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2010 PRESENTS UNIQUE ROTH IRA CONVERSION OPPORTUNITY

As of January 1, 2010, any taxpayer can convert a traditional IRA into a Roth IRA, regardless of his or her income. Current IRA owners¹ should consider doing so.

Roth IRAs differ from traditional IRAs in a number of significant ways. Contributions to a traditional IRA are deductible against income while contributions to a Roth IRA are made with after-tax income. The trade-off is that while IRA contributions are deductible now, IRA withdrawals are taxed as ordinary income when they are taken. In contrast, qualified withdrawals from a Roth IRA (e.g., withdrawals after age 59½ and 5 years from the establishment of any Roth IRA or conversion of the Roth IRA account in question) are not subject to any income tax. Even withdrawals within the 5-year holding period may not be subject to income tax due to the first-in, first-out rule, though a 10% withdrawal penalty will apply to withdrawals before age 59½. Finally, traditional IRA owners must begin taking required minimum distributions at age 70½ while Roth IRA owners are never required to take distributions.

To date, Roth IRAs have been limited to individuals with modified adjusted gross incomes at or below \$120,000 (or \$176,000 for couples filing jointly). Thus, the ability to convert a traditional IRA to a Roth IRA offers higher-income taxpayers an opportunity to establish Roth IRAs for the first time by converting traditional IRA accounts.

Converting a traditional IRA account, however, comes with a hefty price tag as conversion requires taking into income the share of the account funded with pre-tax dollars.² For many taxpayers, this will mean treating as income the entire value of their accounts. For taxpayers whose IRAs have been funded in part with after-tax dollars, the tax burden will depend on the share of accounts funded with pre-tax dollars versus after-tax dollars across all traditional IRA accounts. Thus, an IRA fully funded with after-tax dollars will nevertheless be subject to income tax upon conversion if the taxpayer owns other IRA accounts funded with pre-tax dollars.

Given the substantial cost of converting an IRA to a Roth IRA, conversion may or may not make sense. For taxpayers with IRA accounts at relatively low points in value and which are expected to appreciate over time, it may make sense to take the tax hit now, particularly if income tax rates are expected to increase. It may also make sense to convert if a taxpayer expects being in the top bracket in retirement. This is particularly true for taxpayers who do not expect to use IRA income in retirement. An added benefit of converting now is reducing the taxpayer's taxable estate by the amounts used to pay income taxes now. Conversion may also make use of current business losses and other deductions.

However, for taxpayers who expect to be in a lower bracket in the future or who would need to take distributions from their IRAs to pay the income tax on the conversion, the answer is less clear. Also, if a taxpayer's IRA account is destined for charity, withdrawals from the account will never be subject to income tax after the taxpayer's death, diminishing the benefit of conversion.

Taxpayers who decide to convert should do so cautiously. Another market decline could lead to the overpayment of income tax. While taxpayers may re-characterize and effectively undo a conversion up to October 15th of the year following the conversion, there's no guaranty that the next market decline will come in advance of the re-characterization deadline. Converting taxpayers should also consider segregating converted accounts by asset type, which will facilitate re-characterizing only those classes of assets that have failed.

For taxpayers who are considering conversion, it is crucial to review the potential future savings and compare them against the cost of converting. Crunching the numbers will likely make clear whether a conversion makes sense in a particular situation and to what extent to convert, as conversions can be done in part and over time.

¹ Owners of other qualified retirement accounts, such as profit sharing, 401(k), or Simplified Employee Pensions (SEP-IRAs) may also convert such accounts to Roth IRAs.

² Taxpayers converting in 2010 can take in the income over two tax years in equal shares, which may not make sense if rates are likely to increase.

Please read the important information relating to U.S. tax advice at the end of this Client Alert.

The attorneys listed below will be pleased to discuss the potential consequences of these proposed changes with you.

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IRS ISSUES GUIDANCE ON RECENTLY ENACTED “EXIT TAX” ON CERTAIN U.S. CITIZENS WHO RELINQUISH CITIZENSHIP AND LONG-TERM U.S. RESIDENTS WHO CEASE TO BE LAWFUL PERMANENT RESIDENTS

The IRS has issued detailed guidance on the new “exit tax” enacted in 2008 on certain U.S. citizens who relinquish their citizenship and long-term U.S. residents who cease to be lawful permanent residents of the United States.³ Under the new exit tax (often called a “mark to market tax”), former citizens or long-term residents who are subject to the tax – known as “covered expatriates” – are generally treated for income tax purposes as if they had sold for fair market value all property owned by them on the day before the date of expatriation. However, in the case of some deferred compensation items (for example, property held in a 401(k) plan account or unpaid compensation under an employment contract), the covered expatriate may instead elect to have such items be subject to a fixed 30% withholding tax. Each covered expatriate may exclude up to \$626,000 (\$627,000 in 2010) from the amount of gain realized upon expatriation.

