Federal Estate Tax and Roth IRA Conversion Update

April 2010

By Rachel Sherman, *Director, Client Service*
Susan Doud, *Tax Manager*

What you need to know about the Federal Estate Tax and Roth IRA Conversions

Integrated financial planning at Market Street Trust Company includes a periodic review of clients' estate planning and overall tax situation to identify issues and bring opportunities to our clients' attention. Much has been written in the popular and financial press lately about the federal estate tax landscape and certain changes to the laws governing IRA conversions. We wanted to provide Market Street clients with a brief background and our perspective on these important issues.

Estate Tax

Background

2010 is the final year of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), enacted in 2001, which was intended to return projected federal budget surpluses to taxpayers. As a part of that effort, the estate tax exemption and rates were reduced over a ten-year period. (Taxes on gifts and generation-skipping transfers were also reduced during this time.) As you may know, for 2010, the estate tax rate is repealed. After 2010, EGTRRA provided that the Internal Revenue Code is to be applied as if EGTRRA was never enacted. Thus, in 2011 and beyond (if there is no action by Congress), the estate tax is reinstated with an exemption of $1 million and a top tax rate of 55%. See Table 1 for selected years' exemptions and rates.

Table 1

Year	Federal Estate Tax Exemption	Maximum Tax Rate
2001	$675,000	55%
2005	$2,000,000	47%
2009	$3,500,000	45%
2010	n/a	none
2011	$1,000,000	55%

The Congressional Budget Office (CBO) estimates that, as a result, federal estate tax receipts will plummet in 2011 by approximately $13.5 billion. However, when the pre-2001 estate tax law goes into effect, federal estate tax receipts will rise to over $31 billion per year by 2012, and to over $53 billion in 2019.

Estate Tax Planning Potential Issues

Most believed that Congress would act before 2010 to reenact the estate tax. News reports and commentators have expressed frustration caused by uncertainty in the law.

- One commentator remarked that: "The longer the tax system is in flux, the greater the financial complications for people who lose a loved one this year." Estate Tax's Unclear Fate Challenges Heirs, New York Times (February 17, 2010)
- Another, quoted on the Wall Street Journal's Financial Advisor blog, lamented that: "One of the things that bugs [him] the most at the moment is the unbelievable and inexcusable failure of Congress to fix the federal estate-tax rules."

Many estate plans do not contemplate the possibility of no federal estate tax

According to the CBO, the most recent form of federal taxes on wealth transfers has been in place since 1916. Many estate plans do not provide for the possibility of there being no estate tax. For 2010 at least, those estate plans that are based on formulas or decisions tied to federal transfer taxes that are changed or no longer in existence may at best contain ambiguities and at worst no longer reflect the wishes of the client. For example, the estate plan of a client with a $10m estate may include a bequest to a spouse of "the minimum amount necessary to reduce the federal estate tax to zero after taking into account the applicable federal credit." In 2009, that bequest would have been $6.5m ($10m less the federal credit of $3.5m). In 2010, that bequest would be $0. With no federal estate tax, there is no federal credit. In the worst case scenario, a spouse may be mistakenly disinherited, or a class of beneficiaries, such as children, may receive much more than the client originally intended.

Attempts have been made in Congress to fix this situation, but so far each effort at reform has failed. Although we regularly review relevant press and blogs, we cannot predict what Congress will do. Possibilities include:

- Extending 2009 levels: $3.5m exemption, 45% maximum rate
- Enacting exemption and rate levels above or below 2009 levels
- Taking no action at all (and thus reverting to pre-2001 law of $1m exemption, 55% maximum rate)
- Making the 2010 estate tax repeal permanent

Further, any action taken may be retroactive to January 1, 2010, or purely prospective. No action (i.e., reverting to pre-2001 law) would mean that revenues derived from estate taxes would increase substantially, an attractive proposition for those in Congress looking for easy revenue to mitigate burgeoning deficits.

Client Action May be Needed

While there is no "one-size-fits-all" solution, if you have not already discussed this issue with your Wealth Advisor at Market Street or your attorney, we recommend that you do so. A review of your estate plan should be conducted to ensure that it is free of ambiguities and reflects your wishes in a year when there is no federal estate tax. A revision may be needed to clarify your intent should the plan operate while the federal estate tax is not in place.

Individual Retirement Account Planning

Roth IRA's have been a great retirement planning tool in recent years. For those who qualify, notable benefits of this retirement savings option are tax-free growth and tax-free distributions if the rules are followed. And the rules are pretty simple – hold the account for a minimum of five years before taking a distribution and do not take distributions before age 59½. Further, there is no required minimum distribution for a Roth IRA account once the owner hits 70½. The problem with the Roth IRA is that wealthier individuals do not normally qualify. MAGI (Modified Adjusted Gross Income) limitations phase out an individual's ability to contribute to a Roth starting at $105,000 for singles, and $166,000 for married filing jointly.

One of the hottest topics in financial planning so far this year is legislation beginning in 2010 that eliminates the MAGI limitation on Roth IRA rollovers. This means going forward, anyone who is interested in the benefits of owning a Roth IRA can roll over all or part of a Traditional IRA, a traditional qualified pension plan or an inherited qualified plan into a Roth (unique rules apply for inherited plans). Further, if the conversion occurs during 2010, they can do so with the option of dividing the tax due on the conversion over the 2011 and 2012 tax years, giving the individual until the 2012 income tax return is filed in 2013 to pay the final tax bill.

Debate on this change in the tax code has been going on for months with expert opinion running the gamut: from viewing it as a "slam dunk" for financial planning, to feeling it is always a bad idea to convert to a Roth. There is no general correct answer. Each person's situation is vastly different and should be evaluated individually. Some of the relevant factors in making this decision include cash flow needs, ability to afford the conversion tax, age at the time of the conversion, expectations about future tax rates versus current tax rates and the individual's overall estate plan and goals.

It might make sense to convert to a Roth for a person who:

- Is in the early years of his/her career.
- Has the ability to pay the tax on the conversion from funds other than the IRA monies.
- Currently falls into lower tax brackets and who may expect to be in higher brackets later in life.
- Has at least five years before needing access to the funds.

It may not make sense to convert to a Roth for a person who:

- Is in his/her later or retirement years.
- Has need of the funds for routine expenses.
- Needs assets from the IRA to pay the income tax associated with the conversion.
- Currently falls into higher tax brackets and will either stay there or fall into lower tax brackets in the future.

If you have an interest in exploring this planning opportunity, please contact your Wealth Advisor at Market Street.

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