PLANNING CONSIDERATIONS WITH THE NEW ROTH IRA

By Clark M. Blackman II and Ellen J. Boling

One of the most difficult decisions is whether an existing IRA should be converted into a Roth IRA. This involves considerations related to tax, retirement and estate planning, and may be impacted by numerous interrelated factors.

The new Roth IRA provides another powerful weapon in the taxpayer's arsenal of tax-favored retirement planning vehicles. There are two ways to make contributions to a Roth IRA: through non-deductible cash contributions, or by converting assets in a traditional IRA. A traditional IRA is either a deductible or non-deductible IRA as defined before the 1997 Tax Act.

Because the relatively low income limitations preclude many people from being eligible to make *deductible* contributions to a traditional IRA, the decision of whether to make annual contributions to a Roth IRA is greatly simplified. The more difficult decision (and far more important for many taxpayers), is whether an existing traditional IRA should be converted to a Roth IRA. This decision involves considerations related to tax, retirement, estate, and investment allocation planning and may be influenced by numerous interrelated factors. This is the central focus of this article.

ANNUAL CONTRIBUTIONS

Beginning in 1998, up to $2,000 annually can be contributed to a Roth IRA if modified adjusted gross income (AGI) is:

- No more than $95,000 for single taxpayers.
- No more than $150,000 for joint returns (a spouse may also contribute up to $2,000 annually as long as the couple's combined earned income is at least equal to the contributed amount).
- If you are married but filing a separate tax return you may contribute a portion of the $2,000 maximum contribution amount if your adjusted gross income does not exceed $15,000. However, a proposed technical correction provision may reduce this amount to $10,000.

Although contributions are not deductible, withdrawals from the account are non-taxable if they are made after you reach age 59½, and if at least five years have elapsed since the first Roth IRA contribution was made.

Unlike contributions to a traditional IRA, contributions to a Roth IRA can be made even if you are a participant in a qualified plan such as a 401(k), and even after you reach age 70½.

LIMITATIONS ON CONVERTING

Beginning in 1998, you may convert existing traditional IRAs into a Roth IRA during any tax year in which your adjusted gross income does not exceed $100,000. The same $100,000 limit applies whether you are single or married filing a joint return (married individuals filing separate returns are not eligible to convert regardless of their income level). "Adjusted gross income" for purposes of conversion does not include any taxable income recognized as a result of a conversion to a Roth IRA. In addition, beginning in year 2005, minimum required distributions from any type of plan are also excluded. Your adjusted growth income is on line 32, at the bottom of your Form 1040.

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Although the AGI limitation may initially eliminate you from converting, you may be able to "manage" your income and expenses to keep your adjusted growth income at or below the $100,000 threshold.

For example, a retired taxpayer with significant investment income might shift a large portion of his or her investments to either tax-free municipal bonds or one-year Treasury bills payable after December 31 of the year of conversion. Closely-held business owners might consider shifting income into tax years immediately before or after the year of conversion or pulling deductions into the year of conversion from tax years immediately before and after the year of conversion. Both employees and business owners might reduce their adjusted gross income by increasing their contributions to qualified retirement plans during the year of conversion. Of course, managing income and expenses shouldn't be done to the extent that you have insufficient assets or income to fund living expenses during the conversion year.

If you convert a traditional IRA to a Roth IRA and your income exceeds the $100,000 AGI limitation, you may essentially reverse the transfer any time up to the extended due date of the tax return for the year of conversion. The specific wording of the statute actually allows transfers from one type of IRA to any other type of IRA for any reason, not exclusively in the situation where adjusted growth income exceeds the $100,000 limitation. This creates an opportunity to lock-in a conversion value at or near the lowest IRA account value during the year of conversion. For example, if you convert (or have already converted) your traditional IRA at a time when the IRA account value is high, and your IRA account value subsequently declines in value, you may transfer the converted Roth IRA back to a traditional IRA, and then reconvert to a Roth IRA at the lower IRA account value.

In light of the recent stock market correction, such a strategy may be very beneficial for anyone who made a conversion earlier in the year or for those who have not yet made a conversion but plan to do so.

