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Roth IRA and 401(k) Conversions Commencing in 2010 and Beyond

(Including Application to Some Who are Not USA Citizens or Residents)

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As many are aware, there is an opportunity to convert Regular IRA and 401(k) accounts into Roth IRA and 401(k) accounts.[1] Commencing in 2010, this ability has been expanded to all regardless of income level. This ability continues beyond 2010 but without the ability to delay the actual taxation beyond the year of conversion. One of the keys is some of the income limitations with respect to Roth Accounts have been removed.

We have delayed releasing this memo in the hope of greater certainty in the law and greater stability in the financial markets. Our waiting for greater clarity has been in vain.

The potential benefit of these conversions is an increase in the value of the tax savings relative to that in the original "statutory promise". The cost is paying up the original promise of income tax deferral at the date of the conversion. This payment renders all future net income and gains in these Accounts tax free. Thus, where that future is long, the present value of future taxes avoided is likely to be large. Indeed, where these accounts are bequeathed to much younger

[1] For much of this discussion, there is little practical distinction between an IRA or Individual Retirement Account and a 401(k). One is typically private while the later is employer sponsored. Thus, we will use the phrase "Regular Account" or "Roth Account" (collectively, "Accounts") when referencing both.

There are other eligible defined contribution pension schemes with respect to these elections and choices. They are generally used by self-employed people including partners in partnerships and members in limited liability companies and limited liability partnerships. The principles and concepts are typically nearly identical. The significant differences are largely focused on maximum contribution limits and certain administrative matters. Thus, we have not specifically included discussion of these pension schemes here knowing that the overall issues are nearly the same.

heirs, the avoided tax may, indeed, be huge. However, there are pitfalls with these conversions especially when the potential future deferral period is relatively short.

Regular Accounts generally permit a deduction of the current year contributions from otherwise taxable income and for current earnings within these accounts to be free of current income taxation.[2] With respect to Regular IRA contributions, the ability to deduct the annual contributions is curtailed based on certain income limitations determined annually. Upon distribution, generally the amount of the distribution is included in taxable income. To the extent prior contributions were not deductible, their subsequent distribution is not taxable. The taxable portion of these distributions is subject to income tax at the individual's highest marginal rate of tax imposed during that taxable year of distribution. If the distribution is pre-mature with one notable and several minor exceptions, there is a 10% penalty tax imposed. Generally, a pre-mature distribution occurs when the beneficiary is under the age of 59 ½. No further contributions can be made upon reaching the age of 70 ½. One is required to make distributions upon reaching age 70 ½.

Roth Accounts are, in a sense, the mirror of Regular Accounts. The initial contribution is not deductible. The income is not subject to taxation within the accounts. And, finally, the distributions are not subject to income tax so long as they are qualified. Qualified distributions, with limited exception, are those made after the beneficiary has attained the age of 59 ½. One may make contributions after reaching the age of 70 ½. One is not required to make distributions upon reaching age 70 ½. Qualified distributions (tax free) may not be made until the passage of five years commencing with the year of first contribution.

Contributions to both Regular and Roth Accounts are made based on percentages of earned income and carry maximum annual limitations. Thus, no earned income in a particular tax year results in no ability to make a contribution to any pension account.

[2] There are exceptions. Two come to mind. Certain partnership or partnership-like investments generate unrelated business income. The unrelated business income is subject to income tax payable by the plan. Some common sources of this are found in mining and mineral based investments commonly sold by brokers. The tax is paid by the trustee of the plan with few investors being aware. Another source is the withholding tax associated with dividends and interest from non-USA based stocks and bonds. *E.g.,* the dividend paid by Siemens AG carries a 15% withholding tax paid to Germany. That withholding tax results in a foreign tax credit directly reducing USA income tax when the investment is held by a USA person but not when it is held within a Regular or Roth Account. There is a limited exception with respect to certain disregarded entities held by these Accounts where the foreign tax credit would result in current tax savings within the Accounts.

One may make a contribution to a Roth IRA for 2010 only to the extent adjusted gross income[3] is less than US$105,000 if single; US$167,000 for joint filers. The maximum amount of the contribution is phased down to zero when adjusted gross income reaches US$120,000 if single; US$177,000 joint.[4]

The maximum annual contribution to a Regular or Roth IRA for 2010 is US$5,000 or earned income if lower. One may add another US$1,000 to the US$5,000 once one attains the age of 50 by the end of the current tax year.[5]

Regular and Roth 401(k)s are employer sponsored plans which generally carry higher contribution limits.

