THE WALSHLAW REPORT

Experts in Estate Planning, Elder Law, Taxation, Business Law Fall/Winter **2009**

ROTH IRA CONVERSIONS – ON SALE IN 2010

Back in 1974, Congress first authorized taxpayers to established tax-deferred individual retirement accounts (IRAs). Most people are familiar with the basic concepts of IRAs: in exchange for a tax deduction when amounts are contributed to an IRA, the account grows without any income taxation until amounts are withdrawn, at which time ALL of the withdrawn amount is taxed as ordinary income. To ensure that the money sheltered in IRAs would eventually be subject to income tax, Congress also added a complex set of rules mandating that taxpayers start taking money out of their IRA accounts after age 70½.

In 1997, Congress enacted the Roth IRA, which is a mirror image of the traditional IRA. Taxpayers get no deduction for the amounts contributed to the Roth IRA, but when the money is withdrawn during retirement years, NONE of the distribution is taxed. Unlike traditional IRAs, there is no rule mandating that taxpayers take out any money from a Roth IRA during their lifetime.

The conventional wisdom with traditional IRAs was that taxpayers would get a tax deduction during their high-tax peak earning years and would withdraw money during their lower-tax retirement years. In 1974, the top federal income tax rate was 70%, while the lowest marginal rate at that time was 14%. Currently, however, the highest marginal federal income tax rate is 35% and the lowest rate is 10%. Moreover, if one considers that by retirement age a taxpayer will likely no longer be paying any mortgage interest or claiming personal exemptions for dependent children, the tax rate difference between peak earning years and retirement years is further minimized and may be eliminated entirely.

Why then haven't Roth IRAs been more popular? Part of that is probably inertia, but part is also the income restrictions on Roth eligibility. Single taxpayers earning more than $120,000 and married taxpayers earning more than $176,000 can't make any contributions to a Roth IRA. As a result, most higher income taxpayers (the ones with more ability to make Roth IRA contributions) have been frozen out of Roth participation. Even more restrictive limits are currently in place on taxpayers who want to convert their traditional IRA to a Roth IRA: their income may not exceed $100,000 per year. A taxpayer must pay the income tax on the full value of the traditional IRA in order to make the conversion to a Roth IRA.

IN THIS ISSUE:

In an effort to raise revenues (in the short term), Congress recently liberalized the rules regarding converting a traditional IRA to a Roth IRA. Beginning in 2010, there are no longer any income limits on *converting* from a traditional to a Roth IRA. (Income limits will still apply on *contributing* to a Roth IRA.)

In addition, for conversions made in 2010

(only), Congress has added an extra incentive: the taxpayer may elect either (1) to report the income from the conversion on their 2010 return, or (2) to report the income from the conversion one-half on their 2011 return and one-half on their 2012 return.

In one sense, having a traditional IRA is like having a mortgage on your home. Until the mortgage (or tax) is paid off, you don't really own it free and clear.

The conversion works best if the taxpayer has sufficient funds outside the IRA with which to pay the tax. Assume the following facts for a taxpayer who is withdrawing income from his or her IRA:

Traditional IRA balance	$ 500,000
Cash outside IRA	$ 200,000
Combined federal and state tax rate	40%
Rate of return on investments	5%

The taxpayer's net annual income before making the conversion and after making the conversion (and paying the tax) can be compared as follows:

BEFORE CONVERSION		AFTER CONVERSION	
IRA income	$25,000	Roth IRA income	$25,000
Non-IRA income	10,000	Non-IRA income	0
	35,000		25,000
Tax	-14,000	Tax	- 0
Net income	$21,000	Net income	$25,000

It is clear that a dollar in an income taxable traditional IRA is worth less than a dollar in a tax-free Roth IRA, yet the two accounts are treated the same for estate tax purposes: a traditional IRA is reported at its full value on a deceased account holder's estate tax return, even though the net amount that the beneficiaries will ultimately receive will be reduced by income taxes. By contrast, a beneficiary of a Roth IRA owner will receive the full value of the account, undiminished by income taxes.

Now that we have seen why, in general, conversion from a traditional IRA to a Roth IRA may be desirable, why might now be a particularly desirable time to make the conversion?

1. Depressed valuations. In effect, the U.S. Treasury and the Comptroller of Maryland are partners with you in your traditional IRA. There's a lot to be said for buying out your partners when values are low. With last year's meltdown in the financial markets, even with the partial recovery we've had since March, the current market conditions may allow us to convert our traditional IRA accounts when they are hopefully at their low points, at least when compared to where they will be in the future.

2. Wait-and-see opportunity. The Internal Revenue Code permits a taxpayer who converts from a traditional IRA to a Roth IRA to change his or her mind by converting back by the due date (including extensions) for filing the income tax return. Thus, a taxpayer who converts a traditional IRA to a Roth IRA on January 4, 2010 has until as late as October 17, 2011 to re-evaluate their decision. Some commentators have suggested that taxpayers first divide their traditional IRA into several IRAs of different portfolio so as to be able to re-convert any part of the portfolio that performs poorly without having to re-convert the entire portfolio.

