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tax and accounting ISSUES

# Demystifying the Roth IRA

Of all the tax law changes that were enacted in the past two years, the Roth IRA has the widest application. Almost every working individual has an IRA and consideration must be given to converting regular tax deferred IRA accounts to tax exempt Roth IRA accounts.

Regular IRA accounts may contain both pre tax and after tax components. The pre tax portion of a regular IRA is made up of deductible contributions, rollovers from qualified plans, and investment earnings. After tax amounts are from non-deductible $2,000/year contributions. Pre tax amounts are taxable to the account owner on withdrawal and after tax amounts are a non-taxable return of invested capital. The benefit is a tax deferral, not exemption from income tax.

Roth IRA contributions are exclusively in after tax dollars. Annual $2,000/year contributions are not deductible. If amounts from regular IRA's are transferred to a Roth IRA account (Roth IRA conversions), income tax must be paid on the taxable amount deemed to be distributed out of the regular IRA. By this payment of income tax, pre tax amounts are converted to after tax amounts going into the Roth IRA. Earnings within the Roth IRA are exempt from tax on withdrawal, as are distributions of converted funds.

The Roth IRA tax exemption is not infinite. As soon as the account owner dies, designated beneficiaries must either distribute the balance of the account within five years of the account owner's death or commence distributions within one year of death over the life of the designated beneficiary. Post mortem Roth IRA distributions are subject to the same rules as regular IRA distributions so the Roth conversion does nothing to stretch out the distribution period. The assets in the account are eventually converted back to being taxable investments.

What are the economics of a Roth IRA conversion? The individual makes a tax payment for the year of withdrawal and receives in exchange a tax exemption instead of a tax deferral. The conversion also allows individuals to avoid the requirement of making distributions during their lives. Whether this immediate payment of tax is a good investment depends on a number of factors that are unique to the individual.

**a) The tax rate that will be applied to the IRA conversion**
We always want to create deductions against the highest income tax rates and realize taxable income against the lowest rates. If a Roth conversion causes a bunching of income and is taxed at a higher rate than future withdrawals, this negatively impacts the economics of conversion.

**b) Whether the individual pays the tax out of IRA assets or other after tax dollars**
It's better to pay income taxes using assets whose investment income would be taxable. This maximizes the total after tax return.

**c) The expected rate of return**
Low rates of return magnify the negative aspects of paying income taxes immediately as the conversion occurs. *(See the special Roth IRA recharacterization planning point later in the newsletter that avoids the Roth conversion- bear market trap.)*

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**d) The number of years that the tax exemption will be in effect**
There are no required distributions when the owner of a Roth IRA account is alive, but heirs are required to make distributions. Individuals planning on living to 100 would have a longer tax-exempt compounding period than with regular IRA accounts where distributions are required to start an age 70 1⁄2.

**e) The future tax rates that would have been applied to taxable IRA distributions**
If assets and taxable income decline during retirement years, there may be opportunities to withdraw regular IRA funds at low tax rates. If low rates are available in the future, there is little value in paying taxes up front to obtain a future tax exemption.

**f) Whether the individual will need Roth IRA distributions to meet living expenses**
If money could be left in a Roth IRA account indefinitely, the income stream is worth more than if the income is taxable. With the Roth you get higher after tax income with no increase in risk. For example, if your marginal income tax rate is 30%, Roth IRA assets are worth 42.9% more than taxable assets. Depleting the Roth accounts quickly to meet living expenses reduces the tax exemption benefit.

**g) The account owner's mortality probability**
Required distributions start when a Roth IRA owner dies. Individuals with bad life expectancies probably have a required Roth IRA distribution schedule that is very close to that of regular IRA's. Your ability to stockpile assets in Roth accounts is limited.

