UK US TAX SERVICES LLP

ROTH IRA CONVERSIONS AND U.K. EXCESS FOREIGN TAX CREDITS

Recent changes to the Internal Revenue Code have allowed the conversion of traditional Individual Retirement Accounts ("IRAs") into Roth IRAs irrespective of the income limits that existed prior to 2010 for such conversions. The potential benefits of a Roth IRA over a traditional IRA are well documented and include the ability to receive a distribution from the Roth IRA without imposition of additional U.S. federal income taxes, no requirement to take mandatory distributions once the Roth IRA account holder reaches 70½ years old, and the ability to bequeath the proceeds of the Roth IRA to the holder's heirs without the imposition of U.S. federal estate tax.

The benefits of converting a traditional IRA to a Roth IRA, however, come at a cost. The holder must take into income the value of the amount of the IRA account so converted into income. Once the conversion takes place, the Roth IRA grows in value tax-free and receives the benefits described in the paragraph above.

Little has been written, however, about the conversion of a traditional IRA to a Roth IRA for U.S. citizens who are U.K. resident. These individuals must navigate the tax rules associated with both U.S. and U.K. tax rules. For such individuals, the conversion of a traditional IRA to a Roth IRA offers certain unexpected results that can substantially ease the costs associated with the income inclusion otherwise required by this conversion.

As a starting point, because distributions from a Roth IRA are exempt from U.S. federal income tax, under the U.S./U.K. income tax treaty (the "U.K. Treaty"), such proceeds are exempt from U.K. tax as well. This position not only finds support from the plain language of Article 18 of the U.K. Treaty, but has been confirmed by the HM Revenue and Customs in a publication discussing the application of Article 18 to Roth IRAs.

Moreover, for a U.S. citizen who is in an excess foreign tax credit position (general basket), which typically arises for U.S. individuals working in the U.K. where the U.K. tax rates are higher than the U.S. rates on earned income, an additional benefit may also be available. The IRS has ruled that taxable income arising from pension distributions, which are analogous to the income arising from a conversion from a regular IRA to a Roth IRA, are in part classified as foreign source active income. Such active foreign source income can absorb the excess foreign tax credits that the person has who converts the traditional IRA to a Roth IRA.

The amount of the pension distribution that is treated as foreign source active income is based upon the amount that the IRA holder contributed to the IRA from foreign source earnings. A person who contributed to an IRA (or who rolled over contributions from an employer pension scheme to an IRA) when the person worked abroad would therefore be deemed to receive foreign source active income on the rollover to the extent the initial contributions were from foreign sourced active income.

A simple example demonstrates the benefits of this rule. Jane Smith worked 20 years for a U.S. multinational company, of which 8 years was spent in the U.S., 7 years in France and the remaining 5 years in Germany. She contributed $10,000 to her employer pension scheme in each year throughout the period. She left the company after 20 years and rolled her pension entitlements into an ordinary IRA. She then moved to the U.K. for an additional 4 years, contributing an additional $10,000 per year to the IRA. After 24 years, the $240,000 she invested in the pension account had grown to $400,000.

If Ms. Smith decides to rollover the entire $400,000 into a Roth IRA in 2011, she will include in income $400,000. On her 2011 tax return, Ms. Smith will be entitled to report $160,000 of the $400,000 of income as active foreign source income and will be able to use excess foreign tax credits against the tax arising from that $160,000 of income. If she has sufficient excess foreign tax credits, she can therefore effectively convert the entire $400,000 IRA balance to a Roth IRA while only incurring additional U.S. tax on $240,000 of the income. The remaining $160,000 of income would be sheltered by her excess foreign tax credits.

Indeed, it is even possible to maximize this benefit assuming a favorable set of facts. For a person with a pre-existing IRA account who moves to the U.K., it should be possible to make a contribution to the IRA which is deductible for both U.S. and U.K. tax purposes (although the deduction will be limited to the lesser of the amount that can be contributed to the IRA under U.S. rules or to an analogous pension scheme under U.K. rules). The amount so contributed could then be rolled over into a Roth IRA without incurring any additional U.K. tax (although it would be fully taxable in the U.S.). A portion of the amount would be considered active foreign source income with the ability to shelter that income from U.S. tax using excess U.K. foreign tax credits.

In summary, the new rules on Roth IRA conversions may benefit U.S. citizens residing in the U.K. who are in an excess foreign tax credit position. The rules are inherently fact specific but assuming a comparatively normal situation, where the U.S. citizen has excess foreign tax credits, much of the sting of the cost of conversion may be mitigated by using such excess credits against the deemed income that arises as a result of the conversion.