Integrated Advice Regarding Roth IRA Conversion and Estate Planning

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IRAs After the TRA '97 – What Hath Congress Roth?

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The new Roth IRA allows nondeductible contributions and tax-free withdrawals, if the rules are met. Further, for taxpayers who qualify, regular (i.e., deductible) IRAs can be converted to Roth IRAs. Should tax advisers tell eligible clients to convert? Through detailed examples, this article examines a multitude of considerations in determining the answer to this question.

The enactment of the Taxpayer Relief Act of 1997 (TRA '97) significantly increased the ability of retirement plan participants to accumulate wealth and reduce taxes. It created a new type of IRA—the Roth IRA—and expanded retirement planning opportunities for current, regular (i.e., deductible) IRA owners.

All of the new IRA provisions became effective on Jan. 1, 1998. This article explains how tax advisers can use the new IRA laws to provide maximum tax benefits for their clients.

Regular IRAs

For regular IRAs, much of the pre-TRA '97 law still applies, but there are enhancements. Under Sec. 219(b)(1)(A), a taxpayer may still contribute up to $2,000 per year, provided earned income is at least that high. If the taxpayer is not an active participant in an employer-sponsored retirement plan (active participant), the contribution is fully deductible. If the taxpayer is an active participant, the maximum $2,000 deduction is reduced proportionately over a new adjusted gross income (AGI) phaseout range, under Sec. 219(g)(3), as follows:

AGI Limits

Tax Year	Other than married filing jointly	Married filing jointly
1997 (pre-TRA '97)	$25,000-$35,000	$40,000-$50,000
1998	$30,000-$40,000	$50,000-$60,000
1999	$31,000-$41,000	$51,000-$61,000
2000	$32,000-$42,000	$52,000-$62,000
2001	$33,000-$43,000	$53,000-$63,000
2002	$34,000-$44,000	$54,000-$64,000
2003	$40,000-$50,000	$60,000-$70,000
2004	$45,000-$55,000	$65,000-$75,000
2005	$50,000-$60,000	$70,000-$80,000
2006	$50,000-$60,000	$75,000-$85,000
2007 and thereafter	$50,000-$60,000	$80,000-100,000

Active Participants

Prior to the TRA '97, the spouse of an active participant was also treated as an active participant. Under post-TRA '97 Sec. 219(g)(1) and (7), if the taxpayer is not an active participant, but his spouse is, there is no IRA deduction if their combined AGI equals or exceeds $160,000. The maximum $2,000 deduction is reduced proportionately, under Sec. 219(g)(7)(B), if combined AGI is between $150,000 and $160,000.

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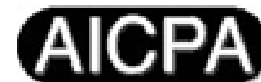

EXECUTIVE SUMMARY

- **Roth IRAs are not for everyone; AGI limits determine who can create and contribute to such an account or convert an existing regular IRA.**
- **If conversion from a regular IRA to a Roth IRA occurs in 1998, the taxpayer can spread the income inclusion (i.e., the regular IRA balance) over four tax years.**
- **A lower tax rate in retirement does not necessarily mean that contributing to a regular IRA will be more beneficial than contributing to a Roth IRA.**

Example 1: H's and W's combined 1998 AGI is $140,000; H is an active participant. W can make a fully deductible IRA contribution of $2,000 for 1998. H cannot make a deductible IRA contribution, because he is an active participant and their combined AGI exceeds the applicable phaseout limit. As will be discussed, H could make a $2,000 contribution to a Roth IRA for 1998; W could make a $2,000 contribution to either a Roth IRA or a regular IRA.

Penalty-Free Withdrawals

The TRA '97 also increases an IRA owner's ability to withdraw funds before age 59½ without incurring the 10% penalty. Under Sec. 72(t)(2)(E), the penalty can be avoided if the funds are used to pay for qualified higher education expenses of the taxpayer, his spouse, or a child or grandchild. Early withdrawals of up to $10,000 are also permitted under Sec. 72(t)(2)(F) if used within 120 days to pay the costs of a first-time home purchase, including, under Sec. 72(t)(8)(C), costs incurred for the acquisition, construction or reconstruction of a first-time homebuyer's principal residence, or financing, settlement or closing costs. According to Sec. 72 (t)(8)(A), such withdrawals can be used by the IRA owner, his spouse, child, grandchild or ancestor, or ancestor of the IRA owner's spouse.

