IRA CONVERSIONS: OLDER TAXPAYERS NEED TO CONSIDER SPECIAL FACTORS

By Paul Erickson and Don Cunningham

There are several factors that are frequently ignored when individuals are trying to decide whether to convert a traditional IRA into a Roth IRA, in particular the estate tax consequences. Even many of the popular conversion calculators available on the Internet do not quantify these factors, which can result in erroneous decisions.

Have you considered converting a traditional IRA into a Roth IRA? Perhaps you have plugged the numbers into one of the many IRA conversion calculators available on the Internet and concluded that conversion is not advantageous.

Unfortunately, the failure of these calculators to fully consider all factors can lead to serious error. The primary articles of information used to compute net conversion values are tax rates, age, and rate of return. Although the net dollar results can vary, the decision whether to convert or not is generally the same. Most, if not all, conversion calculators ignore or simply note other important factors that need to be considered in the conversion decision. For example, there are numerous income tax advantages to the Roth IRA, as well as an important estate tax effect, that are not quantified in these conversion calculators.

This article discusses the missing income tax factors and demonstrates how omission of the estate tax effect can lead to an erroneous conversion decision.

ROTH IRA ADVANTAGES

The Roth IRA offers four important income tax advantages over the traditional IRA:

- The traditional IRA does not allow contributions beyond age 70½, whereas the Roth IRA has no maximum age at which contributions must cease. As a result, the Roth IRA provides a mechanism for continuing tax-free accumulation beyond the period allowed by the traditional IRA.
- Distributions from a regular IRA are included in adjusted gross income, and therefore can increase the amount of Social Security receipts subject to income tax. In contrast, Roth IRA distributions are not taxable and do not affect the taxability of Social Security receipts.
- Under the traditional IRA the taxpayer must begin mandatory distributions at age 70½. All earnings and previously deducted contributions are taxable, which in most cases is 100% of the distribution. These early distributions and their taxation limit the traditional IRA's potential to generate tax-free accumulation. Obviously, if the taxpayer lives beyond 70½ years and does not need to withdraw the funds for retirement, the Roth IRA offers greater potential for tax-free accumulation.
- The Roth IRA offers an additional deferral opportunity. Although either IRA can be distributed over the remaining life expectancy of heirs, distributions from the Roth IRA can be deferred until the death of both taxpayer and spouse. This deferral occurs because a Roth IRA left to the taxpayer's spouse is treated as if originated by the surviving spouse. Distributions are not required until the spouse dies, at which time the fund is distributed over the life of the spouse's heirs, with tax-free accumulation to those heirs as well. Under the traditional IRA, distributions must begin immediately upon the death of the original owner. The heirs have the option to receive these distributions over their life expectancy or a period not to exceed five years beyond the end of the tax year of the decedent's death. The heirs pay

Paul Erickson is a professor in the Department of Accounting, and Don Cunningham is a professor in the Department of Finance at Baylor University, Waco, Texas.

income tax on the taxable portion of these distributions at their marginal income tax rates.

If none of these factors are considered, the traditional (deductible) IRA and the Roth IRA produce the same investment results. The tax benefits of the Roth IRA benefits are simply "back-loaded"—in other words, taxes are paid at the beginning and the tax benefits occur at the end—whereas the tax benefits from the traditional IRA are "front-loaded." But the ending amounts will be the same assuming the tax brackets do not change.

For example, assume a taxpayer in the 28% income tax bracket remains in that bracket upon retirement in 20 years. Investments earn 7% before tax, and all contributions and earnings are withdrawn at retirement.

For comparison purposes, the pretax traditional contribution must be compared with the pretax equivalent of a Roth IRA contribution. If a taxpayer in the 28% income tax bracket chooses the deductible IRA, a $2,000 aftertax contribution has a pretax equivalent contribution of $2,778 [$2,000 × (1/1 – 0.28)]. This amount accumulates tax-free and then incurs taxes at distribution, for a net after-all-taxes amount of $7,740 [$2,778$(1 + 0.07)^{20}$ (1 – 0.28)]. If the taxpayer chooses the Roth IRA, $2,778 must be earned to pay taxes up front of $778, for a net aftertax contribution of $2,000. This aftertax $2,000 contribution also accumulates to a distributable net after-all-taxes amount of $7,740 [$2,000$(1 + 0.07)^{20}$]. For both IRAs, the net distributable amount is the same.

