Estate planning opportunities with Roth IRA conversions

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Executive summary. Beginning January 1, 2010, as part of the Tax Increase Prevention and Reconciliation Act of 2005, several favorable provisions for Roth conversions were introduced. These changes provide opportunities for many individuals who were previously restricted from completing Roth conversions. Here we examine Roth conversions with a particular focus on the estate planning considerations for high net worth individuals.[1]

Figure 1, on page 2, outlines major aspects of the tax law changes that apply to Roth IRA conversions.

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1 For a broader discussion of Roth conversions, see Bruno and Jaconetti (2009).

Figure 1. Roth IRA rules: What has changed in 2010?

	Rules prior to 2010	Rules as of January 2010
Contributing to a Roth IRA	Modified adjusted gross income limits apply.	Same rules apply. MAGI limits for 2010 are: Single: $120,000 Married, filing jointly: $177,000
Converting to a Roth IRA	Individuals with MAGI of $100,000 or less could convert a traditional IRA or employer plan account to a Roth. Married couples who file separately could not convert (unless the two had lived apart for more than one year).	The income limits are removed. For 2010 conversions only, any taxable income created by the conversion can be spread evenly across the 2011 and 2012 tax years, unless the taxpayer chooses to recognize the income in 2010. The rule against married couples who file separately is lifted.

Notes: The investor must be able to report earned income greater than or equal to the contribution. See also footnote 2 of this paper.

Source: Vanguard.

Background

With a traditional IRA[2], investment contributions in many cases are tax-deductible, depending on the individual's income and whether he or she participates in an employer-sponsored retirement plan, such as a 401(k). The account grows tax-deferred until the account owner makes withdrawals, which are then subject to ordinary income taxes. In addition, account owners are required to take minimum distributions beginning at age 70½.

On the other hand, with a Roth IRA, investors contribute after-tax dollars. The account grows tax-free, and qualified withdrawals are tax-free. In addition, Roth IRA owners are not subject to required minimum distributions, so these accounts may benefit from a prolonged period of tax-free growth.

When a traditional IRA is converted to a Roth, any pre-tax IRA assets that are converted are subject to income tax. This tax liability presents some key considerations for anyone deciding whether to make a conversion.

From a planning perspective, it is also important to keep in mind the situations that apply to IRA beneficiaries. For example, non-spouse beneficiaries of both traditional IRAs and Roth IRAs are required to take minimum distributions upon the death of the account owner. However, Roth IRA distributions will be tax-free to the beneficiary, whereas those from a traditional IRA will be taxed as ordinary income. If a spouse assumes a traditional IRA, he or she will be subject to RMDs beginning at age 70 1/2; with a Roth IRA, by contrast, the spouse will not have to take RMDs.

A broad overview of federal estate taxes

Before we discuss the estate-planning opportunities offered by Roth IRA conversions, an overview of the estate tax laws may be helpful. (Note that in this paper we focus specifically on the federal estate tax. We do not address other taxes, such as the inheritance or estate taxes imposed by some states or the federal generation-skipping transfer tax.)

2 We use the term "*traditional*" throughout to mean any tax-deferred (non-Roth) IRA.

When an individual passes away, the federal government imposes an estate tax on his or her worldwide assets. The assets are generally assigned their value as of the date of death. The current status of the estate tax is unusual: Under the Economic Growth and Tax Relief Reconciliation Act of 2001, it technically does not apply to the assets of those who die in 2010. However, at the time of this writing it is generally anticipated that Congress will act this year to reinstate the estate tax, which may be applied retroactively. In the absence of any new legislation, the estate tax will reappear in 2011 with an exemption level set at $1,000,000. (The exemption defines the amount of assets that effectively pass to heirs free of estate tax.)

Figure 2. Federal estate tax rates and exemption amounts

Year	Estate tax rate	Estate tax exemption
2005	47%	$1,500,000
2006	46%	$2,000,000
2007	45%	$2,000,000
2008	45%	$2,000,000
2009	45%	$3,500,000
2010	No tax imposed as of this writing	No tax imposed as of this writing
2011	55%	$1,000,000

Source: Vanguard.