Excise Tax Repeal

For many active participants, one of the most profound law changes was the repeal of the 15% excess distribution and excess accumulation taxes by TRA '97 Section 1073(a), for tax years after 1996. The excess distribution tax was imposed on taxpayers who received substantial retirement plan and IRA distributions. The excess accumulation tax was levied against the estates of IRA owners who had substantial retirement account balances at death. Some tax advisers had encouraged their clients with significant IRA balances to make early withdrawals to avoid these taxes; now, most clients will be best served by retaining their IRA accumulations instead of making taxable distributions before (1) the funds are desired or (2) required by the minimum distribution rules.

However, it may be wise to take taxable IRA distributions earlier than required when there will be significant estate taxes, and the IRA holds the only funds available to pay them. The taxpayer would take an IRA distribution, pay the income tax and give the after-tax proceeds to the beneficiaries. Methods of leveraging gifts with second-to-die life insurance policies, grantor retained annuity trusts, grantor retained unitrusts, family limited partnerships and other techniques may be appropriate for wealthy individuals. The strategy of prematurely incurring income taxes on IRAs and gifting after-tax proceeds will, in limited circumstances, be beneficial by reducing the estate and providing beneficiaries funds to pay estate taxes. Because this strategy will maximize family wealth in only limited circumstances, tax advisers should run the numbers to determine whether the family would benefit.

Roth IRAs

Named for Senator Roth (R-Del.), the new Roth IRA does not allow a deduction when contributions are made, but allows tax-free withdrawals of both contributions and earnings. Thus, unlike regular IRAs, which only defer taxes, the Roth IRA allows the tax-free accumulation of wealth. Contributions are capped by Sec. 408A(c) at the lesser of $2,000 per year or 100% of earned income for the year; as is discussed below, AGI phaseouts apply. Generally, withdrawals can occur tax-free under Sec. 408A(d)(1) and (2) if the Roth IRA account has been established for five years and (1) the owner is at least age 59½, (2) the owner is deceased or disabled or (3) the distribution will be used for first-time homebuyer expenses.

Contributions

Under Sec. 408A(c)(2)(B), the maximum contribution a taxpayer can make to all IRAs is $2,000 per year ($4,000 if married filing jointly) or 100% of earned income, whichever is less. While a taxpayer can contribute to a Roth IRA even if he is an active participant, the following AGI phaseout ranges apply under Sec. 408A(c)(3)(C): $95,000 to $110,000 for single taxpayers and $150,000 to $160,000 for joint filers.

Example 2: N is single and an active participant. His 1998 AGI is $100,000. The maximum contribution he can make to a Roth IRA for 1998 is $1,333, computed as follows:

Maximum contribution
= $2,000 - [((AGI - $95,000)/$15,000) x $2,000]
= $2,000 - [(($100,000 - $95,000)/$15,000 x $2,000]
= $2,000 - [$5,000/$15,000 x $2,000]
= $2,000 - [$667]
= $1,333

Author's Note: The author especially thanks Steven T. Kohman, CPA, for his quantitative analysis and editorial assistance and Scott L. Olson for his research and editorial assistance with this article.

Above the phaseout levels, taxpayers can still contribute to a regular, nondeductible IRA, even if their AGI exceeds the phaseout amounts for deductible or Roth IRAs.

Distributions

If the Roth IRA owner takes a distribution before five years has passed or before age 59½, it is tax-free under Sec. 408A(d)(1)(B) only to the extent of the previously contributed amounts (i.e., only the earnings are taxable). This rule also applies to the beneficiary of a Roth IRA whose owner dies before the five-year period has ended. The beneficiary may withdraw funds tax-free as long as they do not exceed the amount contributed, but must wait until the five-year period has passed before being able to make a tax-free withdrawal of the Roth IRA's earnings.

Sec. 408A(d)(1)(B) and (2)(A) provide that distributions from Roth IRAs before age 59½ are subject to the Sec. 72(t) 10% penalty imposed on premature distributions from regular IRAs. No penalty applies if the owner is deceased or disabled, or the distribution is for a first-time home purchase.