A direct conversion from a qualified retirement plan, such as a 401(k) plan or a defined-benefits plan, is not allowed. If you have such plans, you would need to first rollover the qualified plan into a traditional IRA and then convert to a Roth IRA. Unfortunately, this is not possible if you are currently employed by the company sponsoring the plan. However, if you have a 401(k) plan with a previous employer, it typically can be converted to a traditional IRA at any time.

SHOULD YOU CONVERT?

There are several major factors that will have an impact on any decision to convert. These include:

Your Tax Bracket in the Years of Conversion and in Year of Distribution

The conversion from a traditional IRA to a Roth IRA will cause the amount converted to be included in your gross income for the year(s) of conversion to the extent that it would otherwise be taxable if taken as a traditional IRA distribution. Your marginal income tax rate in both the year(s) of conversion and the years of future distributions is a critical factor in assessing whether a traditional IRA should be converted to a Roth IRA.

It is interesting to note that there is no difference between paying the income taxes at the "front end" (i.e., making a conversion) or paying the taxes at the "back end" (i.e., not converting) if the marginal income tax rate when making contributions is the same as the tax rate when distributions are taken.

For example, if a fully taxable traditional IRA with a $2 million balance is converted to a Roth IRA, and the applicable marginal income tax rate is 39.6%, income taxes of $792,000 will reduce the balance in the Roth IRA to $1,208,000. After ten years of growth at an 8% rate of return, the $1,208,000 will grow to $2,607,981. On the other hand, if the traditional IRA is not converted, the account will grow (over the same period of time and at the same rate of return) to $4,317,850. Once the taxes of $1,709,869 are paid (again, based on a 39.6% rate), the remaining balance is $2,607,981, the same as the converted Roth IRA. [This example intentionally ignores other benefits of the Roth IRA that would in fact result in a disparity between traditional and converted Roth IRAs, such as the ability to pay the income taxes resulting from the conversion with funds outside the IRA, or the additional deferral benefits of not being required to take minimum distributions prior to the participant's death. These factors are discussed later.]

However, if the marginal income tax rate at the time of conversion differs from the rate at the time of distribution, a disparity in the overall benefits will occur.

If you are in a higher tax bracket in the year(s) of conversion than you expect to be in the years of distribution (likely if you convert during your working years), the net aftertax benefits favor the traditional IRA.

For example, a fully taxable $2 million traditional IRA converted at a 39.6% marginal tax rate would result in an income tax liability of $792,000 leaving $1,208,000 in the Roth IRA. At an 8% compound annual rate of return over 10 years, the Roth IRA will grow to $2,607,981, all of which can be withdrawn completely income tax-free. If the $2 million traditional IRA is not converted, the IRA will grow to $4,317,850, assuming the same 8% compound annual rate of return over 10 years. If the applicable marginal tax rate declines to 31% at the time of withdrawal, a tax liability of $1,338,534 would be owed resulting in a net balance of

$2,979,317.

Therefore, keeping the traditional IRA (i.e., not converting) results in $371,336 of additional aftertax funds. The larger the tax rate differential, the larger the benefit of keeping the traditional IRA.

A decline in tax rates could occur from either a decrease in income in later years or a change in state residence by the taxpayer. Consider, for example, a taxpayer currently working in California or New York who is subject to a marginal state income tax rate of 8% to 10%. If he or she retires to Texas, Florida, or Nevada (which have no state income taxes), the taxpayer's overall tax rate is more likely to be lower, perhaps significantly lower. This common scenario would significantly reduce the benefits of converting to a Roth IRA.

On the other hand, if a taxpayer is in a lower tax bracket in the contemplated year(s) of conversion than he or she expects to be in the years of distribution, the net aftertax benefits favor the Roth IRA.

