions from Roth IRAs, nor will they be included in MAGI. In 2010 you have an opportunity to convert traditional IRAs to Roth IRAs, regardless of your income. In addition to other potential benefits of converting to Roth IRAs, as discussed on page three of this newsletter, a Roth conversion may help reduce your post-2012 MAGI, thereby reducing your exposure to the surtax.

Since items which are otherwise excluded from income are not included in investment income for purposes of the surtax, in the future you may wish to focus more investments in items such as tax exempt bonds, tax deferred non-qualified annuities, and life insurance.

There may be some particular strategies with respect to life insurance and annuities that could prove beneficial with regard to the new surtax. For instance, if your life insurance policy has substantial cash surrender value, you may take withdrawals from the policy that reduce basis first. Those withdrawn amounts are not counted in investment income. Alternatively, you can take a loan against a policy to get money out that will not be investment income or included in MAGI. So, if you were approaching the threshold amount, you could consider taking a loan against your insurance policy and paying it back later. Naturally, you would not want to take any action that would affect the continued viability of the policy.

continued on page 5



ROTH IRAs: ESTATE PLANNING OPPORTUNITIES

Elizabeth H. Hutchins

A Roth IRA can be a powerful tool for building and preserving wealth for your family. If you have a traditional IRA, you may benefit from converting it to a Roth IRA. Under prior law, only taxpayers with a modified adjusted gross income (MAGI) of \$100,000 or less could make a Roth IRA conversion. However, in 2010, everyone can convert to a Roth IRA. Although the Roth *conversion* is now available to all taxpayers, higher income taxpayers are still ineligible to make Roth IRA contributions. For 2010, contributions are phased out beginning at MAGI of \$167,000 for married couples filing jointly (\$105,000 for single filers).

The most attractive feature of a Roth IRA is that after tax is paid at the time of conversion, all future growth in the Roth IRA may be distributed to you (and your beneficiaries after your death) free of income tax if the qualified distribution rules are met. An important advantage of a Roth IRA is that the owner is not required to take minimum distributions (although beneficiaries do have required minimum distributions). This allows for maximum tax-free growth within the account during the owner's lifetime. Compare this with a traditional IRA, where the owner is required to take minimum distributions beginning at age 70-1/2.

With a Roth IRA, you can preserve more wealth for your family by leaving funds in the IRA for as long as possible. After your death, your spouse can treat the Roth IRA as his or her own and not be required to take distributions during the spouse's lifetime. When you and your spouse are gone, your heirs will have the same distribution requirements that apply to all IRAs. In most situations, they will be able to take the distributions in installments over their life expectancies if they do not want to take distributions sooner. The best part is that all of these distributions would be free of income tax, compared to the traditional IRA, where all distributions will be taxed at ordinary income rates.

After you convert an IRA to a Roth IRA, distributions may not be taken for the first five years without paying income tax. If distributions are taken before age 59-1/2 and are not otherwise qualified (for example, for qualified first-time home-buyer expenses), those distributions will be subject to both income taxation and an early withdrawal penalty. Before converting, it is important to understand the specific rules governing what is considered to be a qualified distribution.

When you convert from a traditional to a Roth IRA, you will be subject to income taxes on the amount you convert. For conversions made in 2010, there is a one-time opportunity to report this income in two equal installments in 2011 and 2012 (rather than reporting in 2010). This treatment applies unless the owner elects otherwise. It is important to consider the increasing income tax rates in 2011 and 2012 in deciding which year to report the income, as well as whether reporting the entire amount in one year would move you into a higher tax bracket. Payment of tax now is essentially a prepayment of tax on the current value of the IRA in exchange for permanent income tax-free treatment. Remember that all or part of an IRA can be converted.

When deciding whether to convert to a Roth IRA, also consider the possible effect if you have a college-age child who needs financial aid. Many colleges use the data from the FAFSA (Free Application for Federal Student Aid) to determine loan and aid eligibility. The FAFSA information is based largely on a family's income, and the income from the Roth conversion could cause a child to lose all or a part of his or her financial aid for the year in which the income is reported.

The new health care law imposes a 3.8% Medicare surtax that will apply to investment income starting in 2013 (see the article in this newsletter about health care reform). The surtax will not apply to distributions from IRAs or Roth IRAs. However, converting to a Roth IRA before 2013 can help avoid the surtax by reducing post-2012 MAGI.

continued on page 4

RECENT (AND IMMINENT?) TRANSFER TAX CHANGES

Melissa A. R. May

As you may know, Congress has allowed the Federal estate and generation-skipping transfer (GST) taxes to lapse, for 2010 only. As the law currently stands, the estate and GST taxes will be reinstated on January 1, 2011, for estates and generation-skipping transfers worth \$1 million or more. It is possible; however, that Congress will restore the estate and GST taxes in some form this year. In June, the House Committee on Ways and Means may begin drafting a bill to revive the estate tax. Meanwhile, new carryover basis rules are in effect for assets inherited from a person who dies in 2010. These rules may affect the recipient's income tax bill when he or she sells an inherited asset. Also, existing estate planning documents that include tax formulas based on the estate tax under previous law may produce unintended results if death occurs while the estate tax is repealed.

In addition to the changes and continuing uncertainty surrounding estate and GST tax laws, the U.S. House of Representatives has passed H.R. 4849, the Small Business and Infrastructure Jobs Tax Act, which will affect the ability to use certain gifting techniques involving grantor retained annuity trusts (GRATs) if it becomes law. Specifically, H.R. 4849 would require:

1. A 10-year minimum term for GRATs, which means that the grantor assumes a greater risk that the GRAT will "fail" because he or she does not outlive the GRAT term;
2. The value of the remainder interest (essentially, the value of the gift for gift tax purposes) to be greater than zero; and
3. The annuity amount to remain constant (or increase) during the first 10 years of the GRAT.

continued on page 5

Continued from page 3

Roth IRAs could have an estate tax benefit. The full value of a traditional IRA would be included in your taxable estate (assuming the estate tax returns in 2011). All withdrawals by non-charitable beneficiaries would also be subject to ordinary income tax. Although an income tax deduction would be available for estate taxes paid, the deduction does not always match in full the amount of the estate tax. By paying income tax on amounts converted into a Roth IRA, you benefit your heirs by allowing them to receive future distributions tax free.

You should consider converting to a Roth IRA if you expect a higher income tax rate in the future when you begin withdrawing the IRA funds. The conversion is much more beneficial if you can pay the income tax on conversion from sources other than the IRA. The best candidate for a conversion is someone who would not need their IRA to fund retirement living expenses. People who have several years for the Roth IRA earnings to accumulate before retirement can also benefit. Conversely, the conversion may not be as beneficial if the full amount of the IRA will be needed to fund retirement living expenses, if you would need to use IRA funds to pay the tax on the conversion, or if you expect to be in a lower income tax bracket when distributions are taken from the IRA. To determine whether a Roth IRA conversion is a good idea for you, it is important to analyze all of the income and investment implications. Many investment companies provide projections illustrating the effects of a conversion. Upon conversion, be sure to consult your estate planner to coordinate the beneficiary designation of the Roth IRA with your overall estate plan.



Liz co-chairs Sirote's Estates, Wills & Trusts department. Her practice includes planning for the management and distribution of clients' estates to accomplish their goals and to minimize estate taxes using sophisticated estate planning tools and techniques. She counsels business owners regarding succession planning. In probate administration, she assists in the orderly distribution of estate assets and planning for estate and income tax issues.