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Roth IRA Conversion Benefits Seniors

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The previous article, "Roth IRA can yield more with planning than 401(k)", published in the AZ Republic 2/25/09, outlined the benefit of no required minimum distributions after age 70.5 for money inside a Roth IRA. Yet, many seniors believe that it doesn't make sense to convert a traditional IRA to a Roth IRA late in life. However, seniors do not understand that they have far longer life expectancies than they believe. If a couple is age 65, there's a 47% chance that at least one of them will reach age 93 and a 26% chance that one will reach 97. Here are the potential benefits to seniors of a Roth IRA conversion:

Increased size of your IRA: If you pay the one-time conversion tax with dollars outside your traditional IRA, you'll have effectively a larger amount of money in your Roth IRA. This is because the Roth IRA contains only after-tax dollars. Part of your traditional IRA is owed to the IRS when you make any withdrawals, so you really don't own the whole IRA.

Reducing the Tax Rate of Distributions: If there will be a substantial amount left in your IRA when you die, you may wish to consider the tax rate that will apply to your heirs. Unless the IRA will be fully spent by your spouse, most couples leave the remainder of the IRA and other assets to their children. For those ages 70-90, their kids are typically Baby Boomers who are in their prime earning years.

Example: If a son and his wife have a joint 2009 taxable income of \$65,000, they are in the 15% marginal Federal tax rate. If a \$350,000 traditional IRA is inherited (after Dad and Mom die), now there is a \$415,000 taxable income. They are now pushed into the 35% Federal tax bracket and let's suppose they are in a state that has a 5% income tax rate. Now,

they will lose 40% of the IRA, or \$140,000 of taxes. This would be avoided if the son inherited a properly structured Roth IRA. Now there would be \$0 income tax.

Reducing tax on Social Security Benefits: Seniors have involuntarily had Social Security tax withheld from their paychecks for 30-50 years of employment. It really aggravates them when the government taxes them on the Social Security check that they receive when they retire.

If you file a federal tax return as "Single", and your combined income is between \$25-34,000, you may have to pay income tax on 50% of your Social Security benefits. If more than \$34,000, up to 85% of benefits may be taxable.

If you are "Married Filing Jointly", and your combined income is between \$32,000-44,000, you may have to pay income tax on 50% of your benefits. If more than \$44,000, up to 85% of your benefits may be taxable.

Note: The definition of "combined income" is your Adjusted Gross Income (the bottom line of page 1 of the 1040 Form) + Nontaxable interest (typically from municipal bonds) + ½ of your Social Security benefits. If you do have to pay taxes on your Social Security benefits, you can make quarterly estimated tax payments to the IRS or choose to have federal taxes withheld from your benefits.

Solution: If a married couple had \$32,000 of "combined income" but needed an extra \$20,000/year to enjoy life, they could pull this from a Roth IRA. Distributions that you take from a Roth IRA don't count as the "nontaxable interest" that goes into the calculation of



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how much of your social security benefit is taxable.

Estate Tax Savings: Under current law, if a wealthy person dies in 2009, each spouse (assuming the proper estate planning A/B Trust has been implemented) can have a \$3.5 million exemption from estate tax. However, this tax cut was part of a law enacted by President Bush in 2001 and expires at the end of 2010. In 2011, the pre-Bush rules will apply and only \$1 million per spouse has the estate tax exemption.

If one does a conversion to a Roth IRA, the one-time income tax paid will reduce the size of the taxable estate and therefore the estate tax due. Estate tax rates in 2011 can be as high as 55%. The highest income tax rate in 2009 is 35%. So, even if one had to pay a 35% tax on a 2009 Roth IRA conversion, one could save as much as a 55% estate tax rate in 2011 and beyond.

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