

THE ROTH IRA - IT'S REALLY AMAZING¹

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Introduction

The Taxpayer Relief Act of 1997 made several significant changes to the Internal Revenue Code. One of the most beneficial changes from an estate planning perspective is the creation of the Roth IRA.

Roth IRA

As in the case of a traditional IRA, earnings on investments held by a Roth IRA are not subject to income tax. However, with a traditional IRA both contributions and earnings are taxed when they are distributed. In the case of a Roth IRA, qualified distributions are entirely tax-free. A qualified distribution is any distribution taken at least five years after the Roth IRA is established and which is:

- made on or after the taxpayer attains age 59 1/2; or
- used by a first time buyer to acquire a principal residence; or
- made because the taxpayer is disabled; or
- made to a beneficiary after the taxpayer's death.

Nonqualified distributions are also not taxable to the extent of the owner's basis in the Roth IRA, which can be withdrawn first.

A traditional IRA can be converted to a Roth IRA if the account owner's adjusted gross income is \$100,000 or less (not including income recognized as a result of the rollover). This income limitation is the same for single taxpayers and married taxpayers filing jointly, and applies only in the actual year the conversion occurs. As a result, in appropriate circumstances it may possible to avoid this income limitation by accelerating income into the year before the conversion is to occur, or deferring income until the year after the conversion.

Conversions are also prohibited a year that a married taxpayer elects to file separately. Amounts held in a qualified plan cannot be rolled over directly to a Roth IRA but could be rolled over to a traditional IRA, followed by a rollover to a Roth IRA.

¹ This article is current as of November 2005. Please contact Willms, S.C. for current information on this topic.

There is no tax deduction for contributions to a Roth IRA. Furthermore, all amounts transferred from a traditional IRA to a Roth IRA must be included in income in the year of the transfer as if they had been distributed and not rolled over. Thus, accumulated non-deductible contributions transferred from the traditional IRA to the Roth IRA are not included in income. However, the 10% penalty tax on early withdrawals does not apply on a rollover to a Roth IRA.

Distributions from a traditional IRA must begin when the IRA owner reaches his or her required beginning date (RBD). In most cases, this will be April 1st following the year in which the IRA owner turns 70-1/2. There is no requirement that distributions be made from a Roth IRA during the life of the person who has established it. Although some taxpayers will be prevented from making contributions directly to a Roth IRA because of the income limitations that apply, they may instead make a non-deductible contribution to a traditional IRA, which can potentially be rolled into a Roth IRA at a future point.

The ability to roll a traditional IRA into a Roth IRA makes a Roth IRA a very important estate planning tool for eligible taxpayers, because lifetime distributions are not required from a Roth IRA. As a result, the entire Roth IRA will be able to continue to grow pre-tax during the owner's lifetime. Although distributions are not required from a Roth IRA during a participant's lifetime, the minimum distribution rules of the Internal Revenue Code will continue to apply after the participant's death.

The rate at which distributions must be made from a traditional IRA to his or her designated beneficiary depends in part on whether or not the IRA designates a "qualified beneficiary" to receive the benefits following the account owner's death. If so, then distributions after the account owner's death can be stretched out over the lifetime of the designated beneficiary. In the case of a trust, the beneficiary with the shortest life expectancy will be used to determine the rate of distributions, unless the trust is divided into separate accounts for each beneficiary by December 31st of the year following the account owner's death.

An example may best illustrate the tax-free growth potential of a Roth IRA.

Example:

Robert is age 60, married with three children and several grandchildren. Robert has accumulated \$500,000 in an IRA. Robert and his wife have sufficient assets outside of his IRA to support their accustomed standard of living. Accordingly, Robert decides to roll his existing IRA to a Roth IRA, and to establish an irrevocable trust for his grandchildren that he designates as the beneficiary of his retirement plan. Robert's oldest grandchild is 11 years old when the Roth IRA is established.

When Robert transfers his existing IRA to a Roth IRA, he will have to pay income tax on the current IRA balance. Assuming that Robert is in the highest income tax bracket for federal income tax purposes, he will have to

pay \$198,000 in federal income taxes at the time of the rollover. However, Robert can use amounts held outside the IRA to pay this tax.

If the Roth IRA grows at a pre-tax rate of 8% a year pre-tax, Robert does not make any withdrawals during his life, and Robert lives until age 84 (his life expectancy based on IRS tables), then at Robert's death the retirement plan will have a balance of \$3,170,590.

When Robert dies, distributions from the Roth IRA must commence. The Roth IRA could be annuitized over a term of years equal to the life expectancy of his oldest grandchild as of the date Robert died. Robert's oldest grandchild would be 35 at this time. The life expectancy of a 35 year old is 47 years. Therefore, if Robert lives until age 84, then after his death the Roth IRA could be annuitized over a 47-year term. If the plan benefits grew at a rate of 8% during this term, the total amount distributed to Robert's grandchildren from the Roth IRA over the 47-year term would be approximately \$30,550,000. Furthermore, none of these distributions would be subject to income tax.

If a spouse of the account owner is designated as the beneficiary of a Roth IRA and the IRA owner dies first, the surviving spouses may rollover the account balance to either an IRA or Roth IRA, and then designate a new beneficiary for purposes of the minimum distribution rules. If, on the other hand, the owner's spouse dies first, the owner may designate a new beneficiary.

It is also very important to consider the estate tax ramifications of establishing a Roth IRA. If the beneficiaries of the Roth IRA are different than those receiving the remainder of the owner's estate, then it will be very important to apportion the estate's tax liability attributable to the Roth IRA in a manner that is consistent with the owner's dispositive intentions. A "boiler plate" tax clause which provides that all estate taxes are payable from the residue of the decedent's probate estate (including estate taxes attributable to non-probate property) could produce disastrous consequences.

Furthermore, if the recipients of the Roth IRA are obligated to pay the estate taxes attributable to it, then it will be important to identify a source of funds that can be used to pay those taxes. One option would be to use amounts held inside the Roth IRA to fund the payment of the tax. However, this would leave less inside the Roth IRA to be reinvested pre-tax. A second option would be to create an irrevocable life insurance trust at the time the Roth IRA was established. If the irrevocable insurance trust was designated as the beneficiary of the Roth IRA, insurance proceeds collected at death could be used to fund the payment of the estate taxes due at that time.

Although the potential estate planning benefits of a Roth IRA are tremendous, a Roth IRA will not be appropriate for everyone. As mentioned above, amounts contributed to a Roth IRA must be included in income in the year of contribution. In many cases, transferring

funds from a traditional IRA will only make the most sense if there are additional liquid funds outside of the IRA that can be used to pay the income tax that will be generated as the result of the rollover. However, it is possible to transfer only part of traditional IRA to a Roth IRA.

Conclusion

In summary, a Roth IRA is superior to a traditional IRA for maximizing retirement benefits payable to a designated beneficiary after a taxpayer's death. As a result, in many cases, a Roth IRA can be a very useful tool when constructing a client's estate plan.