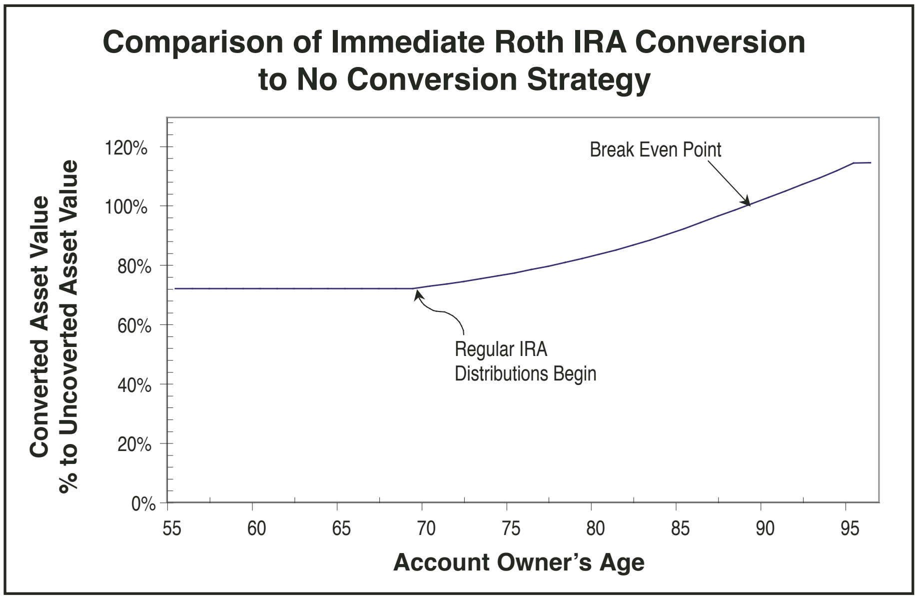
**h) Whether the regular or Roth IRA accounts can be rolled over by a surviving spouse**
Just like regular IRA accounts, Roth IRA's can be rolled over by a surviving spouse but not by other designated beneficiaries. If the surviving spouse has a life expectancy significantly beyond that of the account owner, there are more years of earning exempt income to make up for the up front payment of income tax at conversion.

**i) The asset allocation of the portfolio over time**
The dream of every investor is to realize large portfolio gains that are exempt from tax. As a practical matter, an individual's risk tolerance decreases after retirement and investments are made in lower yielding but less volatile investments. Under these circumstances avoiding up front payment of income taxes is more important than the incremental income from having a tax exemption vs. simply having a tax deferral.

**j) Whether the IRA assets will be subject to estate taxes**
By paying income taxes on conversion, an individual avoids estate taxes on that amount. This can lessen the burden of paying income taxes up front.

The following graph shows the growth in assets in regular and Roth IRA accounts at a 7% rate of return. Until the owner's death at age 85, assets are assumed to remain in the Roth IRA account and compound free of income taxes except for the initial tax paid at time of conversion. After age 85 the Roth IRA is distributed out over a 10-year period, and the earnings on accumulated distributed assets are subject to income taxes. Income tax rates were kept constant at 28% over the 40-year period.

The assets in the regular IRA are subject to minimum distributions starting at age 70 1⁄2, and the distributions and earnings on accumulated distributed assets are subject to income taxes. In this example the entire account balance is paid out by the time the owner reaches age 96.




This example shows three main points:

a) It takes the tax exempt compounding in the Roth IRA account amount 30 years to catch up in value to the regular IRA account.

b) At the end of a 40-year investment period the regular IRA is only 10% below the value of the Roth IRA.

c) The Roth IRA advantage is insensi tive to return on investment because regular IRA's compound in value without significant taxes being paid until individuals are well into their 80's. (This is when distribution percentages rise dramatically.)

## Conditions that make Roth IRA's positive

If you have these factors you should look into doing Roth IRA conversions:

a) There is a low tax cost to convert.
b) Non-IRA assets are available for the income tax incurred on conversion.
c) Roth IRA assets are not needed to meet living expenses.
d) You have a long-term investment horizon.
e) You have high future income tax rates
f) You have exposure to estate taxes.

## Negative aspects of Roth IRA conversions

a) You lose income tax planning opportunities. One of the objectives of tax planning is to recognize income in low tax years. You should be trying to maximize the tax deferral period AND pay taxes at the lowest possible rate. Paying a high rate of tax when doing Roth conversions is counter productive.

b) Family planing opportunities are lost. Heirs in low tax brackets can receive interests in regular IRA accounts, minimizing the tax cost of distributions.

c) You have paid tax on unrealized asset appreciation. Most individuals pay tax on stock gains when the securities are sold and the cash is used immediately for living expenses during retirement. A Roth IRA conversion entails realization of gains for tax purposes, but market exposure remains the same.

Having a Roth IRA account decline has the same effect as an unrealized decline in the market value of securities. At least with stocks that are owned directly they can be sold and a tax deduction generated.

d) You lose earning power. Your invested capital immediately declines by the amount of the income tax paid on conversion.

### Conclusions

The benefits advertised by the financial services industry are overblown. In the absence of careful financial engineering, the advantages of immediate Roth IRA conversion are minor. Analysis of the benefits of Roth conversions must be done as part of a comprehensive financial plan to ensure that the benefits are real. Don't rush out to do Roth IRA conversion just because you see a commercial on TV.

**Editors Note:** *If you are interested in developing a strategy for the management of your IRA's and retirement plans, and you want to do something that's appropriate for YOUR individual situation, consider using our copyrighted Retirement Strategizer service. Our financial simulation models can plan an IRA distribution strategy (including Roth conversions) that's most advantageous for you.*

### 1998 Tax Law Changes

**1) An exception was enacted that may reduce the loss of 50% of the deduction for business meals.** If an employer provides meals to employees on the employer's business premises AND over 50% of meals provided are for the convenience of the employer, then all of the cost of the meals would be deductible. Qualification of meals "for the convenience of the employer" requires as substantial noncompensatory business reason such as a required presence during working hours or unavailability of meals from other sources.