Roth IRA owners are not subject to the minimum distribution rules that normally require regular IRA owners to begin taking taxable distributions at age 70½. In addition, Sec. 408A(c)(4) permits taxpayers to contribute to a Roth IRA beyond age 70½. The rules requiring distributions after a Roth IRA owner's death are apparently the same as the rules for regular IRAs, except that the beneficiary's distributions from a Roth IRA (including the amounts appreciated after the IRA owner's death) will be tax-free. Thus, a Roth IRA owner can designate his spouse as the account beneficiary; on the account owner's death, the surviving spouse would have the option of postponing minimum distributions until death. After the surviving spouse's death, the subsequent beneficiary (usually a child) would be required to take nontaxable minimum distributions based on his own life expectancy.

Regular IRA versus Roth IRA

Many taxpayers who are active participants will choose to make a Roth IRA contribution because their high AGIs preclude them from deducting regular IRA contributions. However, if a regular IRA deduction is available, to which type of IRA should contributions be made? As was discussed, an eligible taxpayer can contribute to both types of IRAs each year, as long as the total contributions do not exceed $2,000 (or earned income, if lower). The analysis in this article indicates that a Roth IRA would be preferable in most situations.

Many financial planners have been using a simplified analysis to illustrate which IRA would be more beneficial, as reflected below. This table[1] compares contributing $2,000 to a regular IRA versus a Roth IRA. Both IRAs grow for ten years at 10% annually. The owner is in the 28% tax bracket until the final year (when all of the accumulated funds are withdrawn); the IRA owner is shown in various tax brackets when the funds are withdrawn.

	Regular *(deductible)* IRA			Roth IRA
Contribution tax rate	28%	28%	28%	28%
Withdrawal tax rate	15%	28%	31%	Tax-Free
Amount contributed	$2,000	$2,000	$2,000	$2,000
Tax savings ($2,000 × 0.28)	560	560	560	0
Tax savings fund (after 10 yrs.)	1,136	1,122	1,119	0
IRA fund	5,187	5,187	5,187	5,187
IRA taxes (at withdrawal)	778	1,452	1,608	0
Net assets	$5,545	$4,857	$4,698	$5,187

The first conclusion that can be drawn from this oversimplified analysis is that contributing to a Roth IRA will be advantageous when the tax rate at retirement will equal or exceed the tax rate when contributions are made. The second conclusion is that contributing to a Roth IRA will not be advantageous when the tax rate at withdrawal will be lower than when the contributions were made. However, this conclusion is not true if a longer timeframe is used. The table below uses the same assumptions as in the table above, but shows the net assets available after the IRA has been retained for a greater number of years and before all of the funds are withdrawn.

The primary problem with using a 10-year analysis is that a lower tax rate in retirement does not necessarily mean that contributing to a regular IRA will be more beneficial than contributing to a Roth IRA. Roth IRAs have other advantages--they are not subject to the minimum distribution rules during the owner's life and longer investment periods will be common (especially for wealthy taxpayers).

	Withdrawal Tax Rate	Net Assets
After 20 years	15%	$13,714
	28%	11,937
	31%	11,527
	Roth	$13,455
After 30 years	15%	$34,227
	28%	29,636
	31%	28,576
	Roth	34,899
After 40 years	15%	$86,086
	28%	74,209
	31%	71,469
	Roth	$90,519

The above analysis can also be applied to employees who have a choice of making non-matching contributions to either an employer plan (e.g., a Section 401(k) plan) or a Roth IRA. Employees should consider investing in retirement plans in the following priority: (1) employer-matched contributions, (2) Roth IRAs for employee and spouse, and (3) non-matched contributions.

Conversion to a Roth IRA

Perhaps the most significant feature of the TRA '97 for taxpayers who have IRA accumulations is the ability under Sec. 408A(d)(3) to convert a regular IRA to a Roth IRA. Although generally, income taxes must be paid on the amount converted at the time of the con-

[1]All tables in examples were calculated using Microsoft® Excel 97.

version, Sec. 408A(d)(3)(A)(iii) allows the owner to include the income ratably over four years, if the conversion occurs in 1998.