Under the exit tax and the new IRS guidance, the term “covered expatriate” generally includes three categories of expatriates or former long-term U.S. residents. First, it includes former U.S. citizens or long-term residents with a net worth of \$2 million or more as of the date of expatriation. Second, it includes former U.S. citizens or long-term residents who had average annual net income tax liability for the five preceding years of \$145,000 or more. Finally, a “covered expatriate” generally includes former U.S. citizens or long-term residents who fail to certify under penalty of perjury that they have complied with all U.S. Federal tax obligations for the previous five years, including obligations to pay and file returns. An expatriate or former long-term resident need only fit into one of these categories in order to be subject to exit tax. Note that the last category is a trap for the unwary: even if they have only modest income and net wealth, many long-term residents may not realize that they must make a certification in order to avoid exit tax upon leaving the United States.

Finally, the IRS notice provides guidance on a new 30% withholding tax (also enacted in 2008) on distributions to a covered expatriate from certain trusts held for their benefit. However, IRS guidance is still pending on a new tax on U.S. citizens or residents who receive gifts or bequests from a covered expatriate. This new “donee tax” was enacted at the same time as the exit tax and generally applies to any property received after June 16, 2008 by gift from a covered expatriate or by reason of a covered expatriate’s death. The donee tax departs from Congress’s traditional policy of imposing wealth transfer taxes on the transferor rather than the transferee. Many issues regarding the new donee tax remain unresolved. We will keep you abreast of any important developments.

If you are contemplating relinquishing your United States citizenship or you are a long-term U.S. resident contemplating leaving the United States, it is important that you consult with us in advance in order to assess any possible tax consequences of such relinquishment or departure.

IRS RELEASES INFLATION-ADJUSTED AMOUNTS FOR 2010

The IRS has announced inflation-adjusted amounts for various exemptions and exclusions for 2010. Of particular note:

- Annual exclusion amounts for 2010 remain at \$13,000/donee (or \$26,000/donee if spouses split gifts on their gift tax returns);
- The annual exclusion amount for gifts to a non-citizen spouse is increased to \$134,000 for 2010 from 2009’s \$133,000;
- The reporting threshold for gifts from foreign corporations and partnerships will be \$14,165 in 2010 (increased from \$14,139 for 2009); and
- The exemption from the “kiddie” tax for 2010 remains at \$1,900.

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STATEMENT ABOUT CIRCULAR 230

Recent amendments to a Treasury Department regulation, known as Circular 230, require lawyers and accountants to follow strict rules in issuing a written statement about a Federal tax issue. The most onerous rules of compliance under §10.35 of the Circular involve written advice about so-called Listed Transactions, arrangements that have tax avoidance as their principal purpose and what are called Marketed Opinions. We do not believe any issue discussed in this memorandum relates to a Listed Transaction. We believe the tax benefit sought is consistent with the Internal Revenue Code of 1986 as amended (Code) and Congressional purpose. That means the principal purpose is not tax avoidance. We also believe no issue discussed herein is a significant Federal tax issue – meaning that we believe the IRS does not have a reasonable basis for a successful challenge on the overall Federal tax treatment of the issues discussed in this memorandum. That means we do not think this memorandum must comply with §10.35 of the Circular. Nevertheless, we add the following statements to ensure compliance with said §10.35. Notwithstanding these statements, we believe the conclusions reached herein are correct.

1. The written advice contained in this memorandum is not intended or written by us to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties.
2. No one may use any part of this memorandum in promoting, marketing or recommending an arrangement relating to any Federal tax issue to any taxpayer.
3. Nothing herein shall be construed to impose a limitation on disclosure by any person of the tax treatment or tax structure of any transaction that is addressed herein.

³ The exit tax applies only to U.S. citizens and long-term residents who relinquish citizenship or cease to be lawful permanent residents after June 16, 2008. Individuals who expatriated or ceased to be long-term U.S. residents before June 17, 2008 may instead be subject in the ten taxable years following expatriation to an “alternative tax” computed using special rules on gain recognition and source income.