Kennebec Savings Bank

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Roth IRA conversions

Is this something to be considered EARLY in retirement?

IRAs have become a very important element of retirement security. The Individual Retirement Account was added to the tax code in 1974, along with the ERISA overhaul of retirement plan regulation. Contributions may be deductible, depending upon the taxpayer's income, and distributions are taxable as ordinary income. The Roth IRA became available in 1998. There are no deductions for contributions, but if all conditions are met, all the distributions from a Roth IRA during retirement are tax-free.

Some 55 million households owned an IRA as of year-end 2022—more than 40% of households. However, over 90% of IRA assets are held in traditional IRAs, nearly $10 trillion (see the table below). The reason for the disparity is that traditional IRAs have been used, through a rollover of the funds, to preserve the tax deferral for distributions from 401(k) plans and other qualified retirement plans. The contribution limit for such plans is far higher than the limits for IRAs.

The Roth conversion option

A traditional IRA may, at the option of the account owner, be converted to a Roth IRA. There are no income restrictions on who may exercise the conversion option. However, there is a price to be paid, as the entire amount of the conversion must be included in ordinary income.

For larger IRAs, that can be an intimidating tax bill. But when one works through the math, conversion to a Roth may be a very good idea, especially early in retirement. That was the conclusion of economist David Bernstein, in an essay "The Role of Roth Conversions Early in Retirement" [*Tax Notes*, November 22, 2021].

IRA ownership for retirement security

Type of IRA	Year made available	Assets (trillions of dollars, year-end 2022)	Median age of owner
Traditional IRA	1974	$9.7	61
Roth IRA	1998	$1.1	51

Source: Investment Company Institute 2023 Fact Book

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The optimum conditions are that the taxpayer no longer has wage income, has not yet started Social Security benefits, and has other financial resources to draw upon to meet expenses, such as an after-tax investment portfolio. In that situation, the cost of conversion to a Roth IRA may be relatively low.

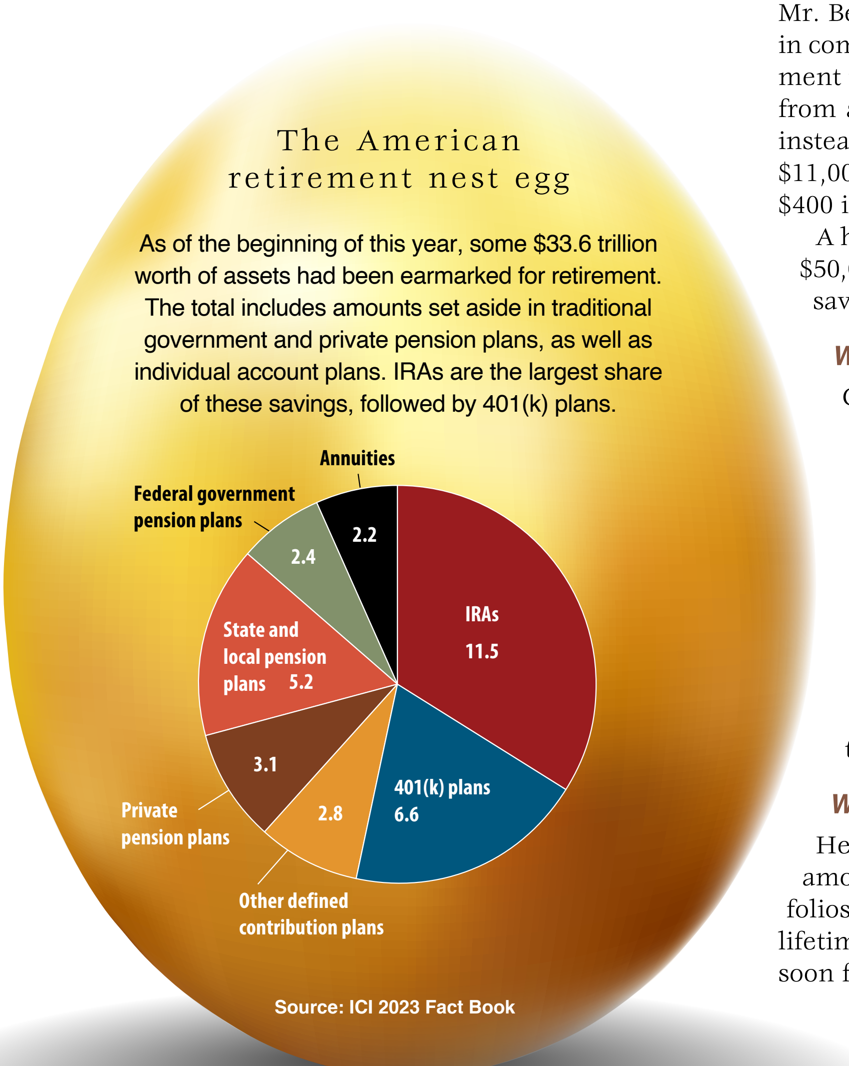
Bernstein offers a taxpayer with investment income of $10,000 and no Social Security benefits. A married taxpayer filing jointly, claiming the standard deduction, could convert $14,800 to a Roth IRA at no cost whatsoever. "It would be irrational for this taxpayer to fail to convert some assets from a traditional plan to a Roth account," Bernstein writes.