Not well known and of some considerable relevance today is the possibility of an actual deductible loss with respect to the investments within these accounts. Nondeductible contributions to both Regular and Roth Accounts create basis in the account. If, upon the final distribution from any given account this tax basis has not been recovered, then the difference between that tax basis and the actual cumulative distributions is claimed as a miscellaneous itemized deduction subject to the two percent floor. This would occur where the account had cumulative investment losses from inception. Please bear in mind that where there is an overall imbedded loss in these accounts, there is no income tax and no early withdrawal penalty when one removes the investments from the account. This, sadly, is not out of the realm of possibility in light of the recent and continuing Second Great Contraction.

Generally, distributions from Regular Accounts are included in the beneficiary's taxable income. In addition, there is a 10% penalty tax assessed on the amount of the early distribution. An early distribution is one made prior to the beneficiary attaining the age of 59 ½. There are exceptions most of which deal with some statutorily defined extraordinary need such as health care and even the first time purchase of a principal residence. Most are limited and of little practical use.

There is one surprisingly little known exception embodied in IRC §72(t) coincidentally known as a "72(t) election" – there is no real English term for it. A taxpayer of any age may elect to make regular annual withdrawals based on the

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[3] An approximate definition of "adjusted gross income" is that which is reflected on the last line of page 1 of your annual Form 1040. It is before itemized deductions, standard deduction, dependency claims, etc. Critically, for those of us who are employed outside of the USA, adjusted gross income is after the approximate U$91,000 exclusion for foreign sourced earned income. The exclusion amount is adjusted a bit each year for inflation.

[4] These income limitations are subject to mandatory inflation adjustments. Thus, they change a bit each year.

[5] This includes those whose earned income sources in partnerships, limited liability companies, limited liability partnerships and foreign disregarded entities.

application of an annuity concept using Internal Revenue Service actuarial tables. Essentially, one calculates a distribution amount which would result in equal annual withdrawals allowing for the account's expected future earnings[6] such that at the expected date of death the account balance is zero. As a consequence, the resulting distribution from a US$1 million account balance for a 50 year old is far larger than for a 20 year old with the same account balance. The distributions must be made for at least five years with no adjustment whether in response to shifting investment returns or otherwise. There is no allowance for any unique individual issues such as health which might render the actuarial assumptions invalid. The 72(t) distribution is included in taxable income but there is no 10% penalty.

There are some similar issues with Roth Accounts.

A word or two is in order for those of us who reside and work outside of the USA and those non-USA citizens who work or worked in the past in the USA.

First are USA citizens and certain residents[7] who live and work outside of the USA. For us, there is no difference for good or ill in the application of these rules.

There may be some consideration as to any current or future income tax consequence with respect to the country in which we actually physically reside and work. With respect to Costa Rica, there is no Costa Rican tax impact with respect to Regular and Roth Accounts.

For non-USA citizens and non-USA residents who formerly worked in the USA generating these accounts, there are current USA income tax considerations. The USA expects to tax distributions from these accounts which you may have earned while employed in the USA regardless of where you live at the time of the distribution. Special considerations need to be made as you would likely be taxed as a nonresident alien with respect to these distributions when you no longer reside in the USA. For those who do reside in the USA, you look no different than any other USA citizen taxpayer until such time as you abandon that status through departure.

For USA citizens and long-term USA residents, these accounts pose special issues upon renunciation of either citizenship or, typically, "green card".

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[6] The rate of expected future earnings is defined in the law.

[7] US persons are subject to USA income tax on our worldwide income. US persons are all citizens of the USA and certain residents. Residents include "green card" holders plus a few others as defined in the Internal Revenue Code; not immigration law. It makes no difference where we actually live or work. Dual citizenship is not relevant.

Finally, we need to consider estate taxation. Both the Regular and Roth Accounts are included in our taxable estates. They generally carry the same income tax consequence, or lack thereof, with respect to our heirs.

Thus, someone who inherits a Regular Account must include distributions in their otherwise taxable income. However, there is a bit of “double counting” because the source of that distribution caused the estate to pay a higher estate tax. Thus, the estate tax allocable to that distribution may result in an itemized deduction to the receiving heir. Itemized deductions, however, can in no way fully compensate for that increase in estate tax. Thus, where there is the opportunity for near death tax planning, one often distributes these taxable Regular Accounts prior to death. This technique results in the deduction of the consequent income tax associated with the Regular Account from the otherwise taxable estate leaving the net principal unencumbered to the heirs.

