

Roth IRAs for estate planning get a big boost from Congress

Many people should consider converting a regular IRA or old 401(k) plan into a Roth IRA, as a result of a change that takes effect on January 1 of next year.

With a regular IRA, contributions are often tax-deductible, but you have to take a certain amount of money out of the account each year once you turn age 70½, and you have to pay income tax on the withdrawals. If you leave the IRA to your heirs, they will have to pay income tax on the money they take out.

With a Roth IRA, there's no tax deduction for contributions, but withdrawals are tax-free.

Roth IRAs can be better for estate planning, because:

- There are no required distributions. So if you don't need the IRA funds to live on, you can leave the entire IRA to your heirs without having it diminished each year. You'll leave more to your heirs because you won't have to pay tax on the annual distributions.
- Your heirs won't have to pay income tax on their withdrawals.
- If tax rates go up (which seems likely), you'll save because you'll contribute after-tax dollars at today's rates, and won't have to pay taxes on withdrawals at a higher rate in the future.

In the past, many people were not allowed to convert a regular IRA into a Roth IRA. Conversions were prohibited for taxpayers with modified adjusted gross income of \$100,000 or more, and for married taxpayers filing separately regardless of what their income was.

However, starting January 1, 2010, these restrictions will be eliminated, and anyone can convert a regular IRA or an old 401(k) plan into a Roth IRA.

The one drawback is that if you convert to a Roth, the amount you convert is considered taxable income to you, and you have to pay income tax on it. And you'll need to be able to pay the taxes from a source other than the IRA itself, since taking money from the IRA would defeat the purpose of the conversion.

However, there are a number of reasons why this might be a good time to make a conversion:

- The value of many people's IRAs is at a low point right now, as a result of the last year's stock market losses. So it might make sense to convert now rather than wait until the value of the IRA goes up, and more taxes are owed.
- Converting now lets you pay income taxes at current rates, rather than paying at future rates which might well increase significantly.
- There's a one-time incentive for conversions in 2010, thanks to Congress. If you convert in 2010, you can report no income from the conversion on



your 2010 tax return, then report half the amount as 2011 income and the other half as 2012 income. In this way you can delay paying the tax.

- You might not owe tax on the whole amount. This is true if you've made any nondeductible IRA contributions over the years. If you can figure out what percentage of your contributions to all your IRAs were nondeductible – including any IRAs resulting from 401(k) rollovers – then you don't have to pay tax on that percentage of your Roth conversion.
- You don't have to convert your entire IRA to a Roth all at once. You can convert only as much as you're comfortable with, and you can convert additional amounts in future years. For instance, you might want to convert only the maximum amount in 2010 that will keep you in the same tax bracket.
- If you change your mind, you can undo a Roth conversion with no tax penalty up until October 15 of the conversion year.

After you convert to a Roth IRA, you can contribute additional money to the account each year – unless you have modified adjusted gross income above \$120,000 for single filers or \$176,000 for married couples. However, even if your income is above that level, you can still contribute. Just put the money into a regular IRA, then convert that IRA to a Roth.

By the way, the fact that you can undo a Roth conversion up until October 15 with no penalty creates the opportunity for some sophisticated investment planning. Suppose you plan to invest in three asset classes. You can convert the regular IRA funds into three separate Roth IRAs, each of which is invested in a different asset class. Suppose that by October, two of the Roth IRAs have increased in value, and one has lost money. You can undo the conversion for just the loser, and in that way you won't have to pay taxes based on the higher value of the loser at the time of the conversion.

How an executor can save taxes after someone dies

When a person dies, the value of his or her estate for tax purposes is its value at the date of death. However, the tax isn't due until nine months after death. If the value of an estate plummets in the nine months after a person's death, this can create very bad consequences for the heirs – namely, a large amount of tax is due, but the assets that will be used to pay the tax have disappeared.

As you can imagine, this happened fairly frequently following last year's stock market crash, when the value of many estates rapidly diminished.

However, there is a way to reduce the effect of this problem. An executor can choose to value the estate, not at the date of death, but at a date exactly six months after the death, if the resulting tax is lower. This is known as the "alternate valuation date."

Not all property can be revalued after six months using this method. Property that was distributed or sold before the six-month date is valued as of the date when it was distributed or sold, not at the six-month date. And property that has declined in value simply because of the lapse of six months' time (such as a patent or a life estate) can't be revalued.

Keep in mind that if the alternate valuation date is used, the value of the property at that date becomes the basis of the property for the heirs who receive it. This means that while the heirs may save as a result of lower estate taxes, they might end up paying higher capital gains taxes when they sell the assets, because the property has a lower basis.

Occasionally, when different heirs receive different types of assets, this difference in basis can mean that the alternate valuation date is a net gain for some heirs and a net loss for others. This can make the executor's decision very difficult.



