



## Estate Planning Considerations Intrinsic with Roth Conversions<sup>1</sup>

By: Robert S. Keebler, CPA, MST, DEP



There has been a great deal of discussion during the last several months regarding Roth IRAs and the sweeping change the year 2010 will bring. As many of us are aware, under the current law, numerous taxpayers are not eligible to execute a Roth IRA conversion because their Modified Adjusted Gross Income (“MAGI”) exceeds the current \$100,000 threshold. However, as a result of the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), in 2010 all of this will change. Starting on January 1, 2010, everyone will be eligible to convert to a Roth IRA because the \$100,000 limitation will no longer apply.

While the recent discussions have focused chiefly on the eligibility of taxpayers to convert and the fundamental question of whether a Roth IRA conversion would be advantageous for the taxpayer, little attention has been paid to the essential estate planning considerations inherent with a Roth conversion.

This means that while many of your clients will now be contemplating whether a Roth IRA conversion would be beneficial, you need to help facilitate their understanding of the estate planning and legal issues surrounding the conversion.

Although the decision to convert to a Roth IRA is principally driven by quantitative analysis, the estate planning issues discussed in this article need to be reviewed and taken into consideration to ensure the conversion is properly designed and incorporated into the taxpayer’s overall estate plan. Notably, a Roth conversion raises beneficiary designation issues, Unified Credit and GST planning issues, estate tax apportionment issues, the potential need to draft additional trusts, such as standalone IRA trusts and charitable lead and/or charitable remainder trusts, recharacterization issues and also asset protection issues. The following article discusses each of these concerns in more detail.

### Beneficiary Designation Forms

A client’s beneficiary designation forms need to be updated to seamlessly integrate the Roth IRA into the overall estate plan. The accurate preparation of beneficiary designation forms is critical to ensure the intended distribution of assets, separate shares and to maximize the opportunity for post-death stretch out. Therefore, the conversion of all or a portion of an individual’s regular IRA into a Roth IRA necessitates the review of beneficiary designation forms and possibly amendments to the individual’s overall estate plan.

### Unified Credit and GST Planning

The integration of a Roth IRA into an individual’s overall estate plan usually necessitates additional GST planning along with the coordination of the funding of the Bypass Trust. If an individual is considering funding the Bypass Trust with retirement assets, it is generally advantageous, and will result in more wealth being transferred to family members, if a Roth IRA, which is not subject to income tax, is used to fund the Bypass Trust. For example, assuming a 30% income tax rate, a Bypass Trust fully funded with a Traditional IRA will result in \$2,450,000 being transferred to the decedent’s family [i.e.  $\$3,500,000 - (\$3,500,000 * 30\%)$ ]. On the other hand, if the Bypass Trust had been fully funded with a Roth IRA, the net amount passing to family would have been \$3,500,000. This result occurs simply because the Roth IRA is not subject to income tax. Therefore, individuals who plan on funding their Bypass Trust with retirement assets need to consider the benefit of executing a Roth IRA conversion prior to death.

Furthermore, the paying of income tax on a Roth IRA conversion may reduce an individual’s taxable estate so as to reduce or

# Estate Planning Considerations Intrinsic with Roth Conversions<sup>1</sup>

By: Robert S. Keebler, CPA, MST, DEP

negate the payment of estate tax.

Additionally, a Roth IRA is often the best asset to leave to a GST exempt trust for the benefit of one's children and/or grandchildren. In fact, whenever the situation mandates that IRA assets be left in trust, it is often better to convert to a Roth IRA and pay the tax at the IRA owner's level. This is true because of the compressed income tax rates for trusts.

## Estate Tax Apportionment Issues

The Roth IRA is often one of the more valuable assets in an individual's overall estate. This is due to the unique income tax characteristics of the Roth such as tax-free growth and tax-free distributions. Therefore, estate taxes should generally be apportioned away from the Roth IRA asset thereby enabling the Roth IRA to continue to grow on an income tax-free basis. Over a period of many years, this strategy may add significant value for the beneficiaries.

## Standalone IRA Trusts

Most individuals will be well advised to take the added step of leaving their Roth IRA to a trust for the benefit of their children rather than outright to their children. An IRA left outright to a beneficiary has limited asset protection in many jurisdictions whereas an IRA left in a properly drafted trust provides the beneficiary with additional asset protection. See for example, *In re Kirchen*, 344 B.R. 908, 914 (Bankr. E.D. Wis.2006). Additionally, considering the additional investment needed to convert an IRA to a Roth IRA (i.e. the upfront tax liability on the conversion), leaving the Roth IRA to a trust negates the possibility of the Roth IRA beneficiary withdrawing the IRA funds prematurely.