Example 3: B converts $100,000 from her regular IRA to a new Roth IRA in 1998. In each of 1998, 1999, 2000 and 2001, she will include $25,000 in gross income. If the conversion occurred in 1999 or thereafter, the entire $100,000 would be included in B's income in the year of conversion.

The Tax Technical Corrections Act of 1997[2] would impose a 10% penalty on amounts converted from a regular IRA to a Roth IRA that are subsequently withdrawn before the expiration of the four-year income inclusion period. (This is in addition to the 10% penalty imposed on the withdrawal of earnings before the five-year holding period.) If the IRA owner dies before the end of the four-year spread period and named a nonspouse as the beneficiary, the unreported balance must be included as income on the IRA owner's final return. A spouse named as the beneficiary can continue including the amounts ratably in gross income.

AGI Limits

The conversion strategy has a significant drawback--Sec. 408A(c)(3)(B)(i) provides that a regular IRA can be converted to a Roth IRA only if the owner's AGI (computed before the conversion) does not exceed $100,000 (whether married or single). Sec. 408A(c)(3)(B)(ii) bars conversion by married taxpayers filing separately. IRA owners whose AGIs exceed $100,000 should consider tax-planning strategies with the goal of reducing AGI below $100,000 (preferably in 1998) to create a one-year window of opportunity to convert.

Thus, unlike regular IRAs, which only defer taxes, the Roth IRA allows the tax-free accumulation of wealth.

Active Participants

Often, active participants have the option at retirement to roll over their plan accumulations into an IRA. In most circumstances, currently employed active participants will not be allowed to roll over their accumulations in employer plans into an IRA. This puts an employee with a significant accumulation in his employer plan in a worse position than one who has an identical balance in an IRA. Many employees, however, may have IRAs as well, that will will be eligible for conversion before the owner's retirement or termination.

Factors to Consider

The potential for tax-free growth is so compelling that all taxpayers who have substantial IRA balances and qualify for conversion should consider whether to convert at least a portion of their IRAs. Because the decision contains many variables,

Example 4: Balance in IRA Account

Assumptions:

Assumption	Value
G's (IRA owner's) Current and Future Federal Income Tax Rate	28%
Current and future state income tax rate (state taxes apply to investment earnings on after-tax funds, but not to retirement plan distributions)	3%
Income tax rate on additional income generated by the conversion and taxed in 1998-2001	31%
G's age at conversion	55
Beneficiary's age at conversion (used to calculate life expectancy factors)	53
Withdrawal income tax rate	28%
Regular IRA fund amount converted	$100,000
After-tax funds available (used only to pay income taxes)	$100,000
Interest earned on invested funds	10%
Method of calculating required minimum distributions	Joint lives, *recalculated*

	Balance on G Reaching Age:				
	56.08	65	75	85	95
Regular IRA:					
Balance in regular IRA	$110,865	$259,374	$531,652	$692,780	$509,096
Balance in after-tax funds	107,480	194,884	475,801	1,361,611	3,460,417
Total assets	218,344	454,258	1,007,453	2,054,391	3,969,513
Income tax on regular IRA	-31,042	-72,625	-148,862	-193,978	-142,547
Net assets	$187,302	$381,633	$858,591	$1,860,413	$3,826,966
Conversion to Roth IRA:					
Balance in Roth IRA	$110,865	$259,374	$672,750	$1,744,940	$4,525,926
Balance in after-tax funds	91,937	143,610	279,873	545,429	1,062,956
Total assets	202,802	402,984	952,623	2,290,369	5,588,882
Deferred tax liability	-15,500	0	0	0	0
Net assets	$187,302	$402,984	$952,623	$2,290,369	$5,588,882
Roth IRA net assets exceed regular IRA net assets by:	$0	$21,351	$94,032	$429,956	$1,761,916

[2] See Joint Committee on Taxation (JCT), *JCT Description of the Chairman's Mark of the Tax Technical Corrections Act of 1997* (JCX-56-97), Section C.1.

clients likely will seek advice from their CPAs in deciding whether the conversion will be beneficial. A Roth IRA conversion is one of the rare situations in which a CPA may recommend prepaying income taxes; however, many factors must be considered, including:

- The IRA owner's current and future income tax rates.
- The IRA owner's age and life expectancy.
- The IRA owner's anticipated spending needs during retirement.
- The IRA owner's other sources of retirement funds (including pension plans).
- The IRA owner's other sources of after-tax money and investments.
- The age and life expectancy of the IRA owner's beneficiary.
- The beneficiary's planned use of the IRA funds on inheritance.
- The beneficiary's future income tax rates.
- The rate of return on investment.