3. Anyone can do it. With the elimination on the income limits for Roth IRA conversions beginning in 2010, many taxpayers who have been prohibited from making the conversion will for the first time be able to do so.

4. Extra deferral possibilities. As mentioned above, for conversions in 2010 only, taxpayers may elect to report the

income from conversions on their 2011 and 2012 returns. The taxpayer who makes the Roth IRA conversion on January 4, 2010 thus does not have to pay the final installment of income tax on the conversion until April 15, 2013.

5. Possible rising tax rates. In 1963, the top federal income tax rate was 87%. The top rate was lowered to 77% in 1964, and was 50% in 1982. Anyone who has followed the news over the past year may wonder where Washington is going to get all the money it needs to pay for all the spending it has done. By historical standards, our current federal tax rates are low, so even paying tax now at a 35% rate may be better than paying tax later at a much higher rate.

Should *everyone* convert their traditional IRA to a Roth IRA? Absolutely not. Should *some* make the conversion? Absolutely yes. As you may have gleaned from this article, there are a lot of factors that should be considered in making this decision, and of course there will always be some degree of risk if the assumptions made in your decision of whether to convert - or not convert - pan out. But Congress has for the first time provided this opportunity to every taxpayer. At the very least, it is worth considering.

Please give us a call if you are interested in considering whether the Roth conversion may make sense for you. We also welcome the input of the financial advisors and accountants you may be working with in making the decision that is best for you. – ***James D. Walsh, Esq., Member***
jimwalsh@walshlaw.com

PLANNING IN A DOWN ECONOMY-

Does Your Estate Plan Still Make Sense?

Most, if not all of us, are feeling the need to tighten our belts in the current economic climate. If we have recently bought a home or borrowed against our existing one, we may be "upside down" on our loan. Perhaps you simply are less wealthy as you see equity in your home or the value of your 401(k) and IRA dwindle. Despite the feeling that our belts are getting tighter, the new economic climate is the appropriate time to review and be sure your estate plan still makes sense. Just because the economy has taken a nosedive does not mean you get away with putting your long-term estate planning on the shelf.

Just as you see yourself cutting costs in your day-to-day lifestyle (shortening or canceling vacations, clipping coupons, eating out less, driving at the speed limit to save gas), you can take steps to cut costs that your estate might face if you neglect to plan properly. Most of these tips apply in economic boom times just as equally as they do in economic gloom times.

Though you might be gone when the time comes to administer your estate, your loved ones will still be here to clean up the mess. If you take the right approach while you still can, you can tidy up that mess and prevent most of your assets from the probate process which can tie up your money and property for an extended period of time, causing headache on top of heartache for your surviving heirs. To make matters worse, if you are the primary source of income for your family, your accounts might be frozen after your death, making it very difficult for your loved ones to handle their own affairs.

One way to eliminate the concern over how your surviving spouse, partner, or children will pay the bills (or how they will survive at all, given the massive decline in many of our retirement accounts) is through a life insurance policy. If you're in a marriage or long-term relationship, chances are you own your home jointly. However, if the house is mortgaged, your survivor will still be on the hook to make the payments. Purchase enough life insurance to cover the balance of the mortgage, and what is most likely your largest purchase (and therefore your largest expense) can be paid off as soon as the insurance pays out.

If you have a revocable trust, are all of your assets included in it? If you purchased a new home or vacation property after forming your trust, be sure the deed shows the trust as the owner. Keep in mind that a trust can help you avoid probate for most of your assets, but it is difficult to avoid it entirely. And avoiding probate does not mean avoiding taxes, necessarily. Your goal in avoiding probate should be to avoid headache, not your legal duty to pay taxes.

To that end, check the beneficiary designations on your retirement plans and brokerage accounts. If you were recently married, divorced, or had a child, this is very important. It is most likely that you do not want to see your nest egg go to your remarried ex-spouse or partner, nor do you want to neglect one or more of your children.

Review your will, as well. Are there any specific gifts that you have made to a loved one that no longer exist or that have severely depreciated? If to produce extra cash in this economy, you sold that 1963 Corvette that you left to your oldest son in your will, he will not receive any other gift in its place unless you make a revision to your will.

Do your current assets still suit your plans for distributing your estate? If you thought your husband would have enough money of his own to live on after you were gone and decided to leave your kids all your brokerage holdings, does that plan still hold water? Or is it time to reconsider?

Now what about those stocks that you have owned for more than a year that have actually *made* you money despite the doom and gloom on Wall Street? Many investment analysts and economists believe that the capital gains rate on investments will go up in the near future. If you sell off those stocks now and pay the current 15% capital gains rate, you will avoid paying an increased rate in the future. Sell now and take full advantage of the opportunity to offset capital gains with other deductions that are still at your disposal.

If, on the other hand, you have stocks that have lost you money, consider gifting those to loved ones. You can gift up to $12,000 ($24,000 if you are married) to a loved one without paying gift taxes. If you do this with a stock worth $6.00 per share today, and the stock goes up to $12.00 in April, you have effectively made a gift worth twice as much without owing any tax.