Next, assume that the taxpayer converts $34,550 to the Roth IRA. That carries income to the top of the 10% tax bracket. The cost of such a conversion would come to $1,975, which seems a small price to pay compared to the potential for tax-free income.

As one moves up the income brackets, either because the base income is higher than $10,000 or the amount converted gets larger, the tax bill may begin to seem less like a bargain.

Big benefits

There are three benefits offered by the Roth IRA to take into account.



Planning flexibility. Minimum annual distributions are required from traditional IRAs once the owner reaches age 73. There are no such requirements for Roth IRAs. The required minimum distributions are not large in the early years on a percentage basis, but the only way to avoid them is to arrange for a distribution to charity (limited to $100,000 per year).

Tax freedom. After five years, distributions from the Roth IRA are not included in income. The income taxes have effectively been prepaid.

Lower taxes on Social Security benefits. Those required minimum distributions from traditional IRAs may have the side effect of increasing the taxes the retiree must pay on Social Security benefits received. Singles with adjusted gross incomes below $25,000 and married couples below $32,000 do not have to worry about taxes on benefits. For singles with AGI from $25,000 to $34,000, up to 50% of their benefits will be taxed, and above $34,000, up to 85% will be taxed. For married couples, the 50% inclusion bracket is $32,000 to $44,000, and 85% above $44,000.

Unlike many other elements of the tax code, these boundaries have never been adjusted for inflation. Thus, more and more Social Security benefits are being subject to income taxation as the years go by.

Tax savings

Mr. Bernstein offers this example. A couple has $40,000 in combined Social Security benefits and $3,000 in investment income. If they were to take a $50,000 distribution from a traditional IRA, the tax cost would be $7,072. If instead they could take $39,000 from a Roth IRA and $11,000 from a traditional IRA, they would pay about $400 in tax.

A household in the 22% tax bracket that can distribute $50,000 from a Roth IRA instead of a traditional IRA will save about $11,000 in taxes, Bernstein reports.

What is best for you?

Conversion from a traditional IRA to a Roth IRA is a major life decision, definitely worth paying for professional advice before undertaking. The decision must be put into the context of the taxpayer's total resources and wealth management objectives.

The tax consequences of a conversion may be softened by doing partial conversions over time. It's not an all-or-nothing decision. The conversion might be handled at 20% per year for five years, for example. Or a larger share might be converted in a year when one's income is low, putting the transaction in a lower tax bracket.

We can be of service

Helping retirees manage their retirement income is among our core services. We manage investment portfolios as well as large IRAs and Roth IRAs. Looking for lifetime financial security? Call upon our professionals soon for a consultation. ☐

A cloud over estate planning for small businesses

Every small business must have an answer for two questions. First, what will happen to the shares of an owner when the owner dies? Either the shares are purchased by other owners of the business, or the business itself acquires the shares through a stock redemption. A buy-sell agreement will typically be used to establish the plan, including a formula or method for valuing the shares of the company. Second question, how will that purchase be funded? Using life insurance to fund a stock redemption by a business has long been a routine estate planning and business succession strategy.

A recent court case now casts a shadow over that estate planning approach.

Crown C Supply was a closely held company owned by brothers Michael and Thomas Connelly. Michael owned 77.18% of the stock, Thomas the remaining 22.82%. For estate planning purposes, the brothers executed a buy-sell agreement, requiring the company to redeem the shares owned by the first one to die. The company was not cash-rich, so life insurance was purchased to be able to meet the obligation. However, the company was not required to use the life insurance proceeds for that purpose.

Michael died in 2013, when the company was worth about $3.3 million. Pursuant to the buy-sell, $3.0 million of the $3.5 million in life insurance proceeds were paid to redeem Michael's stock, and a federal estate tax was paid. The IRS audited Michael's estate tax return, and it determined an additional $1.0 million was due. Thomas, as the executor, paid the tax and went to the District Court for a refund.