What to do if your child is a spendthrift

Many people wonder about passing along their assets to a child who tends to overspend and hasn't shown an ability to manage money. They worry that such a child will blow through an inheritance quickly and won't have the money to live on as he or she gets older.

Fortunately, there are ways to provide for such children while at the same time protecting them from themselves.

For instance, you can put assets into a trust and give the trustee detailed instructions stating under what conditions and for what purposes the assets can be given to the child.

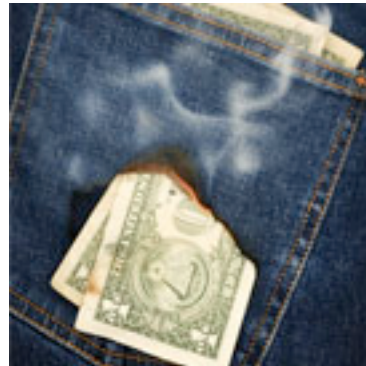
Many people who set up such a trust select a professional trustee or bank for this purpose as opposed to a family member, on the theory that a professional trustee will be less likely to give in to pressure from the child.

A trust can also be a good idea for children who are simply too young to be trusted with large amounts of money. A trustee can manage the money until the child reaches a certain age, at which point the child can receive the funds outright.

Trusts can also be used for children who have a history of gambling or addiction. And they can protect assets for children who are at risk for divorce or who are in a profession where there is a possibility of lawsuits (such as an obstetrician).

Some people go so far as to create trusts that specifically reward children for certain conduct. For instance, trust payments could be increased if the child earns a certain salary, performs community service work, doesn't relapse into an addiction, etc. These trusts can be very beneficial for certain children. However, it can be hard to set up the incentives with precision such that the trustee can verify exactly what payments are owed. Also, there's a danger that the trust will punish a child at the moment when he or she is most in need of support.

Yet another idea is to give a child a minority interest in a family limited partnership that is managed by a more responsible family member, who will make decisions about investments, dividends, etc. This allows the child to benefit from family assets without having too much control over them.



Family foundation? Or donor-advised fund?

Many people assume that only families like the Fords and Rockefellers have family foundations, but in fact a large number of people have set up such charities. There are currently more than 37,000 family foundations in the U.S. Most of these are fairly small; some 60% have assets of less than \$1 million.

Family foundations allow people to take an immediate tax deduction for their contributions, then manage the wealth over time through investments while deciding where to donate it.

Recently, a new alternative has appeared: the donor-advised fund. These funds are basically mutual funds that allow you to make deductible contributions, invest the money, and then provide input on where it should go. Fidelity, Vanguard, and many other companies have set up such funds, as have a number of non-profit organizations and community foundations.

The advantages of a donor-advised fund are:

- They can be less expensive than running a foundation, and require less paperwork.
- You can deduct up to 50% of your adjusted gross income for cash contributions to a donor-advised fund, or 30% for appreciated securities. (For foundations, the limits are 30% for cash and 20% for securities.)
- Foundations generally must make annual donations of 5% of their assets regardless of how their investments have performed, whereas donor-advised funds don't have an annual distribution requirement.
- Foundations' tax records are public – and are often available on the Internet – so anyone can see how much you contributed and where the money went. By contrast, donor-advised funds only have to report aggregate information.

On the other hand, with a foundation you can be certain your contributions will be made exactly as you desire. While most donor-advised funds observe the donor's wishes, they aren't legally obligated to do so.

Foundations also give you more flexibility and control over how your funds are invested. (At Fidelity, for instance, smaller donors are limited to investing in Fidelity's own mutual funds.) And many people appreciate having their name on a foundation and being able to appoint their own board of directors.

Finally, foundations may make better sense if you want to pass control of the investments and donations to your children or other heirs – something that isn't always possible with a donor-advised fund.

Take a look at some unusual wills

Comedian Jack Benny left money in his will to a local florist to deliver one red rose every day to his wife. The florist did so until his wife died nine years later.

- Frederic Baur, the inventor of the Pringles can, asked to have his cremated remains buried inside one of the cans.
- Lawyer Charles Vance Millar, who died in 1926, left his \$750,000 estate to whatever Canadian woman had the most babies in the ensuing 10 years. The money was eventually divided among four women who had nine babies each during the decade.
- Irish playwright George Bernard Shaw's will left more than £500,000 for the development and promotion of a new English alphabet that would have 40 or more letters. (After a will contest, the bequest was reduced to £8,300.)



This newsletter is designed to keep you up-to-date with changes in the law. For help with these or any other legal issues, please call today.

The information in this newsletter is intended solely for your information. It does not constitute legal advice, and it should not be relied on without a discussion of your specific situation with an attorney.