

Estate Planning

Special Interest Articles:

- In 2010, Higher Income Earners May Convert Traditional IRAs to Roth IRAs
- One Step Conversion From Employer Retirement Plans to Roth IRAs
- “Decoupling” the MD Estate Tax: Married Couples Need to Revise Estate Plans to Maximize Estate Tax Exemptions
- Grandparents Avoid Federal Gift Tax By Funding a Grandchild’s Education

Babirak, Vangellow & Carr, P.C.

In 2010, Higher Income Earners May Convert Traditional IRAs to Roth IRAs

Beginning in 2010, the Tax Increase Prevention and Reconciliation Act (TIRPA) of 2005 will allow higher income earners, \$100K and above, to convert their traditional IRAs to Roth IRAs. Traditionally, the Roth IRA was reserved for lower wage earners as a vehicle to save for retirement.

Roth Rules

Roth IRA contributions are after-tax dollars that grow tax free. All distributions are tax free as long as the account has been open for five years and the account holder is age 59 1/2. To access a Roth IRA, individuals must either (1) fund a Roth IRA or (2) convert a traditional IRA to a Roth IRA. Because both avenues have income limitations, higher income individuals are ineligible for a Roth IRA.

Great News for Income Earners \$100K and Above!

TIRPA dramatically changes current law. In 2010, higher income earners may convert traditional IRAs to Roth IRAs. Prior law made earners who had a modified adjusted gross income above \$100K ineligible for conversion. While higher income individuals still may not fund a Roth IRA directly, income earners who make more than \$100K may now convert their traditional IRAs to Roth IRAs.

Income Earners who Convert in 2010 May Divide Tax Liability Over 2 Years

Furthermore, individuals who convert in 2010 may divide the income tax liability due to the conversion owed on the traditional IRA between two years, 2010 and 2011. Unlike the Roth IRA, a traditional IRA, which is divided into principal and earnings, is always taxed on its earnings upon distribution. The tax liability on the conversion will vary depending on whether the individual took a deduction on principal on his tax return.

Is Conversion Right for You?

Whether conversion from a traditional IRA to a Roth IRA is right for you depends on several factors: your current and future tax bracket, your current and future income, the length of time until your retirement, and your estate plans. If you have any questions whether conversion is right for you, give your financial advisor or us a call.

One Step Conversion From Employer Retirement Plans to Roth IRAs

When the Pension Protection Act (PPA) of 2006 takes effect in 2008, Americans will be able to convert their employer retirement plans to Roth IRAs in a single step. As the law currently stands, an

employee must go through a two-step process to convert employer retirement plan to a Roth IRA.

The Two-Step

First, employees must roll their employer plans into a rollover IRA and next, the employee may convert his rollover IRA to a Roth IRA. While the PPA does not impose any substantive change to current law, it eliminates paperwork.

One Step Conversion Requirements

To qualify for the one-step conversion, employees must meet two requirements: (1) the disbursement from the employer plan must be eligible for conversion to an IRA and (2) the employee must be eligible to convert his disbursement to a Roth IRA. Employee eligibility requirements are based on income. Under current law, individuals who exceed \$100K may not directly convert.

2010 Income Earners Exceeding \$100K Can Do the One-Step

For 2008 and 2009, taxpayers with modified adjusted income exceeding \$100K will not be able take advantage of the direct conversion because their incomes exceed the eligibility requirement. In 2010, Tax Increase Prevention and Reconciliation Act (TIRPA) of 2005 allows Americans with incomes in excess of \$100K to directly convert employer retirement plans to Roth IRAs.

For more information on TIRPA, see article also included in this newsletter.

“Decoupling” the Maryland Estate Tax: Married Couples Need to Revise Estate Plans to Maximize Estate Tax Exemptions

Prior to 2004, Maryland had set its estate tax exemption the same as the Federal estate tax exemption, \$1 million.

In 2004, the federal estate tax exemption increased to \$1.5 million for 2004 and 2005. Again, it increased to \$2 million for 2007 and 2008. As the estate tax exemption increased, MD received less in estate tax.

In 2004, MD decoupled from the federal estate tax exemption.

Decoupling Defined

“Decoupling” occurs when a state decides to set its estate tax exemption differently from the federal estate tax exemption. Like many states, Maryland prior to its 2004 legislation set its estate tax exemption the same as the federal estate tax exemption.

Decoupling Causes State Estate Tax Liability

The effects of Maryland’s 2004 decoupling legislation caused some unsettling results for Maryland estates. Under this scheme, Maryland estate tax was due even when no federal estate tax was required. The gap between Maryland’s \$1 million estate tax exemption and the federal estate tax exemption created state estate tax liability. Married couples with estate plans designed to eliminate federal estate tax liability upon the first spouse’s death were now subject to state estate tax liability of \$64,400 in 2004 and \$99,600 in 2006 through 2008.

MD QTIP Saves the Day

In response to these results, in 2006, Maryland enacted legislation to lessen the blows of decoupling. While the state estate tax exemption remains at \$1 million, there were two significant improvements: (1) the 16% cap on state estate tax and (2) the creation of the Maryland QTIP. The 16% cap provides relief to estates between \$1 million and \$1,337,500 where the effective tax rate would have been higher than 16%.

Defer MD Estate Tax

Moreover, under the Maryland only-QTIP election, a surviving spouse who has a qualified MD QTIP trust may defer Maryland estate tax on the deceased spouse’s estate until the death of the surviving spouse.

Two Requirements for MD QTIP

The requirements for the Maryland QTIP are: (1) the QTIP must comply with federal law and (2) a timely filed Maryland estate tax return electing to treat the trust as a QTIP trust for

Maryland estate tax purposes. Prior to the 2006 legislation, married couples were unable to fully utilize the federal estate tax exemption if they wanted to avoid Maryland estate tax liability. Now, the Maryland QTIP offers a solution to married couples’ estate plans to defer state estate tax liability.

Proper Drafting Necessary for MD QTIP

The goal of estate planning is to utilize the client’s exemptions to maximize assets passing through the estate tax-free. In order to defer the MD estate tax until the death of the surviving spouse, a properly drafted MD QTIP trust must be included in your estate plan.

Grandparents Avoid Federal Gift Tax by Funding a Grandchild’s Education

The annual gift tax exclusion allows individuals to make gifts of \$12K or less to an unlimited number of beneficiaries without incurring federal gift tax. However, gifts made by the donor exceeding \$12K may incur gift tax and require the filing of a gift tax return.

Unlimited Annual Exclusion for Prepaid Tuition

One method grandparents may use to avoid the 12K limit is to prepay a grandchild’s tuition. Internal Revenue Code §2503(e) sets forth the unlimited education exclusion for prepaid education.

Requirements for Unlimited Education Exclusion

In order to avoid the federal gift tax on prepaid tuition, the donor must meet the following requirements: (1) the tuition is paid directly to the qualifying educational institution and (2) tuition is non-refundable in case the beneficiary does not attend the institution.

Give the Gift that Keeps on Giving

Prepaying education directly to the institution may be superior to alternative gift giving strategies, such as an outright gift to a grandchild or the creation of a trust to fund education. Such alternatives may cause federal gift tax liability. The unlimited education exclusion gives twofold, first the gift of education to the beneficiary and second, the gift of no gift tax to you.

A properly drafted MD QTIP must be included in your estate plan to defer MD estate tax.