For example, a $2 million traditional IRA converted at a 36% marginal tax rate would result in an income tax liability of $720,000, leaving $1,280,000. At an 8% compound annual rate of return over 10 years, the Roth IRA will grow to $2,763,424, all of which can be withdrawn completely income tax-free. If the $2 million traditional IRA is not converted, the IRA will grow to $4,317,850, assuming the same 8% compound annual rate of return over 10 years. If the applicable marginal tax rate increases to 39.6% by the time of withdrawal, a tax liability of $1,709,869 would be owed, resulting in a net balance of $2,607,981. In this example, converting to a Roth IRA results in $155,443 of additional aftertax funds. The larger the tax rate differential, the larger the benefit of converting to a Roth IRA.

The result of conversion may be additional taxable income, which can push you into a higher income tax bracket. This tax result may be lessened if the conversion occurs in 1998 due to a special rule that allows the tax liability resulting from a 1998 conversion to be spread ratably over four years. You would report 25% of the conversion income on your tax returns for years 1998–2001. The four-year spread applies automatically unless the taxpayer specifically elects not to have it apply.

The impact of additional taxable income resulting from a conversion may impact the availability of other tax benefits, such as the new child or education credits, or the new deduction for interest expense on a loan for higher education expenses. It would also increase the itemized deduction phaseout that is based on adjusted gross income. The loss of these credits and deductions for a conversion year(s) must be weighed against the long-term tax benefits of a Roth IRA.

Finally, one last consideration is the likelihood that tax rates will simply change. Unfortunately, this is a factor that taxpayers have no control over, and which cannot be easily predicted. In the case of taxpayers who do not plan to take distributions from their IRA for many years, the conversion to a Roth IRA could have detrimental consequences if the federal tax structure was significantly altered, for example, to a flat tax or a national sales tax system.

Source of Payment of Conversion Tax Liability

The source of funds for paying the conversion tax can also have a significant impact on your decision of whether or not to convert to a Roth IRA.

If you can pay the income tax liability arising from a conversion with assets *outside* of your IRA, you may benefit greatly. Paying the tax with non-IRA dollars is equivalent to making an additional contribution to the IRA in the amount of the tax paid. As a result, you have increased the total amount of investments receiving the IRA "tax benefit."

As illustrated earlier, there is no difference between paying the income taxes at the "front end" (i.e., making a conversion) or paying the taxes at the "back end" (i.e., not converting) if the taxes are paid from the IRA proceeds. Recall that in both situations a taxpayer in the 39.6% tax bracket with a $2,000,000 IRA earning 8%, would have $2,607,981 after 10 years. However, if the taxpayer is able to pay the conversion tax liability with funds outside the IRA, the Roth IRA will grow to $4,317,850 after 10 years. Compare this amount to a traditional IRA with a $792,000 "side account" (to represent the conversion taxes paid from non-IRA sources); the traditional IRA grows to $2,607,981, and the "side account" grows (at a 5% aftertax rate of return) to $1,290,085, for a total of $3,898,066 after 10 years. Therefore, by paying the "conversion tax" with funds from outside the IRA, the taxpayer accumulates an additional $419,784 after taxes.

Of course, if you have other deductible qualified retirement plans to which you could otherwise make contributions, up to the amount equal to the tax liability arising from the conversion, the benefits of conversion would be reduced (i.e., in the case where you can only fund one or the other, not both). In addition, to the extent you could contribute to a 401(k) program and receive an employer-matching contribution, the decision not to convert (and instead contribute to the 401(k) plan) may yield greater overall benefits. In other words, paying the tax with non-IRA dollars is like making *additional* IRA contributions.

Conversion will be more beneficial to taxpayers who can pay the conversion taxes with assets outside their traditional IRA, and who do not have access to deductible qualified retirement plans to which they can make additional contributions. High wage

earners who have "maxed out" their qualified retirement plans, and retired taxpayers (without access to qualified retirement plans) may be the most likely candidates.

Minimum Distribution Requirements Prior to Death

Perhaps the most powerful benefit of converting to a Roth IRA is the additional tax-deferral benefits over and above those of a traditional IRA. A Roth IRA, unlike a traditional IRA, does not require minimum distributions until after your death (traditional IRAs require minimum annual distributions once you reach age 70½). If you are married at the time of death, the Roth IRA may be rolled over by your surviving spouse into his or her own Roth IRA, without any required distributions until your surviving spouse's death.