> **Action:** *Employers should segregate expenses for meals furnished on business premises from other business meals. Documentation of noncompensatory business purposes for these meals should be maintained.*

**2) Several points on the taxation of home sales were clarified:**

a) The $250,000 per taxpayer gain exclusion applies only if a two-year ownership and occupancy tests are met. The 1998 law change allows that if a move is made within two years and was done for employment health, or other unforeseen reasons, then the maximum $250,000 gain exclusion will be prorated by the amount of time that the ownership and occupancy test was met.

b) The $250,000 exclusion limit applies separately for each spouse (maximum $500,000 on a joint return). The use test must be met separately by each spouse, but ownership by only one spouse is required.

> **Action:** *Homeowners should plan home sales carefully to qualify for the ownership and use requirements. The old deferral of gain from obtained by purchasing a more expensive residence (Section 1034 exclusion) is no longer available.*

**3) The exclusion for employer provided transportation fringe benefits have been expanded.** The current limits are $175/month for the cost of qualified parking benefits and $65 for other benefits (vanpools and transit passes). The exclusion amount of other benefits is now scheduled to increase to $100/month starting in 2002. The exclusions are indexed to inflation. Employees have the option of taking the benefit in cash, so there should be no incremental cost to the employer.

> **Action:** *Employers should consider working these fringe benefits into their compensation arrangements. This is a valuable non-taxable benefit that will have wide appeal.*

**4) Restrictions have been placed on vacation pay expense deductions that have been accrued but not paid at year-end.** To be deductible for the current tax year, the employee must receive payments within 2-1⁄2 months of the end of the employer's accounting year. Payment by the issuance of promissory notes does not qualify as receipt by the employee.

> **Action:** *Employers who want to accelerate the deduction for vacation pay accruals should change company policies to effect payment within 2 1⁄2 months after the close of the fiscal year.*

**5) Federally authorized tax practitioners (CPA's enrolled agents, and enrolled actuaries) have been given a limited confidentiality privilege in tax proceedings before the IRS.** The privilege is limited to tax advice, but does not apply to tax shelter or criminal matters. It is not clear to what extent the accountant's work product is excluded.

> **Action:** *Communications with your CPA regarding tax positions should be segregated from other communications so that the confidentiality privilege clearly applies. This means that discussion of tax advice should be separated from the communication of return information in tax return data organizers. Separate correspondence should be used. If you are sending us information which discusses tax issues, send it in a separate memo so that that particular information can be separated from the tax preparation information. In this way these tax issues will be clearly covered by the confidentiality privilege.*

**6) Who's on first?????** The Internal Revenue Service is no longer the recipient of our tax dollars, it's the United States Treasury.

> **Action:** *Checks should be made payable the United State Treasury. (There is no change if deposits are being made by deposit coupon at your bank. These checks are still made payable to the bank.)*

**7) Starting in 1999, Federal tax payments can be made by credit card.** Credit card companies will charge a "convenience fee" based on the amount charged.

> **Action:** *If you plan to use credit cards for tax payments in the future, contact your card company in advance to see if they are participating in the program and obtain their schedule of fees. You should also compare the government's rate of interest to the credit card company's rate.*

**8) Taxpayer are now able to recharacterize Roth IRA transactions as IRA rollovers.**

Proposed regulations allow individuals to recharacterize a Roth IRA conversion as a regular IRA rollover. This can be done by notifying the IRA trustee before the due date of the individual income tax return (including extensions). If the value of securities in the account has declined since the original conversion date, then declaring the conversion as a rollover, then doing a second Roth conversion at a lower value will reduce the amount of taxable income that is recognized.

> **Action:** *If you have already done a Roth IRA conversion in 1998, do a reconversion transaction if the market value of the assets has declined since the original conversion date.*

**9) Roth IRA income limitations were clarified.**

Conversions are allowed if adjusted gross income is $100,000 or less. The law change allows that in computing AGI limit, mandatory IRA distributions for persons over 70-1/2 do not have to be included.

**10) The holding period to qualify for long term gain has been reduced.**

The holding period to qualify for the long term capital gains rate has been reduced from 18 months to one year. This is an admission by the government that the expense of doing these capital gain computations was more trouble that it was worth.

**11) The fair market valuation of contributions of appreciated stock to private foundations expired on June 30, 1998.**

The FMV deduction is still available for gifts to public charities. Don't sell stock to make gifts to public charities. Gift the stock. Make gifts to private foundations in cash.