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Converting your Traditional IRA or 401(k) to a Roth IRA Can Save You \$100,000 - \$1 million

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The traditional IRA or 401(k) allowed one to take a tax deduction for contributions and earnings would be tax-deferred. However, all distributions (such as taking out money during retirement) are taxable at ordinary (not capital gains) rates. However, if one converts these funds to a Roth IRA, there are several situations where one can save tax.

The Rules: When one converts a traditional IRA or 401(k) to a Roth IRA, one pays income tax on the amount converted. E.g. One converts a \$100,000 IRA in 2008: This adds \$100,000 taxable income to one's other income for 2008. However, the benefit is that if one holds those funds in the Roth IRA for at least 5 years and one does not withdraw any funds until at least age 59.5, then all earnings are tax-free. One also is not required to take the Required Minimum Distributions, starting at age 70.5, required for those with traditional IRAs. In other words, one has TAX-FREE INCOME FOR LIFE. This is the HOLY GRAIL of Tax Planning.

However, if one's Modified Adjusted Gross Income is over \$100,000 (whether filing single or married, joint return), one is not eligible for this conversion until 2010, where this income limit restriction disappears.

Warning: The safest way to do the conversion is for a trustee to trustee direct transfer, so that you never touch the money and inadvertently cause it all to be immediately taxable.

Scenario #1: You are financially successful and are at the 30% combined federal and state tax rate. You have \$2,000,000 in your traditional IRA or

401(k) plus substantial other investments and income sources. You understand that the current income tax rates are at the second lowest in modern history. You believe that the tax rates will increase to 45%. By doing the Roth conversion, you owe \$700,000 of tax, but can pay the tax with funds not in the IRA or 401(k). This leaves the full \$2,000,000 in a Roth IRA. If you earn 8% or \$160,000/year tax-free, you will have saved \$72,000/year in taxes (if this income had been subject to a 45% tax rate). If you or your spouse will live another 30 years, this is a total \$2,160,000 of income tax savings. Your net savings is $\$2,160,000 - \$700,000 = \$1,460,000$. For ease of this example, I did not calculate the potential earnings lost on the \$700,000 of taxes paid.

Scenario #2: You had \$500,000 in your traditional IRA or 401(k), invested in the stock market in October, 2007. Since the peak of the market in October, 2007, you've lost 40% in the last 12 months. You believe that the market will rebound at some point and your account will eventually grow to \$1,000,000. Let's suppose that you are at a combined 30% tax rate between Federal and state. The Roth IRA conversion will cost you \$90,000 of tax (30% times \$300,000 account balance). However, you will save \$210,000 tax (30% times future \$700,000 gain).

Scenario #3: You're retired and simply want to save income tax on your Social Security benefits. Married couples filing a joint return who have more than \$44,000 income pay taxes on up to 85% of Social Security benefits (\$34,000 for singles). However, a couple can have as much as \$32,000 of "base amount"



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income (\$25,000 for a single taxpayer) before a penny of their benefits is included in their taxable income. The "base" calculation includes one-half of your Social Security, plus almost all your other income, including tax-exempt bond interest but not Roth withdrawals. If a couple has \$30,000/year of Social Security income and is at a 20% combined tax rate, there's a potential \$5,100/year of income tax savings by paying living expenses partly with Roth IRA withdrawals instead of distributions from their traditional IRA or 401(k) or other taxable accounts.

Conclusion: There are complex issues involving a Roth IRA conversion. One should consult a specialist who can consider all the income tax, estate issues, and family retirement income concerns before making a decision.

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