The benefits of additional tax deferral during your life (and your surviving spouse's life) can be astounding, especially for taxpayers who do not need to take withdrawals for living expenses, and who wish to maximize the amount of wealth passing to heirs. Both of these situations are fairly common.

For example, consider two taxpayers, John and Bob, each age 55. They are both married and each have $2 million in traditional IRAs. Each desires to pass their entire IRA to their heirs because they have sufficient other resources for their retirement living expenses. Assume John decides not to convert to a Roth IRA, but Bob converts to a Roth IRA and pays the taxes with funds outside of his IRA. Assume further that all IRA assets earn an 8% compound annual rate of return, and that both taxpayers are currently in, and will remain in, the 39.6% federal income tax bracket.

As a result of the required minimum distribution rules, John must begin to take distributions each year beginning at age 70½, and pay the corresponding income tax on each distribution. If John lives to age 90, and required minimum distributions are calculated using joint life expectancy (assuming John's spouse is the same age as John) with no annual recalculation of their life expectancy, his IRA account will be completely distributed by age 90 (of course, John would have accumulated the "aftertax annual distributions" over the years). To make an accurate comparison to Bob, a "side fund" for John would exist with an initial balance equal to Bob's conversion tax liability of $792,000 ($2 million × 39.6%). Assuming an aftertax return of 5% on both the aftertax accumulated distributions fund and the side fund, John will have a total of $19,225,566 at age 90 ($14,856,882 from the accumulated distributions fund, and $4,368,684 from the side fund).

Because Bob is not required to take any distributions, his account grows to $31,936,344 by age 90. Thus, Bob will have an additional $12,710,778 of taxable estate for his heirs by converting to a Roth IRA!

The benefits of additional tax deferral, however, do not necessarily stop at your death. The minimum distribution rules that take effect upon the death of a participant are the same for both traditional and Roth IRAs, and may allow continued deferral by allowing an IRA account to be distributed over the life expectancy of your "designated" beneficiary(ies).

Other Withdrawal Considerations

Any amount distributed from a Roth IRA is characterized in the following order based upon the value of the account as of the end of the taxable year:

- First, from *annual* contributions to the Roth IRA (to the extent that all previous distributions from the Roth IRA have not yet exceeded the contributions);
- Second, from "*converted*" contributions on a first-in, first-out basis; if a particular converted contribution is being analyzed, the dollars that were includible in gross income by virtue of the conversion come out before non-taxable dollars come out; and
- Third, from earnings.

A taxpayer may generally withdraw contributions to a Roth IRA at any time without tax or penalty. Contributions, in this context, include any amount that was converted from a traditional IRA. There are, however, two exceptions to this rule:

- First, if income caused by a 1998 conversion is spread over a four-year period and a distribution is made anytime during the first three years, such distribution results in an acceleration of the recognition of the deferred income to the extent that it would have been taxed in a later year as a result of the four-year spread.
- Second, with respect to amounts converted (regardless of whether or not the conversion income is spread over four years), if a distribution is made before a five-year period beginning January 1 of the calendar year in which the conversion is made, such distribution is subject to a 10% penalty tax (unless an exception applies) to the extent that the distributed amount would have been taxable if it had been distributed from the traditional IRA and not converted to a Roth IRA. [The 10% penalty tax does not apply if: the taxpayer is 59½ or older; dies; becomes disabled; uses the distributed funds to purchase his or her first home (up to $10,000); receives substantially equal periodic payments; uses the distributed funds to pay medical expenses above 7½% of his or her AGI; uses the distributed funds to pay insurance premiums while unemployed; or uses the distributed funds to pay higher education expenses.]

Earnings in a Roth IRA may be distributed income tax-free if they are withdrawn on or after age 59½, and after a five-year period beginning on January 1 of the tax year in

which the first contribution (whether "annual" or "converted") is made to the Roth IRA. Any distribution of earnings made prior to age 59½, but after the five-year holding period, and that occurs as a result of the taxpayer's death or disability, or that is used to purchase a first home (up to $10,000), is also income tax-free. In addition, any distributions of earnings made prior to age 59½ is subject to a 10% penalty tax (unless one of the exceptions noted above applies) regardless of whether the five-year holding period has been satisfied.

