

## { Introduction }

Beginning in 2010, Congress changed the law so that anyone regardless of income level can now convert his or her traditional individual retirement account (“IRA”) or other qualified retirement plan to a Roth IRA. While much has been written about the income tax benefits of converting an IRA to a Roth, this article focuses on the unique estate planning opportunity persons of significant wealth now have which will allow a converted IRA to be left for heirs while also providing the IRA owner with tax-free income for years to come.

## { Traditional IRA versus Roth IRA }

### MECHANICS OF THE TRADITIONAL IRA

Under current law, contributions to a traditional IRA are made with *pre-tax* dollars so that the investment grows on a *tax-deferred* basis since amounts earned inside the account, including contributions and appreciation, are not taxed until distributions are made to the plan participant at a later date. Traditional IRAs are subject to distribution requirements when the plan participant attains age 70 ½ called “**required minimum distribution**” (RMD). Generally, a person must begin taking the RMDs no later than April 1 of the year following the calendar year he or she attains age 70 ½. In addition, the period for taking the RMDs cannot exceed the joint life expectancy of the plan participant and the designated beneficiary. Consequently, distributions are forced out of the tax-favored environment of the IRA thus resulting in income tax to the owner every year thereafter. The result is that the RMD rules serve to continually diminish the tax-deferred amount remaining inside the account.

### MECHANICS OF THE ROTH IRA

On the other hand, contributions to a Roth IRA are made with *after-tax* dollars so that all appreciation inside a Roth account perpetually grows *tax-free*. For that reason, there is no income tax associated with a withdrawal by the plan participant of the funds from the Roth account during retirement or upon distributions to his or her designated beneficiaries. Further, pre-death RMD rules imposed on traditional IRA owners described above do not correspondingly apply to the Roth owner. Accordingly, the plan participant will no longer be required to take any RMDs during life (after attaining age 70 ½) once a conversion of the traditional IRA to a Roth is completed. However, while the plan participant is no longer subject to the RMD rules, his or her designated beneficiaries receiving the Roth account will be required to take RMDs over the beneficiary’s life expectancy. Still, unlike the traditional IRA, distributions received by a Roth beneficiary will be income tax-free!

## TIPRA AND THE ROTH CONVERSION

The *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) signed by President George W. Bush on May 17, 2006, made fundamental changes to the rules for a Roth conversion beginning in 2010. The \$100,000 income limitation that prevented most wealthy individuals from converting a traditional IRA to a Roth no longer applies beginning in 2010. Therefore, anyone can convert all (or a portion) of his or her traditional IRA to a Roth. The conversion requires the payment of the income tax liability associated with the converted amount. However, plan participants completing conversions in 2010 are eligible to have half of the converted amount taxed in 2011 and the remaining half of the converted amount taxed in 2012— *meaning income taxes related to the 2010 conversion are “stretched out” over two additional years* (i.e., taxes are payable on April 15, 2012 and April 15, 2013, respectively). This onetime tax deferral benefit only applies to conversions made in 2010. So for conversions in 2011 and after, the entire conversion amount must be included in the plan participant’s gross income the tax year in which the conversion is completed. Lastly, note that lifting the income limitation for the Roth allows for conversions of existing IRA accounts, but not for funding of a new Roth IRA account.

## ROTH CONVERSION BENEFITS

Notwithstanding the income tax liability associated with the Roth conversion, we believe there are still significant tax benefits which can be attained through a conversion which could be well worth the cost of paying the income tax now rather than over time.

Roth conversion benefits can be magnified for those individuals with large IRAs who do not need the funds for retirement. By converting the IRA during the owner’s lifetime, the Roth account will grow on a tax-free basis without reduction by any RMDs upon the owner attaining age 70 ½ (since RMDs would no longer apply). After the IRA owner’s death, the IRA account will pass to his or her designated beneficiaries who can use the Roth IRA as a tax shelter and continue the IRA assets’ growth inside the tax-free environment over the beneficiary’s lifetime. What’s more, RMDs made each year to the beneficiary over his or her lifetime are income tax-free. In other words, the Roth account can be much more valuable than any brokerage or bank account because heirs are given an opportunity to receive tax-free growth within the Roth IRA long term, perhaps decades.

Note that the RMD rules which do not apply to the Roth owner (as in the traditional IRA) will however apply to the owner’s designated beneficiaries. The RMDs are required to be made over each beneficiary’s own life expectancy (if structured properly). Thus, owners should consider naming *grandchildren* (or trusts for their benefit) as the designated beneficiaries of the Roth in order to maximize the period over which RMDs must be taken thereby compounding the potential tax benefits and growth inside the IRA.

The most ideal candidate for Roth conversions will not only have plenty of non-IRA retirement assets, but also non-IRA assets that can be used to pay the income tax due for the conversion. By using outside funds to pay the tax, the owner can leave the entire IRA account intact allowing it to grow on a tax-free

basis. Since the government allows the income tax liability to be paid over an additional two years for those conversions taking place in 2010, this should alleviate some of the income tax burden. Note that an added benefit of paying the income tax on a conversion is that it reduces the owner's estate tax liability because paying the income tax reduces the owner's gross estate. Additionally, since the Roth IRA is subject to an estate tax at the plan participant's death (because it's owned by the decedent), directing the use of non-IRA assets for the payment of estate taxes attributable to the Roth will further preserve the maximum amount remaining inside the IRA account for continued tax-free growth. Finally, while leaving the IRA account for heirs is the optimal technique for taking advantage of the tax-free nature of the Roth, the owner is still able to withdraw funds (income tax-free) from the IRA if circumstances should change and additional funds are needed to support the owner's lifestyle during retirement.

### { Conclusion }

In conclusion, converting a traditional IRA into a Roth in 2010 can be a powerful wealth transfer tool for certain individuals which should be considered before the close of the year. Particularly for those IRA owners who are not likely to need the IRA assets during retirement, a 2010 Roth conversion is highly beneficial for the following reasons: (a) eliminates the RMDs requirements for the IRA owner during lifetime allowing for tax-free growth to occur inside the account without annual depletion; (b) allows for the payment of the income tax liability associated with the conversion to be stretched out over an additional two year period; (c) effectively reduces the owner's gross estate because assets will be used to pay the income tax liability during life; and (d) transfers wealth to younger generations which will be income tax-free and will continue compounding income tax-free for many years to come.

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