Example 4 in the box on the preceding page demonstrates that a regular-to-Roth IRA conversion will result in greater net assets than if there is no conversion. In this example, net assets are measured in after-tax dollars (i.e., at the different measuring ages, it is assumed that all of the IRA funds are withdrawn and income taxes paid on the withdrawals). Additionally, the conversion occurs in 1998, so the four-year income spread is available.

Example 4 shows the amount that would be inherited by the beneficiary if G (the IRA owner) dies at the stated age and the beneficiary immediately withdraws the entire IRA balance, or the after-tax dollars available to G if he withdraws all funds from the account at the stated age. In the example, G is required to take minimum distributions from his regular IRA at age 70½, which are taxed and added to the after-tax funds balance. Thus, the regular IRA net asset balances are much lower than the Roth IRA balances when G reaches age 75, 85 and 95. Distributions need not be taken from the Roth IRA, allowing for continued tax-free growth. Although the after-tax funds from the Roth IRA are less than the pre-tax funds from the regular IRA, the net combined assets from the Roth IRA exceed that of the regular IRA almost immediately, because the Roth IRA's earnings are tax-free.

The potential for tax-free growth is so compelling that all taxpayers who have substantial IRA balances and qualify for conversion should consider whether to convert at least a portion of their IRAs.

In this example, the benefit of making the conversion occurs 1.08 years after conversion, and continues to grow over time. The conversion is slightly detrimental in the first 1.08 years, because it is assumed that G and his spouse are in the 31% bracket in the conversion year (1998) and the following three years (1999-2001), because of the four-year income inclusion. When G is age 78.9, his Roth IRA's total assets exceed those in a regular IRA. Comparing total assets, however, is useful only in limited circumstances (e.g., when the beneficiary is a charity). A dollar in a regular IRA is generally worth less than an after-tax dollar, and a dollar in a Roth IRA is worth more than an after-tax dollar because of the continued tax-free growth potential of these funds. The different values of a dollar in the Roth and regular IRAs and after-tax funds could become quite substantial.

Example 4 assumes complete withdrawal of the IRA funds at the stated ages. A more realistic assumption is that G will leave the funds in the Roth IRA until they are needed or desired, and then withdraw only the amount needed, not the entire balance. In general, the longer the funds are invested, the more valuable the Roth IRA becomes compared to either after-tax money or a regular IRA. Because the timeframe used to compare a Roth IRA to a regular IRA could be as long as G's and the beneficiary's lives, with only minimum distributions based on the beneficiary's life expectancy throughout, determining the relative value of a dollar in these different environments is quite complex.

In certain circumstances, a Roth IRA may still be beneficial, even if G did not have sufficient after-tax funds to pay the income taxes due on conversion of a portion of a regular IRA. The remaining, unconverted IRA funds are used to pay the income tax liability on the converted portion. However, the conversion is not as beneficial as when after-tax funds are available to pay the income taxes on the converted funds.

Other Variables

Effect of Different Income Tax Rates in Retirement

What is the effect of G having a lower or higher income tax rate in retirement?

Example 5: The facts are the same as in Example 4, except that G's tax bracket changes during retirement. The table below illustrates the difference in net assets after conversion.

Example 5:

G's Tax Bracket In Retirement (age 66 and up)	Amount by which Roth IRA Net Assets Exceed Regular IRA Net Assets when G is Age:			
	65	75	85	95
15%	$21,351	$61,139	$201,872	$853,376
15% ages 66-70, 28% ages 71-95	21,351	87,808	417,824	1,738,271
28% (as in Example 4)	21,351	94,032	429,956	1,761,916
31%	21,351	101,305	477,503	1,939,934
36%	21,351	113,168	552,875	2,213,866

Thus, for a taxpayer in the 28% bracket, converting to a Roth IRA will always be advantageous if the funds are invested for 10 years or more, even if the IRA owner's tax bracket will decline from 28% at the time of conversion to 15% at retirement. Converting to a Roth IRA will be even more advantageous if the IRA owner's bracket will increase during retirement.