Estate Tax Considerations

For wealthy taxpayers subject to estate taxes, the conversion of a traditional IRA to a Roth IRA will reduce their taxable estate by the amount of income taxes paid as a result of such conversion. For example, consider a taxpayer subject to a 35% marginal income tax rate (federal and state) and a 55% estate tax rate with a $2 million traditional IRA and an estate of $5 million. If the taxpayer converts the traditional IRA before his or her death, income tax of $700,000 will be due, thereby reducing the taxpayer's taxable estate by $700,000, and saving $385,000 in estate taxes.

If the same taxpayer dies without converting the $2 million traditional IRA, the entire account constitutes "income in respect of a decedent," does not receive a step-up in tax basis, and therefore, is subject to both estate and income taxes. The recipient of the traditional IRA is allowed a miscellaneous itemized income tax deduction (not subject to the 2% of adjusted gross income floor) for any estate taxes paid on the IRA, however, the deduction is only for federal (not state) estate taxes, and is subject to the 3% phaseout of itemized deductions.

Conversion of a traditional IRA will also be beneficial if that IRA is being used to fund a credit shelter trust to ensure both spouses' applicable estate tax exemption amounts are fully utilized. Funding a credit shelter trust with a Roth IRA allows the ultimate recipients to receive such assets free from both estate and income taxes.

Social Security Considerations

Considerations surrounding Social Security benefits might also impact your decision of whether or not to convert a traditional IRA to a Roth IRA. A conversion may subject a larger portion of your Social Security benefits to taxation as a result of the taxable income that must be recognized in any year in which a conversion is made (or over four years if the conversion is made in 1998).

However, you may still benefit overall (even if a greater portion of Social Security benefits is subject to taxation in the year(s) of conversion) since Roth IRA withdrawals are not subject to tax if they satisfy the special earnings withdrawal rule. For example, once you convert a traditional IRA, and pay the resulting income tax, all future distributions from the Roth IRA are excluded from taxable income. Additionally, none of the funds are subject to the minimum distribution rules imposed on traditional IRAs at age 70½; this may allow you to reduce (or perhaps avoid) income tax on your Social Security benefits.

THE DOWNSIDE: UNCERTAINTY

Because the Roth IRA is new, the rules governing its treatment (both tax and non-tax) are uncertain and subject to change. Congress has addressed numerous initial uncertainties through technical corrections and recently issued regulations. However, because the Roth IRA is so new, there are likely to be some factors and aspects that simply will not be fully known and understood for some time.

Consider that in many states, Roth IRAs do not currently enjoy the same protection from creditors afforded traditional IRAs. The reason is that most state statutes specifically refer to Internal Revenue Code section 408, and Roth IRAs are allowed under a new code section, 408A. It is expected that most state legislatures will act quickly to provide Roth IRAs with the same creditor protection as traditional IRAs, but until such time, this could be a concern for certain taxpayers.

Taxpayers should also verify that their state conforms to federal law with respect to the tax treatment of Roth IRAs. Otherwise, IRA funds could be subject to state taxation at the time of conversion from a traditional IRA, and when funds are ultimately withdrawn from the Roth IRA.

Another concern that many people have expressed is the possibility that Congress could simply change its mind about the taxation of Roth IRAs. One author, Richard J. Werts, in "The Promise of No New Taxes—Will We Ever Learn?" has expressed this concern in noting: ". . . we only need to look to the history of the Social Security Act and Administration to see an uncanny example of an about-face by the Congress on the tax-free promises of deferred withdrawals. The Social Security tax itself is a "forced" Roth-like retirement deferral . . . the contributions are aftertax (i.e., no net taxable benefits occur due to "contributions") and the "withdrawals," in the form of Social Security benefits upon disability or retirement, were tax-free. Tax-free, that is, until the clever and reasonable argument was made that people with other incomes SHOULD pay tax on their Social Security benefits. After all, they are getting much more out than they put in. Exactly the position that all of us will be in when we wish to begin liquidating our Roth IRAs."