Use of a Roth Account removes this problem as there is no deferred income tax imbedded in the Roth Account. As we will discuss more fully below, this is one of the reasons one might convert a Regular Account, pay the imbedded income tax now removing that wealth from the future estate while leaving the Roth Account unencumbered of income tax with respect to the heirs.

A huge caveat is in order here. The estates of those who die before 1 January 2011 will incur zero USA Federal estate tax. Commencing after 31 December 2010, the USA estate and gift tax regimes appear to revert to the former state of the law as it existed some ten years ago. The top tax bracket within the USA Federal estate tax regime can approach 55% on a recent historical basis.[8] There is endless ongoing debate in Congress and elsewhere as to this state of affairs with no apparent consensus.

So, let’s stop here for a moment and consider the impact of the differences between Regular and Roth Accounts.

A Regular Account provides for the deferral of current income tax on both the contribution (with exception) and future earnings within the account. But it is a mere deferral. Thus, the old premise was our marginal tax rates in retirement would likely be lower than during our peak earning and contribution years because our expected retirement total income would be lower. The deferred taxes, including with respect to deductible contributions, were an effective interest free loan over decades for those of us who started these accounts with our first employment in the late 1970s and early 1980s. Thus, this deferred tax aspect provided an even greater rate of return because that deferred tax is effectively invested without interest cost.

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[8] Many USA states also impose estate taxes independently of the USA Federal regime. Some are tied to the USA Federal regime in their calculations.

There is a little discussed issue with these Regular Accounts. For tax years prior to 2011, the top marginal income tax rate is 35%. The tax brackets, on the other hand, provide for marginal rates commencing at 10% based on taxable income as follows for 2010:[9]

Taxable Income	Single	Married Filing Joint
US$0 to US$8,375	0%	
US$0 to US$16,750		0%
8,375 5	10	
16,750		10
8,375 to 34,000	15	
16,750 to 68,000		15
34,000 to 82,400	25	
68,000 to 137,300		25
82,400 to 171,850	28	
137,300 to 209,250		28
171,850 to 373,650	33	
209,250 to 373,650		33
In excess of 373,650	35	
In excess of 373,650		35

[9] The Health Care and Education Reconciliation Act of 2010 actually modifies the existing marginal tax rates for 2010 as well as beyond. These modifications are **not** reflected in the above table. There is now a 0.9% surtax on compensation income commencing in 2010. Thus, the 2010 top marginal income tax rate on compensation received in 2010 is 36.4%; not 35%. The way these things usually work is through side calculations where adding income such as a pension distribution will result in pushing the tax on your wage into a bracket as if it is the last income added. Another rather sad commentary on the state of unnecessary complexity in the USA tax law.

Not presented above are the tax brackets for heads of household and those married but electing to file separately.

Not included in this discussion or analysis is the alternative minimum tax or AMT. The AMT is imposed on all of us. All of us calculate our USA income tax using the regular tax calculation and the AMT paying the higher of the two. The AMT is not new. It was first imposed many years ago with the policy purpose of preventing the “wealthy” from escaping all income tax. It did this by applying a lower flat tax rate (28% for individuals) to a calculation which excludes many deductions and other benefits available for regular tax purposes but allowing for a large “standard” or statutory deduction. Since its inception, its “definitions” of “wealth” have not kept pace with inflation. As a consequence, an ever greater number of American taxpayers of modest means are swept into this alternative tax regime. It has become so complex that one must do the actual calculations as it is no longer possible to “eyeball” the income and deductions for the vast majority and simply dismiss its application. It is truly a trap for the unwary.

Most USA states and some cities also impose income taxes. These state and local income taxes are not considered in this discussion as there are simply too many. They must, however, be considered when doing actual planning and compliance.

Long-term capital gains and so-called “qualified dividends”[10] are taxed at no more than 15% through 2010.

After 2010 as the law sits at this moment, the last two lines above reflecting the top marginal tax bracket will look like the following:

	2010	2011 and 2012	2013
Investment income including short-term capital gains but excluding most dividends	35.0%	39.6%	43.4%
Wages	36.4	41.0	41.9
Most dividends	15.0	39.6	43.4
Long-term (held more than one year) capital gains	15.0	20.0	23.8

The lower regular tax brackets remain but the width of the brackets are likely to expand a bit due to mandatory inflation adjustments.