In short, at present it is unclear what form the estate tax will take when reinstated. **Figure 2** shows the tax rates and exemption amounts that have existed in recent years.

For purposes of this article, we will assume that an estate tax is in place.

Concepts that can help in assessing Roth estate planning opportunities

Given the existence of an estate tax, there are three general "rules" to keep in mind when evaluating the estate planning opportunities available under the new Roth conversion rules.

1. It is generally more advantageous for a decedent to leave assets that do not have an attached income tax liability. Assets with such embedded tax liabilities include traditional IRAs and annuities. If the estate of a traditional IRA owner is large enough to incur estate taxes, the IRA beneficiaries[3] are likely to face "double-taxation" on that asset. First, the IRA is included in the taxable estate; second, the beneficiary is liable for income tax on any future withdrawals from the IRA, including required minimum distributions (RMDs).[4]

2. The estate tax is *tax-inclusive*. In other words, the assets that will be used to pay the estate tax are the same assets that are taxed.

3. The income tax on assets converted from a traditional IRA to a Roth may be *either* tax-exclusive *or* tax-inclusive. The IRA assets need not be used to pay the tax; instead, the investor can use another source, making the conversion tax-exclusive. Indeed, this is often an ideal strategy (of course after considering any capital gains that may result from selling assets within taxable accounts), as it allows for the entire pre-tax IRA balance to move to the Roth account, essentially increasing the after-tax value of the IRA. On the other hand, in a tax-inclusive conversion, the income tax is paid from the traditional IRA assets and the Roth account value is reduced accordingly. Note that when taking withdrawals from an IRA before age 59½, the investor may have to pay ordinary income tax plus a 10% federal penalty tax.

3 It is worth reminding IRA owners that a beneficiary designation supersedes a will. Periodic review of beneficiary designations will help owners ensure that their IRA assets go where intended.

4 It should be noted that taxpayers are generally able to take an income tax deduction for the prorated amount of any estate tax on the traditional IRA in proportion to the RMD (or any withdrawal) that had to be taken in that year.

Furthermore, given these general concepts, the following estate planning opportunities may exist under the conversion rules. We underscore that state planning should be approached holistically; that is, considering the transfer of wealth either during one's lifetime or after death, based on one's specific goals.

A Roth conversion essentially changes an asset with an embedded income tax liability to one with no such tax liability. As a result, a Roth conversion may minimize, or even help avoid, the double taxation if there is a taxable estate.

Regardless of whether an IRA owner expects to leave a taxable estate, "pre-paying" the income tax may be attractive in several instances:

- When the IRA owner's income tax bracket is lower than, or the same as, the beneficiary's bracket.
- When the IRA owner can pay the conversion tax without using the IRA assets, particularly if there is a taxable estate.
- When there is a long time horizon. Note that there is typically a five-year holding period for Roth conversions to avoid penalties. Further, the longer the account is not subject to distributions, the more potential exists for extended tax-free growth in the Roth account.

Aside from any tax benefit to an estate, some investors may place value on the satisfaction of holding an asset on which no future income tax is owed. A Roth IRA, at the owner's death, is subject only to estate tax.

The income tax paid on the conversion would reduce one's taxable estate.

Once a traditional IRA is converted to a Roth IRA, the estate is reduced by the amount of the conversion taxes paid and any future appreciation of these assets. We illustrate this concept with a very simplified example in **Figure 3.**

Figure 3. Hypothetical example of how a Roth conversion reduces an estate

Roth IRA conversion	$500,000
Marginal tax bracket	35%
Income tax due on conversion	**$175,000**
Estate reduction	**$175,000**
Estate tax rate	45%
Estate tax savings	**$78,750**

Note: This is a very simplified example, assuming a taxable estate and flat income and estate taxes. Actual tax due or tax savings may be affected by other deductions and credits.

Although the amount may not be large, this method of estate reduction can be applied without making use of the gift tax exemption (the lifetime amount that can be transferred free of gift tax—currently $1,000,000) or annual exclusion amounts (the annual amount that can be given per donor and donee—currently $13,000).

