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# To Roth, Or Not To Roth, That Is The Question

## (With apologies to the "Great Bard")

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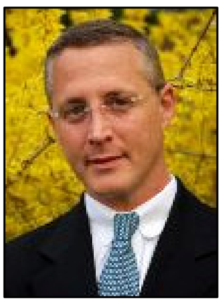

As of January 1, 2010, there is no longer a requirement that an individual's income be less than $100,000 to qualify to convert a Traditional IRA to a Roth IRA. These changes and related details were clearly outlined in an article in the April 2010 issue of the WCBA *Newsletter*. Some of the major disadvantages identified in that article included accelerating the payment of otherwise deferrable income taxes as well as the risk that taxes could conceivably be lower in the future. This article outlines a strategy that is intended to minimize these disadvantages for the charitably inclined taxpayer.

### The Tax Protected Roth Conversion

Traditional IRAs

IRAs are funded either through annual contributions from earned income each year or from rollovers. Typically the majority of deposits to an individual's IRA comes not from regular annual IRA contributions but from rollovers from 401(k), 403(b), Profit Sharing, Defined Benefit and other forms of qualified plans.

In addition, for most IRA owners the greatest portion of the value in these accounts comes not from the deposits, but from their tax-deferred growth.

The compounding tax deferred growth is the most valuable financial aspect of these plans. Additionally, the ability under certain circumstances to extend this tax-sheltered feature to benefit the account owner's heirs makes these accounts exponentially more valuable in the long run.

Roth IRAs

This opportunity for multi-generational income tax deferral is what makes the conversion to Roth IRAs so intriguing. Because Roth IRAs do not have "Required Minimum Distributions" ("RMDs") during the lifetime of the IRA owner or their spouse (G1), the tax deferred growth can inure to the benefit of the next generation (G2). This is one of the key reasons why those who are fortunate enough to be able to get along financially without distributions from their Traditional IRA should give serious consideration to converting to Roth.

Unfortunately, this conversion from Traditional to Roth requires full tax recognition of the amount converted at ordinary income tax rates. However, for those who are regular donors to charitable causes, there is a strategy which can mitigate or fully solve this income tax problem.

Charitable Lead Annuity Trust ("CLAT")

For those individuals who are regular donors to charity, the tax code offers an opportunity to create a large charitable income tax deduction which can be used to shelter the taxable income created by a conversion from a Traditional to a Roth IRA.

*How a CLAT works:* G1 creates and funds a CLAT with cash or other assets. Under the specific details of the trust, annual fixed dollar distributions are made from the CLAT to charities for a period of time chosen by the donor at inception of the trust. The distributions can be made to a qualified charity or to a "Donor Advised Fund".

The donor can choose to take an immediate tax deduction for the present value of this stream of future charitable gifts if the trust is treated as a Grantor trust for income tax purposes. At the end of the trust (for example 15 or 20 years), the remainder interest passes to the donor's personal beneficiaries (G2), with no further gift or estate taxes.

This scenario provides two charitable tax benefits for the donor:

1. Income Tax Deduction: A charitable income tax deduction is available, generally in excess of 75% of the assets transferred to fund the CLAT depending on the term and level of distribution from the CLAT, as well as the current "Applicable Federal Rate." This charitable income tax deduction can be used to offset the taxable income which will be created by the conversion from a Traditional to a Roth IRA.

2. Gift Tax Deduction: G2 will ultimately receive the remainder assets when the CLAT terminates at the end of

the term selected by G1. The present value of this remainder interest is a completed gift when the trust is funded. However, in determining the amount of this gift, there is also a charitable gift tax deduction equal to the charitable income tax deduction. This gift tax deduction will reduce the value of the taxable gift, most likely to less than 25% of the amount transferred to the CLAT.

In addition, under the rules governing taxation of "Grantor Trusts", the Grantor will pay the income taxes each year on CLAT taxable income. These payments will act as an indirect transfer to future generations, but without any gift tax implication.

<u>CLAT Owned Life Insurance on G1</u>

Upon the death of the Grantor/Spouse (G1), the value of the Roth IRA is in the estate for estate tax purposes. In order to maximize the benefits of the Roth income tax deferral, any estate taxes attributable to the Roth account should be paid by non Roth assets.

The CLAT can purchase life insurance on the life of G1. Properly drafted all assets in the CLAT, including the life insurance, will eventually pass to the next generation beneficiaries (G2) or a trust for their benefit without gift or estate taxes. Life Insurance death benefits are also generally income tax free. These assets can eventually be made available to G2 to help pay the estate taxes on the Roth IRA when G1 dies.

***An Opportunity is Created from Separate Ideas Linked Together***

- <u>CLAT:</u> Create a 15 to 20 year CLAT. If it is a "grantor trust" for income tax purposes it will provide an immediate charitable income tax deduction of more than 75% of the assets transferred.

- <u>ROTH Conversion:</u> At the same time the donor converts from regular IRA to a ROTH IRA, an amount equal to the charitable deduction they receive from the CLAT creation.

- <u>Income Tax and Estate Tax Free Life Insurance:</u> The CLAT also purchases and pays premiums and is the beneficiary of a permanent life insurance policy to enhance the values that the remainder beneficiaries receive at the end of charitable lead term.

- <u>Gift Tax Deduction:</u> At the time the CLAT is created, the value of the taxable gift will only equal the assets transferred reduced by an amount equal to CLAT charitable income tax deduction.

## Time Sensitive Planning Opportunity

Although the income limitation to convert to Roth is permanently repealed, it is still critical to review this conversion option now, while interest rates are still low. The lower the Federal Government's "Applicable Federal Rate" (AFR), the more effective this strategy will be. First, in a lower rate environment, there is a higher charitable income tax deduction available when the grantor/donor funds the CLAT. This higher charitable deduction will allow G1 to convert more to Roth with little or no income taxes. This in turn, translates to much greater income tax free distributions to (G2).

In addition, the lower the interest rate, the greater the gift tax charitable deduction available to G1 when calculating the CLAT remainder that will ultimately pass to G2 at the end of the CLAT term.

The chart below provides an example of the tax and financial benefits of this strategy for those who are typically making annual gifts to charity. Our calculations indicate that the advantage of this strategy over both generations is more than 100%, assuming a 6% earnings assumption.

In this example the Roth conversion of $466,438 yields income tax-free distributions to G2 of $5,132,840 over their lifetime, assuming a 6% return.

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Tax Protector Example (G1: M68/F61)