Distributions from the Regular Accounts are piled on top of that particular year’s other taxable income and then taxed at the highest applicable marginal tax rate. Due to the rate structures above, this can easily drive one’s marginal tax rate into higher brackets.

Further, and we think far more significantly, the income within these plans should be focused on dividends and long-term capital gains. To the extent these are the source of the income within these Regular Accounts, the tax benefit of the lower pre-2011 15% rate with respect to dividends was and the lower 15%/20%/ 23.8% rate with respect to long-term capital gains is and was lost albeit the payment of the actual tax is delayed. As we become older and the deferral period shortens, this becomes ever more significant. Back in 2005, we did an analysis demonstrating that a structured program of withdrawals from a Regular Account

[10] Qualified dividends are those as defined in the Internal Revenue Code (“IRC”) §1(h)(11). Dividends paid by corporations organized under the laws of the USA are qualified. However, many dividends sourced in foreign corporations also qualify. Generally, a dividend from a foreign corporation is a qualified dividend where the foreign corporation is organized within a country where the USA has a comprehensive foreign tax treaty. Thus, for example, dividends from German corporations are qualified but dividends from Costa Rican corporations are not. Baring legislative action, this benefit disappears after 2010.

In addition, some dividends paid by corporations may be characterized as capital gains or nontaxable returns of capital. This determination is made at the enterprise level. The country of organization is not relevant. There is no scheduled repeal or alteration of these decades long principles.

beginning at age 50 resulted in more after tax and penalty spendable/investable money than leaving all of the funds in the Regular IRA over a ten year period. The result was most unexpected but turned on the issue of the lower 15% income tax rate on qualified dividends and long-term capital gains.

Roth Accounts, on the other hand, forego the upfront tax savings from deducting the contributions into the account but result in permanent avoidance of income tax on the income and gains within the account so long as one does not violate the rules defining qualified distributions. Common sense says this may be a better option for a younger person as well as a better option where future marginal tax rates are expected to be higher than one's current marginal income tax rate.

What is new and long anticipated for 2010 is Roth Accounts become available to so-called wealthier taxpayers whose income exceeds the current US$105,000 single and US$120,000 annual limitations. For tax years beginning after 2009, all taxpayers regardless of income level may elect to convert their Regular Accounts into Roth Accounts. They may do so even if married filing separately. The obvious benefit is future distributions from the then former Regular Accounts together with future earnings will not be taxable so long as the account remains undisturbed by distributions for five years and, in any event, no withdrawals are made prior to attaining age 59 ½.

With every gift from the "king" comes a hit. The hit here is the entire balance of the Regular Account less any tax basis[11] is treated as taxable income in the year of its conversion into a Roth Account. But, there is no 10% penalty tax so long as there are no distributions from the now Roth Account for five years commencing with the year of conversion. There are limited exceptions. On the other hand, the source of funds to pay this income tax cannot come from the Regular Account or other Regular Account assets without also being included in taxable income and subject to the 10% penalty tax.

There are some points of confusion or silence which I have sensed in the general press concerning this opportunity. The two most salient are:

1. One is not required to convert all of one's Regular Accounts into Roth Accounts. Nor is one required to convert the entirety of any given Regular Account into a Roth Account. This is important as it opens up the decision

[11] Tax basis typically occurs from previous contributions which were not, in fact, deductible from taxable income in the year of contribution. This is most frequently seen in IRA accounts.

The tax basis of these accounts for state income taxation may materially differ from that for Federal or national income tax purposes. The Commonwealth of Massachusetts is a notable example where these basis differences nearly always arise including with respect to 401(k) accounts.

making process especially with respect to the necessary cash needed to pay the associated income tax which could be considerable for those who have saved responsibly.

2. This is not a single year opportunity. Thus, barring intervening statutory change, one could do a series of conversions over a series of years. This has two potential benefits. The first is mitigating the applicable top marginal tax rate. The second is managing the cash needs to pay the income tax cost due to the conversion.