A charitable contribution may offset some of the tax liability incurred in a conversion. An IRA owner planning a Roth conversion may want to consider making a charitable contribution in the same tax year to partially offset the income tax liability resulting from the conversion. Use of a donor-advised fund or family private foundation would provide flexibility with respect to timing and amounts of distributions to charities. Furthermore, the deductibility of charitable contributions is based on adjusted gross income levels. The income resulting from a Roth conversion would increase the account owner's adjusted gross income, thus allowing for a greater charitable contribution.

Guidelines to consider before converting

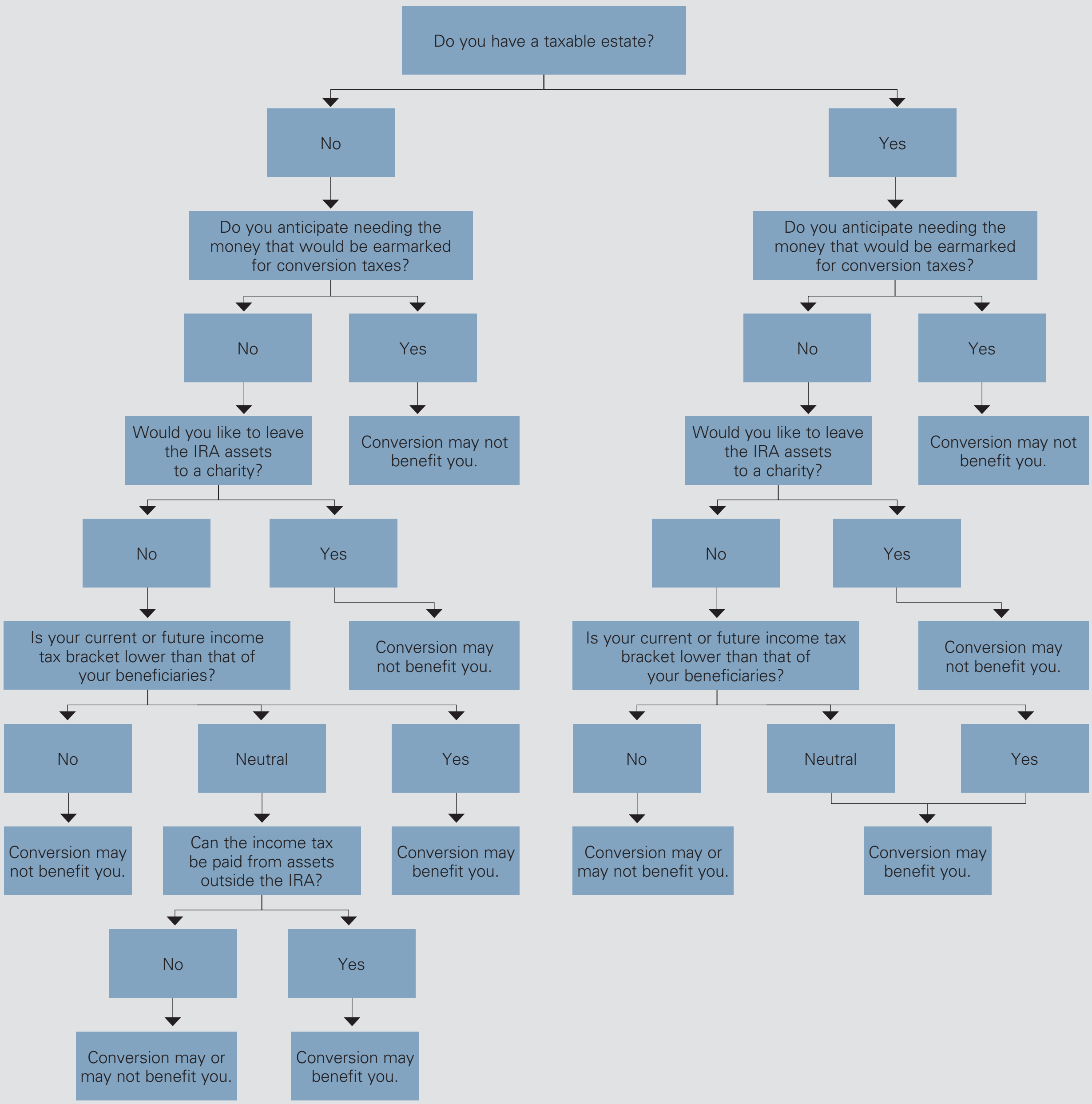
Estate planning is a highly personal process. Decisions that are right for one individual may not be right for another individual in a similar circumstance. This is certainly true for the decision about whether to convert a traditional IRA into a Roth IRA. Nonetheless, there are a few general guidelines that are relevant for anyone who is considering a Roth conversion.