In addition to simply subjecting Roth IRAs to taxation, Congress could make other changes that would impact the overall benefits of Roth IRAs by, for example, applying the same minimum distributions

rules applicable to traditional IRAs once a participant reaches age 70½, accelerating the recognition of Roth IRA funds at the death of the participant—(thereby removing the benefit of additional tax-free deferral over the lives of designated beneficiaries), or characterizing Roth IRA distributions as "alternative minimum tax" preference items.

There is, of course, always the possibility that Roth IRAs already in existence would be grandfathered from any future tax law changes, but unfortunately, it is never certain whether such grandfather provisions will provide sufficient protection of all current benefits.

MAXIMIZING THE BENEFITS

Once you have determined that you qualify to convert your traditional IRA, and that you should in fact do so, the next question (of potentially considerable importance) is *when* should you convert? You should carefully consider the timing (and amount) of your conversion(s) so as to maximize the benefits of conversion.

Although a conversion in 1998 is granted special treatment by allowing the taxable income resulting from the conversion to be spread over four years, you may be better advised to wait to convert your traditional IRA until after 1998, convert over two or more years, or convert in an amount less than the entire account balance.

For example, a conversion after 1998 might be advised depending on your other tax attributes. If a large charitable donation is planned in a subsequent year, the additional taxable income from conversion may allow more of the charitable contribution to be deductible in the year of the donation. If you intend to retire in a few years and will be in a lower tax bracket at that time, delaying conversion of your IRA could be beneficial.

Conversion over two or more years might be advised in an effort to reduce the impact of the graduated tax structure by converting just enough assets so as not to trigger the imposition of a higher tax bracket.

If you intend to use at least some portion of your traditional IRA assets to pay for living expenses during your retirement, but also desire to pass some portion to heirs, the optimal plan might call for conversion of only a portion of the traditional IRA. Your objective is to avoid mandatory withdrawals in excess of income needs due to the minimum distribution rules applicable to traditional IRAs. The optimal plan in this situation would involve two stages. During the first stage of retirement, income is provided exclusively from the traditional IRA in compliance with the minimum distribution rules. The goal during this stage is to completely consume the traditional IRA before the last to die of you and your spouse.

During the second stage, the Roth IRA is used to fund retirement income needs after the traditional IRA has been depleted. The optimal plan will thereby free you from the escalating minimum distribution requirements and allow all remaining account assets to pass to heirs completely income tax-free.

Therefore, by determining your income needs over these two stages, you might maximize your overall benefits by converting only the amount of the current traditional IRA needed to satisfy living expenses during the first stage of retirement.

CONCLUSION

Because so many factors may influence the decision of whether to convert a traditional IRA to a Roth IRA, you need to give careful consideration to the overall impact of numerous and competing factors. There is simply no substitute for crunching the numbers, under multiple scenarios. Even then, the conversion decision depends, to some extent, on your ability to accurately "predict" your personal and financial status in the future, as well as the future tax and legal environment.

To briefly summarize, the following factors will generally tip the scales:

Factors in Favor of Converting

- You are eligible to convert in 1998, and can thereby take advantage of the four-year spread of the income recognized as a result of the conversion.
- You intend to transfer the bulk of your IRA to heirs; avoidance of the required minimum distribution rules at age 70½ results in greater accumulation of IRA assets that may pass to heirs.
- You are able to pay the conversion tax liability from sources outside your IRA account.
- You anticipate being subject to a higher marginal income tax rate during the years you make distributions from the IRA account.

Factors in Favor of Not Converting

- You anticipate being subject to a lower marginal income tax rate during the years you take distributions from the IRA account.
- You have significant fears or expectations that Congress will change the laws in such a way that Roth IRAs will be negatively impacted.

Because the conversion decision can impact tax, retirement, estate, and investment allocation planning, you may want to consult your financial planning professional. ✦