There is an election which is limited to 2010 conversions. One half of the resulting income associated with a 2010 conversion is **required** to be included in one's 2011 taxable income and one half in one's 2012 taxable.[12] One may affirmatively elect to include the entirety of the 2010 conversion taxable income in one's 2010 tax return. **Please note the words. It is not the payment of one half of the associated income tax calculated in 2010 which is delayed and spread over two future years. It is the inclusion of income which is delayed**. Further, including all of the consequent income in 2010 requires an active and affirmative election.[13]

Normally, this would be the proverbial "no brainer" – one would elect to delay the inclusion of 2010 income into 2011 and 2012. However, there are two issues which must be considered effectively requiring near clairvoyance:

1. Splitting income into two tax years would, for many, result in the triggering of lower tax brackets resulting in a lesser total income tax. However, should 2010 prove to be a low income year that generality may not hold true. This could occur should one ultimately end up with unanticipated

[12] Should there be a premature distribution from this now Roth Account, the attendant income tax and 10% penalty would be includable in the 2010 tax return by means of an amended filing.

[13] Pension distributions do not have to be made in cash. Thus, these transfers necessary to accomplish a conversion of a Regular Account into a Roth Account can be accomplished by simply moving the actual securities. Further, distributions (premature or not) from either a Regular Account or a Roth Account do not have to be made in cash. One can also simply transfer selected securities from the Account to one's individual brokerage account. Doing this avoids "round trip" brokerage commissions which arise when one sells the security in the Regular or Roth Account, distributes the cash and repurchases the security. If one distributes the securities, the amount of the distribution is the mean of the buy and sell rate on the close of the day of the transfer. Post distribution basis or tax cost of the security is adjusted to that value. Some recording keeping care may be required as I note that UBS US does not adjust the basis or tax cost of these securities when they are transferred from my pension accounts to my personal accounts.

income in 2011 or 2012. Thus, one could find oneself in a higher tax bracket paying a higher overall tax by failing to elect full taxation in 2010.[14]

2. The second and perhaps greater uncertainty is precisely what those marginal income tax rates will be in 2011 and 2012. Barring legislative action, we already see the top bracket increasing from 35.0% in 2010 to 39.6% in 2011 and 2012 and 43.4% in 2013. The USA Congress and current administration seem to be in a staring match as to the need for imminent legislation which could very well result in higher rates especially as one observes the condition of the USA public fisc. On the other hand, some days ago I read a summary of the recommendations of President Obama's budget commission which shockingly apparently includes recommended tax rate decreases in at least one version reducing individual tax rates to 9%, 15% and 24% as well as repeal the AMT[15].

In its endless wisdom, the US Congress appears to have contemplated this dilemma and others by providing a limited ability to undo prior conversions of Regular Accounts into Roth Accounts. One can unwind the transfer from the Regular Account to the Roth Account if done by the due date of the tax return, including extensions, for the year in which the conversion was made; not the year in which the conversion is taxable. The recharacterization must be done by a "trustee to trustee" transfer of the assets and allocated intervening income from the Roth Account back to the Regular Account. Assuming the conversion to a Roth Account is done in December 2010, this provides about a nine month look back period assuming the due date of the 2010 tax return is properly extended.

One of the biggest risks with these Roth Account conversions is a post conversion collapse in asset value. An illustration is perhaps the best means of seeing this. Assume with me that you have US$350,000 in personal financial assets in a liquid form and US$1,000,000 in your Regular Account on 1 December 2010. The values are market values. You elect to convert your Regular Account into a Roth Account in 2010 effectuating that conversion on 1 December 2010. Here is what this looks like from a financial point of view:

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[14] My economist friends would properly want us to consider the time value of money. But, with the interest rates we see today (*e.g.*, the two year Treasury at 0.51% annually), I do not think it is worth doing the mathematics.

[15] In fairness, I have not read the whole report. Further, the reduced individual tax rates are coupled with the removal of nearly all deductions, credits and exclusions. Included in those proposed removals is the deduction for interest associated with all home mortgage loans. While from a long-term policy point of view I whole heartedly support a repeal of the home mortgage loan interest deduction, one would think now is not the time and, in any event, it would require some significant transition relief. http://blogs.forbes.com/beltway/2010/11/17/who-gets-taxed-under-bowles-simpson-deficit-plan/

At 30 November:

Cash and securities in your personal account	US$ 350,000
Cash and securities in your Regular Account	1,000,000
Deferred income taxes due only upon distribution or conversion[16]	(350,000)
Net asset value of Regular Account	650,000
Net asset value	US$ 1,000,000

Momentarily after the conversion on 1 December:

	Elect to Pay Tax in 2010	One-half of the Tax Paid in 2011 and One-half Paid in 2012
Cash and securities in your personal account	US$ 350,000	US$ 350,000
Cash taxes typically payable on 15 April of the following year (US$1,000,000 taxable value of conversion times the top marginal tax rate)	(350,000)	(396,000)
Cash and securities in your new Roth Account	1,000,000	1,000,000
Net asset value	US$ 1,000,000	US$ 954,000
Cost of conversion	US$ 350,000	US$ 396,000

Please note here there is a US$46,000 liquidity problem if you elect to delay taxation of the conversion. The tax due and payable with your 2011 and 2012 tax returns must come from other earnings as the personal assets on the date of conversion are not sufficient to pay the resulting income tax. One might do this, however, where one-half to the value of the Regular Account upon conversion did not result in triggering the highest marginal tax rates in 2011 and 2012. Of course, we have no idea today what the 2011 and 2012 top marginal tax brackets will actually be nor when they will kick in.

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[16] This is also a contingent liability. It could be less over time if, upon withdrawal in whole or in installments, your top tax rate proved to be less. It could be more if future statutory tax rates increased or your other future income is more than anticipated. Further, it does not include the 10% penalty tax which would arise if you made a premature distribution.

Now assume with me that the market collapses by 75% one month after the conversion in January of the following year. Further assume that your US$350,000 in personal assets is not in cash but rather the same asset mix as your pension accounts. Here is what you would be faced with:

	Elect to Pay Tax in 2010	One-half of the Tax Paid in 2011 and One-half Paid in 2012
Cash and securities in your personal account	US$ 87,500	US$ 87,500
Cash taxes typically payable on 15 April of the following year (US$1,000,000 taxable value of conversion times the top marginal tax rate)	(350,000)	(396,000)
Cash and securities in your new Roth Account	250,000	250,000
Net deficit	US$ (12,500)	US$ (58,500)
Cost of conversion and collapse in values	US$ 1,012,500	US$ 1,058,500

Effectively, you would be both illiquid and insolvent. The taxing authorities are neither kind nor patient. Because this occurred prior to the due date of your tax return, you would immediately undo the transaction removing the US$350,000 of income tax. However, assuming the collapse in values happened beyond the due date of your income tax return but after you had actually paid the tax due, here is what it would look like:

	Elect to Pay Tax in 2010	One-half of the Tax Paid in 2011 and One-half Paid in 2012
Cash and securities in your personal account	US$ 0	US$ (46,500)
Cash and securities in your new Roth Account	250,000	250,000
Net asset value	US$ 250,000	US$ 203,500
Cost of conversion and collapse in values where the collapse in values occurred after payment of actual tax	US$ 750,000	US$ 796,500

Again, you would be illiquid had you not elected to include all of the tax consequence of the conversion in your 2010 tax return.

Had you not done the conversion at all and there was the same collapse in asset value, this is what it would look like:

	No Conversion in 2010	No Conversion in 2010, 2011 or 2012
Cash and securities in your personal account	US$ 87,500	US$ 87,500
Cash and securities in your Regular Account	250,000	250,000
Deferred income taxes due only upon distribution or conversion	(87,500)	(99,000)
Net asset value of Regular Account	162,500	151,000
Net asset value	US$ 250,000	US$ 238,500
Cost of collapse in values	US$ 750,000	US$ 761,500

Admittedly, your net asset value is the same or nearly the same where you did not convert while the deferred income taxes are both contingent and not due in cash. Both the net asset value and contingent liability in the account decline but leave greater resources available to you for investment to help restore your lost wealth.

One can debate whether our assumed 75% collapse in asset value is reasonable. The reader can use different values and test sensitivity of the conclusion. On the other hand, we have seen individual pension accounts and trust accounts which suffered losses well in excess of 50% since mid 2008. Even without the overlay of this kind of income tax regime, the losses for many have been catastrophic.

One final observation is in order. This conversion process resets the tax basis or tax cost in the new Roth Account. This new tax basis is the fair market value of the Regular Account's assets on the date of the conversion. Thus, there would be no tax penalty on an early withdrawal and no income tax on a withdrawal of all or a portion of the new Roth Account if the fair market value declined such that, when combined with post conversion income, the value of the new Roth Account was less than the value of the old Regular Account at the date of conversion. Indeed, there might well be a deductible loss upon closing of the Roth Account.