Effect of Investment Appreciation and Capital Gains on After-Tax Investments

Some critics of the above analysis suggest that it is not realistic to assume that all after-tax investments will generate an increase in value by only the amount of regular income; rather, some of the increase in value will be capital appreciation that is not currently taxed and some will be current capital gain.

Example 6: The facts are the same as in Example 4, except that (1) only 30% of the investment income (e.g., interest and dividends) are taxed at regular rates; (2) capital appreciation occurs on 70% of the investment income; (3) capital gains result each year based on a 15% portfolio turnover rate (i.e.,15% of the beginning year's cumulative capital appreciation not previously taxed); such gains will be taxed at 18%. In addition, the accumulated after-tax appreciation that has not been taxed may be taxed at a capital gains rate (if the investments are sold) or represent a step-up in basis for heirs (if held until death), completely avoiding taxation.

This example demonstrates that when the investor achieves more favorable capital gains tax treatment on after-tax investments, the advantage of a Roth IRA conversion is mitigated somewhat, but still remains.

Example 6:

After-Tax Investment Income *(10% rate of return)*	Amount by which Roth IRA Net Assets Exceed Regular IRA Net Assets when G reaches Age:				
	57	65	75	85	95
Regular income tax rates (as in Example 4)	$2,345	$21,351	$94,032	$429,956	$1,761,916
Capital gains and appreciation, capital gains tax paid in last year	2,275	17,385	71,980	319,130	1,297,430
Capital gains and appreciation, stepped-up basis after death	2,177	14,783	63,331	278,128	1,155,100

When to Convert

Is it better to convert to a Roth IRA earlier or later?

Example 7: In 1998, Y and Z are each 30 years old; each has a $100,000 regular IRA. Y converts his IRA to a Roth IRA at age 30; Z converts his IRA at age 55. By waiting until age 55, Z will not have the four-year spread period for paying tax on the conversion. The table above illustrates the different results.

Example 7:

	Y		Z	
Balances at age 55:				
IRA funds	$1,083,471	(Roth)	$1,083,471	(Regular)
After-tax funds	390,706		530,204	
Total assets	1,474,177		1,613,675	(Before Conversion)
Income tax on IRA	0		-379,215	
Net assets	$1,474,177		$1,234,460	(After Conversion)
Balances at age 70:				
Roth IRA funds	$4,525,926		$4,525,927	
After-tax funds	1,062,956		477,374	
Total and net assets	$5,588,882		$5,003,301	

Making the conversion at a younger age is more beneficial, because the Roth IRA has more time to grow tax-free (as opposed to tax-deferred in a regular IRA). Another advantage of an earlier conversion is that Congress could repeal the ability to convert; however, converted IRAs should be grandfathered.

Inherited Funds

The results in Example 4 can understate the advantages of a Roth IRA, because they do not consider the beneficiary's timeframe for making distributions from the inherited IRA. The analysis does not consider the potential benefits a beneficiary may receive from withdrawing less than all of the funds immediately after the IRA owner's death. Tax-free growth is maximized only if the beneficiary takes the required minimum distributions. Decreasing the rate at which distributions are taken from a inherited regular IRA will only defer taxes, while slowing distributions from an inherited Roth IRA will provide greater tax-free growth.

Example 8: W, age 45, inherits a $100,000 regular IRA. His Federal income tax rate is 28%; his state income tax rate is 3% (on after-tax investment income). All after-tax and IRA funds earn 10% annually. Only required minimum distributions are taken, and they are equal for both the Roth and regular IRA. These distributions are added to the after-tax funds.

Example 8 clearly illustrate the advantage of inheriting a Roth IRA versus a regular IRA; the difference results from the lack of income tax on the Roth IRA.

