WILLMS, S.C.

LAW FIRM

MEMORANDUM

TO: Clients and Friends of Willms, S.C.

FROM: Andrew Willms

DATE: January 2, 2015

RE: The Estate Planning Benefits of Roth IRAs

This memo discusses the significant benefits that can result from converting a traditional IRA to a Roth IRA. The tax benefits of traditional IRAs are well known:

- Contributions of earned income to an IRA are tax deductible (subject to a variety of limitations).[1]
- Income earned inside an IRA is not taxed until distributed.
- Distributions from an IRA can be stretched out over the account owner's lifetime as well as the lifetime of the designated beneficiary.[2]

Contributions to a Roth IRA are not tax deductible and high income earners are prohibited from contributing to a Roth IRA.[3] However, as in the case of a traditional IRA, earnings on investments held by a Roth IRA are not subject to income tax. In addition, qualified distributions from a Roth IRA are entirely tax-free.[4] A qualified distribution is any distribution taken at least 5 years after the Roth IRA is established and which is:

- made on or after the taxpayer attains age 59 1/2; or

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[1] The amount that can be contributed on a pre-tax basis to an IRA is limited to a specified dollar amount that is adjusted annually for inflation. In 2015 the limit is $5,500. In addition, individuals who have income exceeding certain limits may be prohibited from making tax deductible contributions to IRAs. For 2015, the tax deduction for contributions to a traditional IRA for taxpayers who participate in an employer sponsored qualified plan is phased for incomes between $61,000 and $71,000 for individuals and $98,000 to $118,000 for couples. For taxpayers whose employer do not participate in a qualified plan through work but are married to someone who does, the tax deduction for an IRA contribution is phased out if the couple's income is between $183,000 and $193,000.

[2] 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.

[3] The income limits for contributing to a Roth IRA for 2015 are $116,000 and $131,000 for individuals and $183,000 to $193,000 for married couples.

[4] Nonqualified distributions are also not taxable to the extent of the owner's basis in the Roth IRA, which can be withdrawn first.

- 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.

The "minimum distribution rules" require that distributions from a traditional IRA must begin when the IRA owner reaches his or her required beginning date (RBD).[5] In most cases, this will be April 1st following the year in which the IRA owner turns 70-1/2. The minimum distribution rules do not apply to a Roth IRA during the life of the person who has established it. As a result, the entire Roth IRA can continue to grow income tax free during the owner's lifetime. Although distributions are not required from a Roth IRA during a participant's lifetime, the minimum distribution rules will apply after the participant's death, unless the account owner's surviving spouse is designated as the beneficiary of the account. In that case distributions from the Roth IRA can be deferred until the death of the surviving spouse.

A traditional IRA can be converted to a Roth IRA.[6] It is also possible for a surviving spouse who has been designated as the beneficiary of a traditional IRA to roll the account balance into a Roth IRA established in the surviving spouse's name. However, 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 to the account owner.[7] As a result, the conversion of a traditional IRA will be most beneficial 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.

From an estate planning perspective there are three principal benefits to converting a traditional IRA to a Roth IRA, especially when there are funds outside of the IRA that can be used to pay the tax due as a result of the conversion.

1. The minimum distribution rules do not apply to a Roth IRA while the account owner is living.

2. All income generated by investments held inside the IRA is entirely tax free.

3. Amounts used to pay income taxes on the conversion of an IRA to a Roth IRA are not subject to estate taxes. By comparison, the entire amount held in an IRA is subject to estate taxes even though the beneficiaries have to pay income taxes on distributions from the IRA. This can be a very significant consideration when the IRA's estate is large enough to trigger an estate tax.

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[5] Generally speaking, money from an individual retirement account before age 59 1/2 will be subject to a 10 percent early withdrawal penalty in addition to income tax on the amount withdrawn. This penalty does not apply to withdrawals from Roth IRAs.

[6] There are no income limitations with respect to who can convert a traditional IRA to a Roth IRA.

[7] Accumulated non-deductible contributions transferred from the traditional IRA to the Roth IRA are not included in income.

Example 1.

Mary is single and age 65. She has accumulated $500,000 in her IRA account and is no longer contributing to it. She also has $175,000 in a money market account. Assume that the investments in Mary's account generate a total return of 7% a year and that the money market account earns 3% interest.

When Mary turns age 70 1/2 she begins to take distributions from her IRA at the slowest rate permissible under the minimum distribution rules. Mary pays state and federal income taxes on these distributions at a combined 35% rate. Mary then dies at age 80.

Under this scenario, Mary would have received after tax distributions from her account totaling approximately $240,000 during her lifetime and on the date of Mary's death her IRA would have a balance of approximately $914,000 and her money market account would have a balance of $235,000.

Assume further that Mary names her niece Sue as the beneficiary of her IRA and that Sue is age 40 when Mary dies. Sue decides to continue to withdraw the smallest amount possible from the IRA she inherited from Mary, which continues to grow at a rate of 7% per year. Sue's combined state and federal tax rate is also 35%, and Sue also dies at age 80. In this case, after tax Sue would have received approximately $2,530,000 from the IRA during her lifetime and approximately $2,260,000 would remain in the IRA when Sue dies for a total of $4,790,000.

Example 2.

Assume the same facts as Example 1, but that at age 65 Mary converts her IRA to a Roth IRA, and withdraws the funds in her money market account to pay the tax that results from the conversion. Mary does not withdraw any funds from the Roth IRA while she is alive. In this event the Roth IRA would be worth approximately $1,380,000 at Mary's death.

Assume further that Sue once again decides to withdraw the minimum amounts permissible from the Roth IRA during her lifetime and the Roth IRA continues to grow at 7%. Sue would receive tax free distributions from the Roth IRA totaling approximately $5,875,000 during her lifetime and the Roth IRA would have a balance of approximately $3,400,000 at Sue's death, for a total of $9,275,000.

In summary, in many cases a Roth IRA is superior to a traditional IRA for maximizing retirement benefits payable to a designated beneficiary after a taxpayer's death. Although the potential estate planning benefits of a Roth IRA can be tremendous, a Roth IRA will not be appropriate for everyone. Therefore the pros and cons of converting an IRA to a Roth IRA need to be carefully considered on a case by case basis.

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