Whether you already have an estate plan or have been putting it off, there is no time like the present to evaluate what you have and how you want it to be distributed after you are no longer here. If history is any indicator (and it is), the market will be back and you will be glad to have put the matter of planning your estate behind you. **– *Barrett R. King, Esq., Associate***
bking@walshlaw.com

Elder Law Corner

Planning for the Disabled Spouse

One of the surprising challenges in planning for a spouse afflicted with dementia is the stark reality that should the unexpected occur and the healthy spouse predecease the disabled spouse, the disabled spouse will, in most instances, end up as the sole owner of all of the marital assets. Although there are certainly exceptions, in most cases this scenario represents a disaster for asset protection and preservation for the surviving disabled spouse. Why is this? The answer can best be explained by providing an example so common that it can be found in most communities in America today. Imagine a healthy spouse that has been caring for a disabled spouse at home for many years and by doing so has kept the disabled spouse comfortably in their home environment and out of an assisted living and/or skilled nursing facility. Because of the full-time efforts of the healthy spouse, the disabled spouse is able to enjoy an extended quality of life in a non-institutional environment. As a consequence of this intense effort, the primary focus of the family is the care and well being of the disabled spouse. Usually, no one considers the possibility that the healthy spouse caregiver could die first. If that happens and the healthy spouse dies with a Will or Revocable Living Trust leaving everything outright to the surviving disabled spouse or in a general discretionary trust for the benefit of the surviving disabled spouse, then all of the individual and joint assets accumulated during the marriage are now solely in the name of the surviving disabled spouse or are available for the benefit of the surviving disabled spouse, making all of the assets available resources for Medicaid (Maryland Medical Assistance) purposes. In a similar scenario, if the healthy spouse dies first with no Will and there are adult children living, then the surviving disabled spouse will only receive the first $15,000 of the probate assets, plus one-half (1/2) of the remaining probate assets (estate). The other one-half (1/2) of the probate assets goes to the surviving adult children. In either scenario, should the surviving disabled spouse ever need skilled nursing care, all of the assets would be in his or her sole name and would have to be spent down to $2,500.00 or less for the surviving disabled spouse to qualify for Medicaid long-term care skilled nursing benefits. This means that except for certain complicated Medicaid gifting strategies (please contact us for more information about how to save approximately one-half of remaining assets in the event of a nursing home crisis situation), there would be little or no possibility of "Medicaid" asset preservation in such an event as such opportunities would be lost at the moment of death of the healthy spouse.

With this said, not all such scenarios are disasters. Certainly there are many instances after the death of a formerly healthy caregiver spouse where family funds are available to the disabled spouse in sufficient quantity to finance extended periods of private pay assisted living care and subsequently skilled nursing care. Furthermore, those individuals who had the forethought and financial wherewithal to purchase long-term care insurance will utilize policy benefits to finance their care in whole or in part without impacting available funds.

One significant strategy for many families concerns planning for a surviving disabled spouse through the use of a testamentary trust (a trust established by Will at death) for the benefit of a surviving disabled spouse. In this type of planning, we are concerned about preserving marital assets for the supplemental needs of the surviving disabled spouse (should the healthy spouse die first). The Medicaid laws provide for such an exception where a testamentary supplemental needs trust is established by Will (the healthy spouse's Will). Any assets held by such a trust are not considered to be available re-

sources for Medicaid purposes. Such planning allows the healthy spouse to prevent the potential asset protection disaster described above while preserving the marital assets for the supplemental needs of the surviving disabled spouse and while preserving the Medicaid financial eligibility of the surviving disabled spouse (if so desired by the surviving disabled spouse or their Agent). At the death of the surviving disabled spouse, any assets remaining in the trust can pass to children or other beneficiaries with no "pay back" to or recovery by the State of Maryland. Many families view this kind of planning as an attractive alternative to lifetime gifting and the partial or total loss of control that is sometimes represented by such strategies. Furthermore, many healthy spouses see the use of a testamentary supplemental needs trust as striking the perfect balance between their desire to (1) protect assets for the use and benefit of their surviving disabled spouse, (2) allow for the possibility of further asset protection - preserving some portion of the marital assets for children or other future beneficiaries, and (3) implement planning that will not encumber their current lifestyle.

In summary, through the proper use of a testamentary supplemental needs trust, a healthy spouse can ensure that their disabled spouse will have the use and benefit of the couple's marital assets accumulated over a lifetime should the healthy spouse die first, all the while preserving the surviving disabled spouse's ability to financially qualify for Medicaid long-term care skilled nursing benefits, avoiding recovery for Medicaid benefits paid, if any, and providing for surviving children or other beneficiaries after the death of the surviving disabled spouse. If you would like to know more about elder care planning with testamentary trusts, please call us.

** Please note that the planning outlined in this Article is not appropriate for everyone. Asset protection in the elder care context is fact specific and few, if any, family or individual situations are the same. Crisis planning may involve the use of many strategies other than that described above, and pre-crisis planning may involve the use of outright gifts, Medicaid trusts, and other devices. Appropriate elder law planning involves a significant investment of time on the part of the family and the attorney in discussion and counseling.