In general, if tax rates are not the same at the time of the contribution and the time of distribution, one type of IRA will be more advantageous than the other:

- If tax rates increase in retirement years, or if the taxpayer dies and leaves the IRA to beneficiaries with income tax rates higher than the taxpayer's income tax rate, then the Roth IRA is more favorable. This occurs because taxes paid on contributions are computed at a lower rate than the

TABLE 1. IRA CONVERSIONS AND THE EFFECT OF ESTATE TAXES

Age in the year of conversion	55
Tax filing status	Married/Joint
Expected taxable income in year of conversion	$85,000
Income tax rate in the year of conversion	28%
Current balance for all IRAs	$100,000
Amount of Roth conversion	$100,000
Non-deductible contributions	0
Mutual fund investment for IRA	Fixed income
Average annual expected return	8%
Age at withdrawal	65
Income tax rate in the year of withdrawal	20%

Results	**Convert to Roth IRA**	**Keep Trad'l IRA**	**Gain (Loss) If Trad'l Kept**
Initial investment	$100,000	$100,000	
Balancing account (tax saved by not converting)		$31,933 (a)	
Total aftertax value upon withdrawal	$215,892 (b)	$228,619 (c)	$12,727
Vanguard's Conclusion: Keep traditional IRA.			
Estate Tax Considerations			
Estate Tax Effects		($27,953) (d)	
Results after considering estate tax savings	$215,892	$200,666	($15,226)

(a) The balancing account is the income tax saved by not converting. Because an additional $100,000 is included in gross income when taxed upon conversion, part of the taxpayer's income is taxed at 31% and part is taxed at 36%.

(b) Accumulation after 10 years at 8%: $100,000 × $(1.08)^{10}$.

(c) Accumulation of traditional IRA minus taxes at withdrawal, plus accumulation of balancing account invested at an aftertax 5.76% rate of return: [$100,000 x $(1.08)^{10}$ × (1 – 0.20)] + $31,933 × $(1.0576)^{10}$.

(d) The estate tax effect is the amount of estate taxes due on the balancing account—it is the future value of the balancing account invested at a 5.76% aftertax rate of return multiplied by the estate taxes of 50% due at date of death [$31,933 × $(1.0576)^{10}$(0.50)].

rate applied to distributions from the traditional IRA.
- If tax rates decrease in retirement years, or if the beneficiaries' income tax rates are lower than the decedent's rate at conversion, then the traditional IRA is preferred over the Roth IRA.

However, this second generalization does not always hold true if estate taxes are considered. The next section demonstrates how estate taxes result in a greater tax burden on the traditional IRA than on the Roth IRA—an effect that should be considered in the conversion decision.

THE ESTATE TAX FACTOR

The estate tax does not distinguish between the funds subject to income tax in the traditional IRA and the non-taxable funds in a Roth IRA. Both types of IRAs must be included in the decedent's gross estate at fair market value and taxed at the estate's marginal estate tax rate.

However, unlike Roth IRA earnings, traditional IRA earnings do not escape income taxation after death because they are considered "income in respect of decedent." Recipients of traditional IRA earnings must pay income tax on these earnings at their respective income tax rates. As a result, the estate of the taxpayer with the traditional IRA has the extra burden of paying estate taxes on funds that will be used to pay income taxes.

The estate of the taxpayer with the Roth IRA escapes this burden, because the estate is reduced by the amount of income taxes paid as a result of conversion. The net result is a higher total tax bill for the estate of a taxpayer with a traditional IRA.

For example, assume that a taxpayer in the 28% income tax bracket and the 50% estate tax bracket owns a traditional IRA worth $100,000 (all subject to income taxes) and a savings account of $28,000 on which no income tax is owed. If the taxpayer dies today, his estate incurs $64,000 in estate taxes on the aggregate value ($128,000) of his IRA and savings account. If the heirs are also in a 28% income tax bracket, they will subsequently pay an additional $28,000 in income taxes upon collection of the $100,000 IRA (plus tax on additional earnings). The total tax liability is $92,000 for these two assets.