Therefore, considering the added asset protection and the immense benefits that can be obtained from a properly executed stretch Roth IRA, the additional step of leaving a Roth IRA to a trust is almost always worthwhile. For example, the following illustrates the vast benefits that can be obtained from a stretch Roth IRA.

Assume Stacey, age 65, converted her traditional IRA to a Roth IRA in 2003. If Stacey were to die in 2009 and leave her \$500,000 Roth IRA to her daughter Margaret (age 40), Margaret would be able to accumulate, on a tax-free basis, \$1,549,243 in fifteen years, in addition to the tax-free distributions she has taken. This is shown in the following table:

Year	Life Expectancy Factor	Beginning Roth IRA Value	Growth	Annual Tax-Free Distribution	Ending Roth IRA Value
2009	43.6	\$ 500,000	\$ 50,000	\$ -	\$ 550,000
2010	42.6	\$ 550,000	\$ 55,000	\$ 12,911	\$ 592,089
2011	41.6	\$ 592,089	\$ 59,209	\$ 14,233	\$ 637,065
2012	40.6	\$ 637,065	\$ 63,707	\$ 15,691	\$ 685,080
2013	39.6	\$ 685,080	\$ 68,508	\$ 17,300	\$ 736,289
2014	38.6	\$ 736,289	\$ 73,629	\$ 19,075	\$ 790,843
2015	37.6	\$ 790,843	\$ 79,084	\$ 21,033	\$ 848,894
2016	36.6	\$ 848,894	\$ 84,889	\$ 23,194	\$ 910,589
2017	35.6	\$ 910,589	\$ 91,059	\$ 25,578	\$ 976,070
2018	34.6	\$ 976,070	\$ 97,607	\$ 28,210	\$ 1,045,467
2019	33.6	\$ 1,045,467	\$ 104,547	\$ 31,115	\$ 1,118,898
2020	32.6	\$ 1,118,898	\$ 111,890	\$ 34,322	\$ 1,196,466
2021	31.6	\$ 1,196,466	\$ 119,647	\$ 37,863	\$ 1,278,250
2022	30.6	\$ 1,278,250	\$ 127,825	\$ 41,773	\$ 1,364,302
2023	29.6	\$ 1,364,302	\$ 136,430	\$ 46,091	\$ 1,454,641
2024	28.6	\$ 1,454,641	\$ 145,464	\$ 50,862	\$ 1,549,243

# Estate Planning Considerations Intrinsic with Roth Conversions<sup>1</sup>

---

*By: Robert S. Keebler, CPA, MST, DEP*

## **Charitable Remainder Trust**

A Charitable Remainder Trust (CRT) is a split interest trust consisting of an income interest and a remainder interest. During the term of the trust, the income interest is paid out to the trust's "lead" beneficiary. At the end of the trust term, whatever amount remains in the trust (i.e. the remainder) is paid to the charity or charities designated.

The utilization of a CRT may be a beneficial tool in minimizing income tax in the year of a Roth IRA conversion. This is the case because in the year the CRT is funded, an individual is able to claim an immediate income tax charitable deduction for the present value of the charitable remainder interest (i.e. the present value of the amount passing to the charity). Considering a CRT will typically generate an immediate charitable deduction of 10¢ to 30¢ on the dollar, integrating a CRT into the overall estate plan may be useful for reducing income tax in a year when income is artificially increased due to the Roth conversion. Therefore, those clients with substantial conversions and those who are charitably inclined may want to explore including a CRT in their overall estate plan.

## **Charitable Lead Trust**

A Charitable Lead Trust (CLT) is a split interest trust consisting of an income interest and a remainder interest. During the term of the trust, the income interest is paid out to a named charity. At the end of the trust term, the remainder (whatever is left in the trust) is paid to the non-charitable beneficiaries (e.g. children of the donor) that have been designated in the trust instrument.

In the year in which an individual converts to the Roth IRA, they are often looking for an additional income tax shelter. Certain individuals may consider creating a charitable lead trust in the year of conversion. A charitable lead trust structured as a grantor trust may be designed to provide an income tax deduction equal to 100% of the property transferred into the trust. This can provide a very valuable deduction in the year in which income is artificially increased by a Roth conversion. However, the income tax deduction limitations may still apply.

