

Should your IRA take a tax haircut?

In the debate over which is better—the immediate tax deduction for contributing to a traditional IRA or the potential for tax-free income from a Roth IRA—the answer tends to turn on one's assumptions about tax rates. Conventionally, one expects to be in a lower tax bracket during retirement, perhaps dramatically so. That favors the traditional IRA. These days, however, those at higher income levels have been told repeatedly that their tax rates will be going up in the future, perhaps sharply. If so, the advantage shifts to the Roth IRA.

Those who are convinced that they will face higher tax rates in the future may want to consider converting their traditional IRAs to Roth IRAs, locking in at today's relatively lower income tax rates. Conveniently, Congress has made that possible for everyone, beginning January 1, 2010.

For 2009, only those whose adjusted gross income does not cross the \$100,000 barrier (single or married filing jointly) are eligible to convert to Roth IRA status. The income cap comes off January 1, 2010.

What's more, taxpayers who make the conversion during 2010 have an additional choice. The amount of the conversion may be reported as taxable income for the 2010 tax year, or 50% may be reported in 2011 and the remaining 50% in 2012. Normally, deferring the payment of a tax obligation is greatly to be desired. However, the 2011 and 2012 tax rates will be the ones applied to the deferral, so if those rates are raised, the delay could boost the ultimate tax obligation.

In addition to the possibility of tax-free account growth, the Roth IRA is exempt from the required minimum distributions at age 70½ that apply to traditional IRAs. Roth accounts give the retiree maximum flexibility in shaping and controlling income tax obligations during the year.

The estate planning dimension

Paying income tax on a large account all in one year is quite a haircut, one that will present an understandable psychological hurdle to many. One way to get over the hurdle may be to consider the estate tax savings that go with the conversion to the Roth IRA.

Imagine that Doris has a \$500,000 IRA, that her income puts her in a 40% combined federal and state income tax bracket, that she is unmarried (so her estate won't get a marital deduction) and that she will be in the top federal estate tax bracket at her death. The IRA will pass to a grandchild.

If Doris does nothing, the federal estate tax on the IRA will be \$300,000. State death taxes may apply as well, depending upon where Doris lives. Despite that reduction in account value, distributions from the IRA to the grandchild will be taxable income, further reducing the financial benefit of the account.

If Doris converts the IRA to a Roth IRA, paying \$200,000 in income taxes, her taxable estate will be reduced by that same amount. That's a \$120,000 reduction in estate tax exposure. What's more, the Roth IRA distributions to the grandchild will be tax free for life.

Think of it this way. If you paid your child's income taxes, you'd be making a taxable gift. When you prepay the income tax by converting a traditional IRA to a Roth IRA, you are

making an enormous tax-free gift to the account beneficiary. And there's no limit on how large the gift can be.

Downsides

The conversion of a traditional IRA to a Roth IRA triggers a new five-year holding period to avoid tax penalties, so those with an immediate need for the money may want to consider partial conversions instead. A wide variety of credits and deductions may be affected by the conversion decision, so it's important to get professional tax advice before moving ahead.

Still, it's not too soon to be looking at your choices and developing a plan that meets your needs and those of your family. N

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