

The Roth IRA advantage: A closer look

Since its debut in 1997, the Roth IRA, naturally enough, has been sold mainly as a retirement account. To be sure, the prospect of a stream of tax-free income to support a comfortable retirement is a powerful stimulant.

To earn that freedom from taxes, you *do* have to pay income tax on the dollars that go into a Roth IRA. There are requirements for participation that differ in many respects from those of traditional deductible IRAs. However, if you qualify for a deductible IRA, you can do nearly as well (in some cases, even better than with a Roth). It does take some savings discipline. You would need to invest your tax savings in a taxable account, the proceeds of which will help pay taxes on your IRA withdrawals.

So, building a retirement nest egg is not what makes Roth IRAs so special . . .

The real big deal

The true attraction of the Roth IRA is the financial freedom that it can provide over the long term. In a Roth IRA there's no requirement to begin taking withdrawals at age 70^{1/2} or at any point in your lifetime. You even can continue making annual contributions as long as you have earned income.

Money remaining in your account at your death passes to your named beneficiary free of income taxes. And your heir can choose to spread out tax-free withdrawals over his or her own life expectancy. These features can enable some impressive long-term building of wealth.

When you are in the happy position of not needing a portion of the assets in your retirement accounts, the Roth IRA is an especially attractive estate planning tool. Moving retirement account assets into a Roth IRA, you'll pay income tax on the balance transferred. This removes the amount of the tax from your estate and shelters all future growth from income taxes.

To illustrate, we'll consider the hypothetical case of a man we'll call George. Having reached age 70, George retired this year with a generous pension plan and a large stock portfolio. He also has \$100,000 in an IRA rolled over from a profit sharing plan. He knows that he'll have to start taking distributions right away, but he would prefer to leave the account intact for his named beneficiary, his 40-year-old daughter, Shirley. (All calculations used in this illustration assume annual investment returns of 6%.)

Traditional IRA

If George stays in the IRA, he is required to take minimum distributions each year based upon a formula established by the IRS. When George dies at age 85, before taking his required distribution for the year, he will have received a total of \$82,514 (pretax), and Shirley will inherit an IRA with a balance of \$125,912.

That's a handsome sum, and one that Shirley can enhance by taking minimum distributions over her own life expectancy, according to IRS rules. At age 92, for example, Shirley will have received a total of \$377,513 and still have more than \$40,000 in the account. However, as was the case for George, every penny of her withdrawals will be taxed as ordinary income.

The Roth advantage

If George converts the account to a Roth IRA instead, selling enough stock to cover the tax liability, Shirley does much better. She'll inherit a Roth IRA with a balance of \$254,035. Using the same age as above, at 92 Shirley will have collected \$773,587 tax free. And she still would have nearly \$90,000 in the account. The conversion, at a cost of perhaps \$40,000, will have gained Shirley and her heirs more than half a million dollars.

Some details

Of course, it's not quite that simple. To start with, not everyone can make a Roth conversion. Under current rules you can make a conversion only in a year in which your adjusted gross income does not exceed \$100,000. (The amount of the conversion does not count toward this AGI limit.) Strangely, the same cap applies both to married couples filing jointly and to individual filers.

Roth IRA beneficiaries must make the election to take withdrawals over their life expectancies no later than December 31 of the year following the account owner's death. If they don't, they must drain the account within the five years following the year of death.

Both traditional and Roth IRAs are included in the estate of the owner and can be subject to estate taxes. In the year 2007 as much as \$2 million can be exempt from estate tax, and this amount will rise to \$3.5 million in 2009. To ensure the wealth-building potential of an inherited Roth IRA, provision should be made to pay any "death" taxes from other sources.

To date, much of the action in Roth conversions has centered around younger investors, seduced by the prospect of tax-free retirement income. The Roth IRA's use for wealth transfer has not been fully exploited yet by those in or approaching retirement. If the secret gets out, that situation may change dramatically.

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Any developments occurring after January 15, 2007, are not reflected in this article.