One way of mitigating this risk of catastrophic loss is to do these conversions and similar tax and investment moves in a more gradual manner. For example, one could stage the conversion of one's Regular Accounts into Roth Accounts over a period of years. This would effectively "dollar cost average" the cost of these conversions and, thus, mitigate the risk of the more catastrophic loss possibilities. Of course, this adds the risk of future tax rate increases either due to higher income from other sources or by means of legislative change or both. It also leaves open the risk of future legislative repeal of this benefit.[17] On the other hand, it does provide one with the benefit of some "peering into the future" in a positive manner.

The American Bar Association's recent Probate & Property publication addressed this issue in an article entitled *Rethinking Roth IRA Conversions in 2010*.[18] We thought it was well done and worth citing some of their observations of the best candidates to make these conversions while electing to pay the tax in 2010:

1. Someone that will always be in the highest income tax brackets.

2. Someone that will likely be subject to the estate tax. This is easy to say but hard to guess given the current shift in the law governing USA taxation of estates and gifts together with the state of political and fiscal uncertainty in Washington.

3. Someone that is currently in a low income tax bracket but will likely be in a higher income tax bracket in retirement. Here the author used the interesting example of a grad student who inherits a Regular Account. We would add those of us "foreign Americans" who avail ourselves of the foreign earned income exclusion but may be contemplating a return to the USA or not. We would also add someone with the desire and ability to make meaningful charitable contributions including accelerating some which may be contemplated in our wills. For those with land holdings including in Costa Rica, there may be opportunities to make charitable gifts of certain land subject to our maritime zone rules – extra care needs to be exercised where the location of the land is outside of the USA but the opportunity is there nonetheless.[19]

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[17] The risk of repeal of this current opportunity might be lower than the risk of higher future tax rates. This provision accelerates the collection of tax receipts which would otherwise be collected at the later date of retirement. Given the nonsensical methodology the USA uses with respect to budgetary matters and their need to close what is a yawning chasm of debt and deficits, there is probably a better than even chance that this provision will not be repealed in the nearer term. We make no guarantees but this would be consistent with prior USA legislative behavior in other tax matters.

[18] Christopher R. Holt, *Rethinking Roth IRA Conversions in 2010*, Probate & Property, ABA Sept. – Oct. 2010, at 13 – 16.

[19] In order to be deductible from USA taxable income, a charitable contribution must be made to a qualified charity as defined in the Internal Revenue Code. A qualified charity must be organized under USA law and obtain a Private Letter Ruling to the effect that it is so qualified. The problem dealing with conservation land located outside of the USA is well known. There are solutions which are not unduly complex or burdensome but must be implemented long before the actual charitable gift.

4. Someone with tax deduction carryforwards. The author cites someone with excess charitable deductions. We would add those who have business losses sourcing in both foreign and USA disregarded entities.

5. Someone who wants to take advantage of a Roth IRA's exemption from making lifetime required distributions.

The author's list is by no means exhaustive but worthy of consideration. His technical analysis is also well done for those so inclined.

We would like to add a few other considerations which we have not seen widely discussed.

USA pension accounts of all kinds are not available to an individual's creditors even in the circumstance of bankruptcy. They are bankruptcy remote. We are hearing ever greater stories (including within our practice) of "debt collectors" demanding that people tap their IRAs and 401(k)s to meet stressful debt payments associated with home mortgage loans, car loans, credit cards, etc. You are not required to do this. Further, withdrawals to meet these debts are taxable and, typically, attract the 10% penalty tax for early withdrawal.

Next, as discussed above, conversions of Regular Accounts into Roth Accounts attract income tax. For those already stressed with other debt obligations, the resulting tax obligation could cause far more than its fair share of problems. Tax liabilities do not always discharge in bankruptcy.

Thus, if you are experiencing financial stress (including potential job loss), please consult with competent counsel expert in bankruptcy before making any decision concerning these matters.

We are no longer so enthralled with these various defined contribution pension schemes including Regular Accounts and Roth Accounts. We think they were fine and served a very useful purpose years ago. We do not in any way regret personally taking advantage of those prior opportunities. We think today the facts and risks differ:

1. The extreme level of fiscal uncertainty including, but not limited to, potential tax rate increases and other revenue enhancing measures need to be considered. Our old assumption of lower tax rates during our retirement years is looking ever less probable.

2. While we really do not think Social Security will survive in its present form, these Regular Accounts and Roth Accounts result in income during our retirement years when we would, under the present regime, qualify for Social Security and certain medical benefits. However, even under

current law, Social Security benefits are means tested.[20] Thus, the higher our income, the less we collect. Ceasing further contributions to these pension accounts and even liquidating them (not merely converting them) into personal assets may result in savings beyond that demonstrated in our prior 2005 study referenced above.