- As noted previously, converting to a Roth IRA is generally more advantageous when the account owner anticipates being in a higher (or similar) income tax bracket in the future. In estate planning, the beneficiary's anticipated tax bracket should be considered along with the owner's. A conversion becomes more appealing if the owner's current bracket is lower than that expected for the beneficiaries.
- A conversion should be considered if the IRA owner does not expect to need the assets during the remainder of his or her lifetime. If there are cash-flow concerns, particularly early in retirement, then pre-paying the income tax may present a financial risk that outweighs any prospective benefits.
- If in any given year an individual has large income tax deductions that cannot be fully used on his or her personal federal income tax return (potentially even creating "negative taxable income"), there may be a unique opportunity to benefit from a Roth IRA conversion. By making at least a partial conversion of traditional IRA assets, the taxpayer can make full use of the deductions to offset the income tax due on the conversion. (Similar logic could apply to an individual who is in an unusually low tax bracket for the year.)
- A Roth conversion may provide "tax-diversification" benefits, assuming that the investor retains some assets in a traditional IRA or other retirement account. By holding different account types (taxable, tax-deferred, Roth), the investor obtains some insulation from the uncertainty of future tax rates, regardless of their direction.

Inevitably, these opportunities are accompanied by some considerations that should give IRA owners pause.

- If the owner of a traditional IRA intends to leave a large portion of his or her estate to a charity, then it is typically more advantageous to use some or all of the IRA assets for this purpose without making a conversion. The charity, because of its tax-exempt status, will not have to pay income tax when it draws on the traditional IRA assets.
- As discussed above, for some IRA owners, the opportunity cost of prepaying the income tax may be too great. The tax liability resulting from a conversion could be substantial, and the assets used to pay that tax might be invested tax-efficiently in many other ways while remaining available to support the account owner's lifestyle. Further, for some individuals, the immediate loss of assets to pay the conversion tax may present a psychological barrier.
- Finally, the success of a Roth conversion relies heavily on the assumptions made in projecting the growth of the IRA assets, the income taxes owed not only by the IRA owner but also by the beneficiary, and the estate tax laws that apply at the IRA owner's death. The current uncertainty about the U.S. income and estate taxes, as well as the inability to predict the financial markets, highlights the difficulty involved in making such assumptions. This is one of the reasons we recommend consultation with a tax-planning professional.

Decision tree: How a Roth conversion may fit in with the estate-planning process



Note: This decision tree offers only broad guidelines, and it is not intended as a rule for individual situations. IRA owners should consult with a tax-planning or estate-planning professional before deciding to convert.

Source: Vanguard.

Conclusion

A common financial planning tenet is for an investor to defer paying taxes as long as possible. A Roth conversion essentially defies this tenet, as the account owner is accelerating a tax liability in exchange for tax-free growth, with the hope of a lower overall tax bill—the benefit of which may be recognized during the account owner's lifetime or in the beneficiary's lifetime. In some cases, the decision may seem clear-cut. However, in many situations, particularly with regard to estate planning, the trade-offs are not easily quantifiable, and personal circumstances and beliefs will likely drive the conversion decision.

Estate planning should be approached holistically, taking into consideration not only the account owner's investments, income, and retirement goals but also the beneficiary's circumstances with respect to the same questions. The decision appropriate for one individual may not be right for another person in similar circumstances. As with any estate planning technique, the Roth conversion decision requires careful consideration. Accordingly, it is a good idea to consult with a tax-planning professional.

Reference

Bruno, Maria A., and Colleen M. Jaconetti, 2009. *The Rules for Roth Conversions are Changing in 2010*. Valley Forge, Pa.: Vanguard Investment Counseling & Research, The Vanguard Group.

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