## **Recharacterization**

Inherent in the Roth IRA conversion decision is the ability to recharacterize the Roth IRA back to a traditional IRA. The prudent and cautious lawyer will make sure that an individual's durable power of attorney will provide the attorney-in-fact with the right to make any and all tax elections, including an election to recharacterize the Roth IRA. This is because the ability to recharacterize extends beyond an individual's death and is transferred to the individual's personal representative following death. Accordingly, both an individual's IRA trust and last will and testament should be modified to provide for the recharacterization decision.

This can become a very difficult issue, particularly in a second marriage when children of a first marriage are receiving a Roth IRA and the surviving spouse is receiving other property with the burden of the income taxes falling on that other property.

## **Asset Protection**

When an individual transfers funds from a qualified plan to an IRA, they leave the asset protection safe haven of an ERISA protected plan. While some state laws may continue to afford creditor protection for IRA assets, in other states the protection may be diminished.

If an individual is in a bankruptcy situation, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) generally provides asset protection for at least \$1,000,000 of IRA assets and potentially unlimited protection if the rollover IRA can be traced to an ERISA plan. However, in non-bankruptcy situations the laws of many states are not clear as to the asset protection afforded when one rolls over from an ERISA plan to an IRA and subsequently to a Roth IRA. It is the responsibility of legal counsel to provide insight and wisdom on these state law issues.

# Estate Planning Considerations Intrinsic with Roth Conversions<sup>1</sup>

---

By: Robert S. Keebler, CPA, MST, DEP

At the end of the day, although recent discussions have focused on the eligibility of taxpayers to convert to a Roth IRA and the fundamental question of whether a Roth IRA conversion would be beneficial, a Roth conversion also raises a number of estate planning and legal issues that will require the advice of counsel. As is evidenced by this article, these estate planning considerations are an integral component of a successful Roth conversion.

Pursuant to the rules of professional conduct set forth in Circular 230, as promulgated by the United States Department of the Treasury, nothing contained in this communication was intended or written to be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer by the Internal Revenue Service, and it cannot be used by any taxpayer for such purpose. No one, without our express prior written permission, may use or refer to any tax advice in this communication in promoting, marketing, or recommending a partnership or other entity, investment plan or arrangement to any other party.

Due later this month is the new AICPA book *The Rebirth of Roth: A CPA's Ultimate Guide for Client Care*. To learn more about the book or place an order, please call customer service hotline at 1-888-777-7077.

*Robert S. Keebler, CPA, MST, DEP is a partner with Virchow, Krause & Company, LLP and chair of the Virchow, Krause Estate and Financial Planning Group. He is a 2007 recipient of the prestigious Distinguished Estate Planners award from the National Association of Estate Planning counsels. From 2003 to 2006, Mr. Keebler has been named by CPA Magazine as one of the top 100 most influential practitioners in the United States. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Mr. Keebler frequently represents clients before the IRS National Office in the private letter ruling process and in estate, gift and income tax examinations and appeals, and he has received more than 150 favorable private letter rulings including several key rulings of "first impression." He is the Editor-in-Chief of CCH's Journal of Retirement Planning and a member of CCH's Financial and Estate Planning Advisory Board. Mr. Keebler is the author of over 75 articles and columns and is the editor, author or co-author of many books and treatises on wealth transfer and taxation.*

<sup>1</sup> This article was drafted with reference to LISI Employee Benefits and Retirement Planning Newsletter #502 (November 2009) at <http://www.leimbergservices.com/> Leimberg Information Services, Inc. (LISA).

<sup>2</sup> Assuming a ten percent growth rate.

The new AICPA book *The Rebirth of Roth: A CPA's Ultimate Guide for Client Care* is due the end of December. To learn more about the book or place an order, please call the customer service hotline at 1-888-777-7077.

*100+ Roth Examples and Flowcharts* contains an extensive set of examples pertaining to Roth IRAs and the intricacies of this investment vehicle. Edited by Barry Picker, these 100+ examples are a great tool to aid in the comprehensive and expansive rules related to Roth IRA contributions and conversions. To learn more about the book or place an order, please call customer service hotline at 1-800-809-0015.

Now available is CCH's *Roth IRA Conversion Expert*<sup>TM</sup>. This software provides tax practitioners with comprehensive Roth IRA analysis and implementation guidance to convert a traditional IRA to a Roth IRA successfully and efficiently. For more information on the Roth IRA Conversion Expert, please go to <http://tax.cchgroup.com/findrep/findresearch>