The essential question is whether the $3.5 million of insurance proceeds affects the value of the family-owned business, and whether the value is reduced by the obligation to redeem the shares.

In the Courts

Unfortunately, the brothers had not fully complied with their own buy-sell agreement, in that they had not updated the company valuation, nor had they conducted an appraisal of the firm. As a result of those failures, the District Court held that the agreement did not set the price for the value of the shares. The Court reasoned that the enterprise value of the company must be increased by the value of the insurance proceeds it received, sustaining the IRS' higher valuation and increased estate tax due.

The Court of Appeals unanimously affirmed the receipt of the proceeds increased the shareholders' equity in the company. The Court also held that "an obligation to redeem shares is not a liability in the ordinary business sense." When the corporation purchases its own stock, there is a corresponding increase in the value of shares still outstanding.

The estate has appealed the ruling to the U.S. Supreme Court, alleging that there is a split in the federal appellate circuits sufficient to warrant the Court's attention. The question is presented as:

"Whether the proceeds of a life insurance policy taken out by a closely held corporation on a shareholder in order to facilitate the redemption of the shareholder's stock should be considered a corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax."

What it means

The brothers bought enough insurance to cover the value of their company as a going concern, but they did not buy enough to cover the value of the company plus the value of the insurance—it's not even certain that an insurance company would sell such a contract.

There may be a temptation to argue that it was the bad facts in Connelly that led to the unfortunate outcome for the brothers, but estate planner Paul Hood warns against that point of view [LISI Business Entities Newsletter #275 at www.leimbergservices.com]. "If the courts had simply said, because the parties ignored complying with substantial terms of the contract, we'll ignore that it ever existed for estate tax purposes, then we would perhaps have less to worry about as practitioners in applying this case to evaluating other entity buy-sell agreements. Unfortunately, some of the broad language and economic analysis of the decision goes beyond this to potentially threaten very legitimate and rational agreements that are assiduously followed."

If the insurance purchased by a company effectively also becomes subject to the estate tax, much more insurance must be purchased to obtain liquidity for both the redemption and the tax payments. An alternative to consider that reduces the problem could be cross-purchase agreements, in which each partner owns insurance on the others, rather than having the company own it. But for businesses with more than three owners, this approach becomes unwieldy. Guidance on this subject from the U.S. Supreme Court will be much appreciated by owners of small businesses throughout the country. ☐

Special assets require special handling

Actor James Caan had two IRAs, one of which held a partnership interest in a hedge fund. The partnership interest was not publicly traded. As such, the IRA custodian was required to report the year-end value of the interest to the IRS every year, or the custodian would face substantial penalties. Accordingly, the IRA custodial agreement stipulated that Mr. Caan would report to the custodian the value of the partnership interest every year.

No such report was sent to the custodian for 2014. The case does not make clear who dropped the ball that year, because reports had been sent in earlier years. The custodian made several attempts throughout 2015 to get the necessary figures, sending letters to the hedge fund as well as to Mr. Caan's financial advisors, to no avail. When all the correspondence went unanswered, the custodian resigned, and sent a notice that the hedge fund interest was being returned to Mr. Caan, in accordance with the custodial agreement. Further, the value of the interest, some $1.5 million, would be reported to the IRS as a distribution to Caan from the IRA.

Still, there was no response from the financial advisors, until they received Form 1099-R. The distribution was reported on Caan's 2015 income tax return, but was characterized as nontaxable because it was rolled over into an IRA. That was not true at the time of the filing. The interest was liquidated about a year after the distribution, and the proceeds were then deposited in an IRA.

The IRS noticed that the attempted rollover happened long after the 60-day window for rollovers had expired, and issued a notice of deficiency for the taxable distribution. The deficiency notice was sent in April 2018, and in July 2018 Mr. Caan asked for a private letter ruling waiving the 60-day limit. Such a ruling was denied, and the case went to the Tax Court.

Mr. Caan's advisors claimed that they had never received the letters from the IRA custodian, but the Tax Court was not persuaded. The custodian had kept meticulous records, and the story held together very well.

As it happens, violating the 60-day rule was not the most important problem here. When property (as opposed to cash) is distributed from an IRA, only that exact same property is eligible to be rolled tax-deferred into a successor IRA. Even if the IRS had issued a waiver of the 60-day rule, the distribution would have been taxable because the character of the property changed when hedge fund interest was liquidated, ending the rollover privilege.

The Tax Court concluded: "This case is a quintessential example of the pitfalls of holding nontraditional, non-publicly traded assets in an IRA. Failure to follow the labyrinth of rules surrounding these assets can mean forfeiting their tax-advantaged status." ☐