Avoiding the Alternative Minimum Tax with a Roth IRA Conversion

Legal Alert

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The Alternative Minimum Tax ("AMT") was designed to ensure that "wealthy" Americans pay their fair share of federal income tax. Before the AMT system, many "wealthy" taxpayers paid lower federal income tax than less "wealthy" taxpayers due to the many deductions available under the regular income tax rules. Because the AMT thresholds were not indexed for inflation, today many taxpayers who do not consider themselves to be "wealthy" are paying their federal income tax under the AMT system. This Client Alert describes a strategy for avoiding AMT by triggering sufficient additional income in order to reach the AMT rate "crossover point" (whereby the AMT system does not apply) by converting part or all of a traditional Individual Retirement Account ("IRA") into a Roth IRA.

THE AMT SYSTEM

The AMT was enacted in 1969 and contains a separate set of rules from the regular income tax system. Taxpayers must calculate their income tax liability under both the regular income tax rules and the AMT system. If the taxpayer's tax liability is greater under the AMT system, that becomes the amount payable as federal income tax. In many situations, a taxpayer's liability is greater under the AMT system because the AMT rules do not permit many of the deductions that are available under the regular income tax rules (e.g., state and local taxes). On the other hand, the maximum income tax rate under the AMT system is only 28%, which is considerably lower than the highest marginal rate under the regular rules. Thus, if a taxpayer's marginal tax rate under the regular income tax rules is lower than 28% because he has deductions he cannot use under the AMT system, he or she will pay income tax based on the AMT system. In that case, each additional dollar of income will be taxed at 28% until all of the taxpayer's previously unused deductions under the regular tax system are used up and his or her marginal tax rate exceeds 28%. This is often referred to as the "crossover point." Conventional tax planning for taxpayers subject to AMT is often the acceleration of income until the crossover point is reached to take advantage of what would otherwise be a lower 28% marginal tax rate on that additional income.

IRAs

An IRA is an individual retirement plan established by a taxpayer at a financial institution. The owner of the IRA may fund the IRA annually up to certain limitations. The rules applicable to traditional IRAs differ significantly from those that apply to Roth IRAs. Amounts contributed to a traditional IRA are tax deductible when made, and grow tax **deferred** while in the IRA. Amounts distributed from a traditional IRA are subject to federal income tax when received. Additionally, traditional IRAs are subject to the required minimum distribution ("RMD") rules, which require that distributions commence when the IRA owner reaches age 701/2.

In contrast, contributions to a Roth IRA are not tax deductible but earnings in a Roth IRA grow tax **free**. Consequently, qualified distributions from a Roth IRA are not subject to federal income tax. Moreover, the RMD rules do not apply to Roth IRAs during the original owners lifetime, which can result in the Roth IRA growing in value tax free for the original owner's lifetime, unless there is a need for a distribution.

IRA CONVERSIONS

Owners of a traditional IRA are permitted to convert part or all of their traditional IRA into a Roth IRA. Converted amounts are not considered to be contributions; hence, amounts converted do not count against the limitations on contributions to IRAs. Commencing January 1, 2010, any IRA owner may effect a conversion. Previously, taxpayers with annual modified adjusted gross income in excess of $100,000 were not permitted to convert. The value of the amounts converted from a traditional IRA into a Roth IRA is subject to federal income tax for the year in which the conversion is accomplished. For conversions occurring in 2010, unless elected otherwise, the federal income tax burden will be spread ratably over two years (2011 and 2012.) Further, the conversion can be undone (if the taxpayer desires) by reconverting the Roth IRA back into a traditional IRA. Any reconversion must be completed by the due date of the tax return (plus extensions) for the year of the conversion. Of course a reconversion will undo any tax advantages of a Roth IRA conversion.

Some of the factors to consider in deciding whether to convert a traditional IRA into a Roth IRA include whether the individual can pay the tax liability with non-IRA assets (so that the value of the retirement account is not depleted), the individual's current and anticipated future tax rates, the IRA owner's age and health and thus the time period that the assets are expected to be held in a Roth IRA, and the desire to transfer wealth to future generations. Because Roth IRA accounts grow tax free, the economic benefits of a conversion should be more substantial for younger taxpayers and in situations where the IRA owner intends to leave the IRA assets to his descendants at death, as the Roth IRA allows certain beneficiaries to stretch the IRA tax deferral over their lifetimes. Even though Roth IRA beneficiaries are subject to the RMD rules, because Roth IRA assets grow tax free, the Roth IRA stretch benefits could be significant (as compared to the economic benefits for beneficiaries of traditional IRA's.)

THE ROTH IRA CONVERSION STRATEGY

As discussed above, traditional tax planning for taxpayers subject to the AMT is to accelerate income until the crossover point is reached, thus taking advantage of a 28% marginal tax rate on the accelerated income. Of course, many such taxpayers do not have the ability to accelerate income. However, if they have a traditional IRA (or qualified retirement plan account with a distribution available that can be rolled over into a traditional IRA), part or all of the traditional IRA may be converted into Roth a IRA, thereby accelerating the income needed to reach the crossover point. This strategy may be used in any year in which the taxpayer is subject to AMT. The calculations should be made with the assistance of a professional tax advisor, and if this strategy is pursued in 2010, the IRA owner should elect not to spread the tax burden ratably over the otherwise automatic special two year period. The beauty of the strategy is that it simply requires a change in the vehicle in which retirement assets are held to a vehicle that has other advantages beyond the avoidance of AMT.

Additional Tax Planning Tip: Over the past decade or so, tax deferred variable annuities became popular investment assets for use in traditional IRAs. Although the tax deferral of the annuity was not necessarily needed in a tax deferred IRA, these investment vehicles often came with guaranteed income options that made them particularly suitable to provide retirement income. With the severe stock market declines of 2008, the actual cash value of these annuities are often significantly less than their guaranteed income values, making them an excellent choice of asset for a Roth IRA conversion. Using such an asset for a Roth IRA conversion would essentially serve to avoid income tax on the "discount," hence making this a worthwhile tax planning strategy even if AMT were not avoided.

SPECIAL CONSIDERATIONS FOR NEW JERSEY RESIDENTS

New Jersey's income tax rules conform to the federal rules in allowing Roth IRA conversions regardless of the amount of the New Jersey taxpayer's modified adjusted gross income. In addition, a New Jersey taxpayer will recognize taxable income from a Roth IRA conversion for New Jersey purposes in the year or years it is recognized for federal income tax purposes. However, unlike federal law, New Jersey does not allow a tax deduction for a contribution to a traditional IRA. Thus, a New Jersey resident who takes a distribution from a traditional IRA or who converts a traditional IRA to a Roth IRA must include as income for New Jersey income tax purposes only the portion of the distribution or converted amount that reflects earnings accrued in the traditional IRA as well as principal that was not previously taxed (such as rollover amounts from an employer qualified plan.)

Accordingly, a New Jersey resident who is considering the Roth IRA conversion strategy to avoid the federal AMT system should also consider the New Jersey income tax consequences. The high income tax rates applicable to New Jersey residents may make the Roth IRA conversion strategy less appealing for them, particularly if a New Jersey resident is considering retiring to a low or no income tax state such as Florida. Because states treat IRA distributions differently for state tax purposes, a New Jersey resident who is considering moving to a different state should have a tax professional review the other state's tax rules before utilizing this conversion strategy.

If you would like to learn more about the information discussed in this alert, please contact any member of the Taxation Practice Group at Flaster Greenberg PC.

ATTORNEYS MENTIONED

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