Example 9: The facts are the same as in Example 4, except that G dies at age 75. His total assets at death (assuming he converted to a Roth IRA) are less than if he had not converted. G's benefi-

Example 8:

	W's Age			
	45	55	70	85
Inherited regular IRA:				
Balance in regular IRA	$100,000	$196,068	$403,820	$0
Balance in after-tax funds	0	40,240	356,691	1,947,311
Total assets	$100,000	$236,308	$760,511	$1,947,311
Income tax on regular IRA	28,000	54,899	113,070	0
Net assets	$72,000	$181,409	$647,441	$1,947,311
Inherited Roth IRA:				
Balance in Roth IRA	$100,000	$196,068	$403,820	$0
Balance in after-tax funds	0	56,559	510,055	2,832,613
Total and net assets	$100,000	$252,627	$913,875	$2,832,613

Example 9:

	Beneficiary's Age at Inheritance			
	45	55	70	85
Regular IRA:				
Balance in regular IRA	$531,652	$1,042,402	$2,146,917	$0
Balance in after-tax funds	475,801	365,585	55,704	1,287,303
Total assets	1,007,453	1,407,987	2,202,621	1,287,303
Tax on regular IRA, if withdrawn	-148,863	-291,873	-601,137	0
Net assets	$858,590	$1,116,114	$1,601,484	$1,287,303
G Converts to Roth IRA 20 Years Before				
Balance in Roth IRA	$672,750	$1,319,051	$2,716,699	$0
Balance in after-tax funds	279,873	145,807	453,364	6,303,362
Total and net assets	$952,623	$1,464,858	$3,170,063	$6,303,362

Example 9 demonstrates the long-term implications of tax deferral (i.e., a regular IRA) versus tax-free growth (i.e., a Roth IRA), and the significant advantage that accrues to a beneficiary who inherits a converted Roth IRA.

Disadvantages of Converting

The most apparent disadvantage of converting to a Roth IRA is that income taxes will have to be paid on conversion. The benefits to be received are long-term and hard to measure. In addition, if the income tax rates for investment income or IRA distributions are reduced or repealed, the advantages shown in the above examples may not be realized. If the Federal income tax system is radically changed (or abolished in favor of a national flat or sales tax), IRA owners who converted could suffer a reduction in funds without an equivalent reduction in taxes. In addition, making the conversion is not advisable if the beneficiary is a charity. Further, differing income tax laws in some states may result in the Roth IRA earnings being taxed as ordinary investment income. Although several states may change their laws to exempt Roth IRA income (and some intend to do so), this could remain a disadvantage in other states. Finally, if an IRA owner's future tax rate will be significantly lower, converting now at a higher rate may not be as beneficial as waiting until later and converting at a lower rate. Nonetheless, despite all of these potential disadvantages and the uncertainty of the assumptions made, all eligible taxpayers should give serious consideration to converting at least a portion of their regular IRAs to a Roth IRA.

Estate Tax Implications

For Federal estate tax purposes, $1 in a regular IRA is taxed the same as $1 in after-tax funds or a Roth IRA. Example 9, above, demonstrated the additional value available to the beneficiary by inheriting a Roth IRA instead of a regular IRA; such value is not subject to estate taxes because it is not reflected in the dollar value of the taxable estate. Also, when a regular IRA owner incurs income tax to convert to a Roth IRA and subsequently dies, his estate will be reduced by the income taxes paid on conversion. This estate tax savings was not taken into account in the previous examples.

Unified Credit Shelter Trust

A Unified Credit Shelter Trust (UCST) will typically provide a surviving spouse with trust income and the right to invade trust principal for health, maintenance and support. After the surviving spouse's death, the amount in the trust passes to named beneficiaries (usually, the couple's children). The purpose of a UCST is not only to provide the surviving spouse with income, but also to protect trust principal from estate taxes. If properly drafted and executed, the balance of a UCST at the second death will not be subject to estate taxes because the first decedent used, instead of wasted, his unified credit (the "exemption equivalent" amount). It is preferable to create a UCST with discretionary, not mandatory, income distributions to the surviving spouse; because UCSTs do not have to qualify for the marital deduction, income distributions are not required. The purpose of making income distributions discretionary is to create a post-mortem option of allowing the trust to grow. After the surviving spouse's death, the trust (with additional accumulations) would pass to heirs (usually children) free of estate taxes.