If instead, the taxpayer converted the traditional IRA to a Roth IRA, he could save $14,000 in estate taxes. At conversion, he would incur $28,000 in income tax (due three and one-half months after the year in which conversion occurs), which lowers the gross estate by $28,000. The heirs would pay no income tax upon receipt of the Roth IRA fund, and the estate would pay $50,000 in estate taxes [50% of the remaining $72,000 Roth IRA plus the $28,000 savings account]. The total tax liability is $78,000 for these two assets [$28,000 upon conversion, plus $50,000 in estate taxes], which is $14,000 less than the total taxes paid with no conversion.

The greater the time between the date of conversion and the date of death, the greater the tax savings. However, the following example illustrates the non-conversion recommendation of a popular Web site calculator for a 10-year holding period from the date of conversion to the expected date of withdrawal. We use these results here to demonstrate the error of not converting if death should occur at the effective date of withdrawal.

Suppose a married taxpayer holds a traditional IRA (deductible) with a value of $100,000 ($0 basis). Taxable income is $85,000 and the marginal income tax bracket is 28%. Assume the associated income tax due when the traditional IRA is converted to a Roth IRA is paid from a source other than the IRA. [It is usually unwise to pay income tax from IRA funds]. The taxpayer is age 55 and plans to retire at the age of 65. The income tax rate upon retirement declines to 20% and the investment rate is 8%.

Using a popular conversion calculator available on the Internet [Vanguard's Roth IRA Conversion Worksheet, at www.vanguard.com/cgi-bin/RothConv], the value of the traditional IRA is $228,619 and the value of the Roth IRA is $215,892. The calculator recommends that the taxpayer not convert to the Roth IRA because the value of the traditional IRA is greater by $12,727 (see Table 1).

However, there is one important factor missing in this scenario: Suppose the taxpayer dies at age 65. Including the estate tax consequences in the example illustrates the potential error in the recommendation not to convert. If the estate tax savings were recognized from converting to the Roth IRA, then it would be advantageous to convert, even though the conversion calculator indicates otherwise. As shown in the table, the estate tax effect reverses the value of the traditional IRA over the Roth IRA from an excess of $12,727 to a deficit of $15,226. This occurs because the estate of the holder of the traditional IRA pays $27,953 more in estate taxes than it would pay had the holder converted to the Roth IRA.

CUSTOMIZED MODIFICATIONS

When working with conversion formulae, you can modify the traditional IRA value that has excluded the estate tax factor to see what the consequences would be:
- Determine the balancing account (the income tax saved by not converting); and the aftertax rate of return (ATR) on that account—the expected rate of return (IR) multiplied by one minus the marginal tax rate (T) [$ATR = IR \times (1 - T)$].
- Multiply the balancing account (BA) by the future value factor for the number of years (n) between conversion and expected date of death at the aftertax rate of return [$BA \times (1 + ATR)^n$].
- Multiply this result by the marginal estate tax rate.

- Subtract this result from the total accumulated value given for the traditional IRA.

This number should be compared to the total accumulated value given for the Roth IRA. It is important to note that even if the numbers recommend not converting after the estate tax factor is considered, the benefits derived from the income tax advantages previously discussed may still justify a conversion. For example, if estate taxes are low or nonexistent, then the calculator's recommendation to not convert is correct. However, if the spread between future values of converting or not converting is low, additional income tax benefits of the Roth IRA could still justify converting the traditional IRA to the Roth IRA.

CONCLUSION

There are several implications about the decision to convert from a traditional IRA to a Roth IRA that are ignored by conversion calculators. These factors are particularly important if the holder of the IRA has no real need for the funds.

Estate taxes impose a severe penalty on traditional IRA accounts by making no distinction between before-tax and aftertax dollars. In effect, the taxpayer's estate pays estate taxes on funds used to pay income taxes on the distribution of earnings.

Conversion to a Roth IRA avoids the estate tax on income taxes because income taxes paid at conversion reduce the taxpayer's taxable estate.

It is simply wise decision-making to consider the issues raised here and perform the necessary calculations before arriving at a decision of whether or not to convert a traditional IRA to a Roth IRA. ✦

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