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Tough Economic Times Present Unique Opportunities

By Abbe I. Herbst and John J. Hess

The economic news gets grimmer with each passing day. Unemployment is rising, salaries are frozen, dividends are reduced and the values of securities are depressed. Yet, for those who are fortunate enough to still have resources available at their disposal, these tough economic times are ripe with unprecedented opportunities, as this article will discuss.

Roth IRA Conversions

If the value of your individual retirement account ("IRA") is much lower than in the past, but you think it will recover, now may be an excellent time to convert to a Roth IRA, pay the income tax that results from the conversion, and enjoy years of further growth that will not be subject to income taxes when the assets and their earnings are withdrawn.

In a traditional IRA, the contributions are excluded from income and thus not subject to income tax when they are added to the IRA. Later, when withdrawals are made (no later than April 1 of the year after the participant attains age 70 1/2), they are included in the gross income of the participant.

A Roth IRA reverses the traditional IRA rules. In a Roth IRA, the contributions are taxed as ordinary income when they are made (or in the year of the conversion), but any later withdrawals are completely free of income tax. Moreover, the pre-death minimum distribution rules do not apply to a participant's Roth IRA, and the account can remain intact until death.

For 2009, a conversion to a Roth IRA is permitted only if the participant's adjusted gross income does not exceed $100,000 and, if the participant is married, files a joint income tax return. There are many taxpayers whose income has been reduced as a result of the gyrations in the financial markets, and they may be able to take advantage of the ability to convert their traditional IRAs to Roth IRAs. Hopefully, the markets will recover to their robust growth of the past. When that growth is withdrawn from a Roth IRA, it will not be subject to income tax.

For tax years beginning in 2010, the income limitation discussed above will no longer apply, thereby allowing higher income taxpayers to convert to Roth IRAs. In addition, the income on a Roth IRA conversion made in 2010 will be reportable ratably in 2011 and 2012, unless the taxpayer elects to recognize the income in 2010.

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Elimination of Required Minimum Distributions in 2009

In 2009, generally no minimum distributions are required to be taken out of traditional individual retirement plans and employer-provided qualified defined contribution plans. This means that participants and beneficiaries do not have to reduce their account balances by making withdrawals from them. It also means that their gross incomes will be less, which may result in less amounts of their Social Security benefits being subject to income tax.

In Kind Gifts of Securities

The annual exclusion for federal gift tax purposes has been increased to $13,000 per recipient (or $26,000 per recipient if the donor and spouse agree to file "split gift" gift tax returns). For those in a position to make gifts, the depressed values of stocks present an opportunity to make gifts of the shares themselves instead of selling at a loss in order to make gifts of cash.

For example, if the donor wishes to make a gift worth $10,000, and has a considerable number of shares of a stock that were purchased many years ago at $50 per share and are now worth only $25, the donor could make a gift of 400 shares (having a current value of $10,000), without having to part with any cash. If the shares later recovered all of their value and were sold by the recipient of the gift, the basis for the gain on the sale would be the $50 per share donor's basis. If the shares were sold at a price above $25 per share but before their value reached $50, there would be no gain or loss to report.

Low Interest Loans

The historically low interest rates that are currently in effect make this a very good time to make low interest loans to family members, without incurring any adverse tax effects to the lender. Internal Revenue Code provisions penalize those who make interest-free loans, but the low interest rates currently in effect enable one family member to assist another at a minimal rate of interest, without adverse tax consequences to the lender. For April 2009, the minimum permissible interest rate for a term loan of 3 years or less is only 0.83%. In April of 2007, the minimum interest rate would have been 4.84%.

Charitable Lead Annuity Trusts

Charitable organizations have been severely affected by the economic downturn: the values of their assets are reduced, contributions are not as generous as they once were, and many corporations that used to have foundations that supported other charities have simply ceased to exist.

Now is an excellent time to establish a charitable lead annuity trust ("CLT"). In the most common type of CLT, the trust instrument provides for the charity to receive a fixed sum every year for a stated term, and at the end of the term the assets pass to an individual, such as a family member. As compared to higher interest rates, the current historically low interest rates result in a larger gift tax charitable deduction for the charity's annuity interest and a smaller gift tax value for the gift passing to the individual at the end of the term: a win-win for contributors and for charities.

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