Traditionally, tax advisers have preferred to fund their clients' UCSTs with after-tax dollars and/or life insurance proceeds. Some tax and estate planning attorneys, however, customarily draft intricate IRA and retirement plan beneficiary designations that have the effect of funding UCSTs with IRA or other retirement accounts if they are needed to fund the trust fully. The strategy of using IRAs and

retirement plans to fund a UCST will become more popular as the post-TRA '97 Sec. 2010(c) exemption equivalent increases from $600,000 in 1997 to $1 million by 2006[3], and the contributions and growth in IRAs and retirement plans continue.

Use of disclaimers: IRA owners should consider disclaimer provisions for their IRA beneficiary designation. These sophisticated IRA and retirement plan beneficiary designations should consider the use of disclaimer provisions. The disclaimer strategy will typically name the surviving spouse as the primary beneficiary and the UCST as the secondary beneficiary of the retirement plan or IRA. The disclaimer strategy allows a "free second look" for a surviving spouse to decide whether to retain all of the IRA proceeds outright (using the marital deduction) or to disclaim all or a portion of the IRA proceeds into the UCST. The surviving spouse makes this decision after the first death, when the financial picture of the survivor and the family is known.

If the disclaimer strategy is used in both the will (or revocable trust) and the IRA with integrated language between the will and IRA beneficiary designation, the surviving spouse would be able to choose which assets (if any) would be used to fund the trust. Having disclaimers in both the will and the IRA is referred to as a "double disclaimer" strategy. In many cases, this strategy will yield a better result than drafting wills and IRA beneficiary designations based on projections about who will die first, when they will die, the family's needs, and the amount of after-tax and IRA funds available to fund the UCST.

The disclaimer strategy allows a "free second look" for a surviving spouse to decide whether to retain all the IRA proceeds outright (using the marital deduction) or to disclaim all or a portion of the IRA proceeds into the UCST.

Advisers usually prefer funding a UCST with after-tax funds, if available, instead of pre-tax funds, because an after-tax dollar is worth more to an heir than a pre-tax dollar. The income in respect of a decedent associated with pre-tax funds diminishes the value of the UCST to the heir; however, Sec. 691 does not apply to a Roth IRA. Thus, advisers should at least consider whether funding the UCST with Roth IRAs is preferable to using after-tax accumulations. If the marital bequest or the surviving spouse's independent assets suffice to make the surviving spouse financially secure, children or grandchildren should be named as the beneficiaries of Roth IRAs to the extent of the exemption equivalent. The long life expectancy of a young beneficiary would require smaller minimum distributions in early years, thereby resulting in significant tax-free growth of the Roth IRA. Although this strategy is good for regular IRAs, it provides an estate planning bonus with Roth IRAs.

Naming children instead of the surviving spouse as the primary beneficiaries will be advisable only in larger estates. When the security of having the principal and income of the exemption equivalent amount available to the surviving spouse is desired, the adviser should consider recommending a double-disclaimer strategy. The client could take a "wait and see" approach and allow the surviving spouse to determine the optimal strategy after the first death, when more information is available.

Conclusion

The Roth IRA provides significant opportunities for tax-free growth. In most cases, annual contributions should be made to Roth IRAs instead of regular IRAs. Further, the benefits of the Roth IRA are so substantial that practically all clients who qualify should consider whether it would be beneficial to convert at least a portion of their existing IRAs to a Roth IRA. Because the analysis of whether to make this conversion is so important and complex, there is an opportunity for tax advisers to provide substantial assistance to their clients.

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Jim offers free, initial consultations to individuals who are interested in retirement and estate planning. For more information about a free seminar coming to your area, a free consultation or a videotape offer, as well as extensive advice about how to reduce taxes and accumulate wealth, please visit http://www.rothira-advisor.com. You can also contact Jim by phone at (800) 387-1129, or (412) 521-2732, or by e-mail at admin@rothira-advisor.com.

[3]See Soled and Arnell, "Planning Implications of the TRA '97's Increase in the Unified Credit," 28 ***The Tax Adviser*** 704 (Nov. 1997).