3. The assets in which one can invest the funds within a Regular Account or a Roth Account are limited. One of the limitations, however, is **not** non-publically traded securities including those organized in foreign jurisdictions. Thus, one can invest these Accounts in certain private business enterprises. We used to do this frequently with our clients' privately held multinational businesses to considerable benefit. We have not seen this done much in more recent times with no obvious reasons. Thus, we have considered some opportunities in this area which could help solve some of these newer problems.[21]

4. Our last observation will, perhaps, be the most controversial. The USA today is the single largest net debtor nation state in human history. In my and others' far more competent views, there is no way the USA and its various subdivisions can repay their debt. This is mathematics; not politics. There are well known typical behavior patterns in which such nation states behave.[22] About the last thing I want is for my wealth to be

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[20] Up to 85% of one's Social Security benefit is currently included in taxable income where income, as defined, exceeds US$34,000 single; US$44,000 married filing joint; or zero married filing separate. The definition of income is modified adjusted gross income (approximately equal to the last line of page 1 of Form 1040) plus tax exempt interest income among other issues. It is not much of a stretch to include otherwise tax exempt distributions from a Roth Account in this calculation of "income". While not explicitly means tested, including Social Security in taxable income where other income exceeds a threshold certainly gets to the economic equivalent.

It also would not surprise me to see additional means testing done on asset levels at some point in the future.

[21] Great care needs to be exercised in this area. There are many traps for the unwary. Further, these Accounts require a trustee. Indeed, that is one of the primary rolls of the mutual fund companies and brokerage houses in which we establish these accounts. We know of no major brokerage house or similar that will hold nonpublicly traded securities in either a Regular or Roth Account. There are a few nontraditional institutions that will.

[22] I arrived at this conclusion some years ago. Recently, my conclusions were thoroughly buttressed by those far more competent than me. I encourage you to read This Time Is Different by Carmen M. Reinhart and Kenneth S. Rogoff. The book is outstanding. Their new research thoroughly buttresses, and statistically confirms, that we should expect behavior out of the USA (and a few others) which is in every way comparable Chile, Brazil, Argentina and others under the old juntas.

Recently, for example, President (Mrs.) Kirchner of Argentina was widely reported in the Anglo mainstream media to have "confiscated" the private pension accounts of Argentines. Not quite. Mrs. Kirchner required the private pension plans to divest of all other assets to invest exclusively tied up in accounts over which there is a very heavy level of state control including dictating institutions which can hold the investments, the nature and quantity of those investments and so on. Nor do I want extreme levels of uncertainty (where avoidable) over the potential taxation of either income or principal, now or in the future. To the extent this view is shared, one would consider the following:

a. Cease further contributions into these accounts. That does not mean one ceases to save and invest.

b. Make use of the 72(t) election where appropriate and helpful albeit this is a slow process.

c. Consider making far larger (even draconian) taxable withdrawals from these accounts especially before 2011 and paying any necessary penalty.

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in Argentine sovereign bonds. This is effective confiscation if the bonds do not pay off but a vastly different mechanism.

As Reinhart and Rogoff so exquisitely demonstrate and flat out state, the only thing exceptional about the USA is size and scope.

Please never doubt. It is not in our interest for the USA or anyone else to fail. Indeed, we would be happily wrong as that would only get to better results for all, including us.

Permitted investments in USA private pension plans are currently statutorily limited. So, further restricting those investments is not much of a legislative task easily administered through a rather modest amendment to current law.

The play I hear being discussed a bit in Washington is along the line of protecting all those poor American savers who lost half or more of their IRAs/401(k)s to those nasty bankers on Wall Street. They will be protected by the US government by requiring some meaningful percentage (50%?) of their pension accounts be invested in the "safest investment in the world" known as US Treasury bills, notes and bonds. There would be several trillion made available to the US Treasury through this gimmick. And "safest investment in the world"? In the face of massive quantitative easing and other potential forms of sovereign default? Not in my accounts. If I listen correctly, the only way to avoid this possibility is to avoid USA pension accounts including Regular and Roth Accounts.

We do not think there is a simple one size fits all answer to this issue. Each of us have different circumstances, needs and beliefs as to the future all of which suggest differing solutions.

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We hope this is helpful. There is a lot of math in the various planning opportunities. We are certainly happy to help with that as well as work with you to tailor a more specific plan of action.