Thinking Ahead

Estate Planning Benefits of the Roth IRA

Christine Fahlund, CFP®, a senior financial planner with T. Rowe Price, discusses the new rules for Roth IRA conversions as well as the benefits of leaving those assets to your heirs.

Starting in 2010, new rules on Roth IRA conversions allow investors at any income level to convert all or part of their Traditional IRAs to a Roth IRA. This change in the tax law provides previously ineligible taxpayers with a new retirement investing opportunity, as well as a new tool for estate planning purposes.

Maybe you haven’t thought of passing on a retirement account to your heirs, but doing so could be an effective way to leave a legacy for your family. The potential for tax-advantaged growth, over the long term, can be quite substantial—especially over several decades. Although all types of retirement accounts have the potential to benefit your heirs, leaving Roth IRA assets to beneficiaries is a tax-effective way to build wealth for your family.

BENEFITS OF YOUR ROTH IRA

The Roth IRA can play an important part in an estate planning strategy for anyone who doesn’t need the money during retirement. Important considerations include:

- Your expected sources of retirement income
- Who your beneficiaries are and their ages
- Your ultimate estate planning goals

It is common for a surviving spouse who inherits assets in a Roth IRA to roll them over into a Roth IRA that he or she owns. In this case, the spouse will never be required to withdraw minimum distributions from the account (unless current tax laws change). On the other hand, if a surviving spouse or a non-spouse transfers the assets into an Inherited Roth IRA, distributions generally must be taken from the account annually, starting no later than December 31 of the year after the account holder’s death. These distributions are generally income tax-free to the beneficiary, regardless of age (certain conditions apply).
If a non-spouse beneficiary is relatively young, he or she will likely have many years to take distributions. For example, if your granddaughter inherits your Roth IRA at age 20, she may have more than 60 years during which to take required minimum distributions (RMDs). Meanwhile, the assets remaining in the account continue to be invested to help meet potential future needs. Even when the beneficiary is considerably older than 20, leaving the assets in an Inherited Roth IRA and taking only RMDs could amount to a significant financial benefit for him or her.

A Roth IRA can be passed on to more than one generation. When the beneficiary creates an Inherited Roth IRA, he or she then names his or her own beneficiary; if there are still assets in the account at the time of his or her death, his or her beneficiary may continue taking RMDs for the remainder of the original beneficiary’s life expectancy.*

For purposes of calculating potential estate taxes, assets in Roth and Traditional IRAs are included, even if the transfer of assets to beneficiaries avoids probate. Under current law, for individuals who pass away in 2010, there is no federal estate tax due.** In 2011, however, the tax is scheduled to be reinstated with an exemption for estate values of $1 million or less. Because current estate tax laws can vary significantly by state, you will want to consult an attorney about your particular situation. Be sure to ask about the tax implications of passing on your IRA or other tax-deferred assets.

ESTABLISHING YOUR ROTH IRA
When you set up your Roth IRA, you will first designate a primary beneficiary (typically your spouse). To maximize the potential future amount for your beneficiary, avoid taking unnecessary withdrawals. When feasible, try to use other resources for living expenses throughout your lifetime.

When your spouse inherits your Roth IRA, he or she will roll it over into a new Roth IRA in his or her name. Like you, your spouse is not required to take any withdrawals and may even elect to continue contributing to the account, if eligible.

Your spouse can then designate his or her beneficiaries. Each beneficiary could inherit a share of the assets in the Roth IRA and can elect to either receive the benefits as a lump sum or transfer them into an Inherited Roth IRA and take RMDs (or more) each year as potential tax-free income.

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I’m planning to use my IRA assets during my retirement, rather than passing the account to my heirs. Should I convert to a Roth IRA?

When deciding whether to convert to a Roth IRA, there are three main factors to consider: your current age, what you expect your tax rates to be in the future, and the portion of your IRA that is taxable due to the conversion. For example, if you are currently under age 59½ and in a high tax bracket, it might be better to stay with the Traditional IRA. This is especially true if you expect your tax rate to drop significantly once you retire. That way, rather than paying higher taxes now, because of the Roth conversion, you defer paying them until you are in a lower tax bracket when you retire.

On the other hand, regardless of your current age, if you expect tax rates to rise significantly in the future, it might be better to convert some of your tax-deferred assets now, while you are in a lower tax bracket. No one can see into the future, but you may wish to have accounts with different tax characteristics to hedge against a possible rise in future tax rates. This technique is called “tax diversification.” (See Digging Deeper on page 8.)

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*Life expectancy is based on the Single Life Expectancy Table in IRS Publication 590.

**Congress could amend the laws at any time and may attempt to make them retroactive.
SPECIAL CONSIDERATIONS

Think about these factors when deciding whether to convert a Traditional IRA to a Roth IRA for estate planning purposes:

- **How the Conversion “Tax” Can Reduce the Size of Your Estate.** If the original owner converts a portion or all of a Traditional IRA to a Roth IRA and pays a substantial amount in income taxes on the conversion, this may effectively reduce the size of the taxable estate. Depending on the size of the owner’s overall estate, this could be an important consideration.

- **The Effect of the Unlimited Estate Tax Marital Deduction.** When a spouse inherits the original owner’s Roth IRA, the assets are included in the deceased spouse’s taxable estate, but an unlimited estate tax marital deduction will apply if the spouse is a U.S. citizen. This enables those assets to pass, free of estate taxes, to the surviving spouse. (Special rules apply for a spouse who is a non-U.S. citizen.) Only at the time of the surviving spouse’s death will estate taxes potentially have to be paid on these assets.

- **Tax Issues for Non-spouse Beneficiaries.** Assets left to non-spouse beneficiaries may be subject to federal estate taxes. Once they inherit the assets, though, non-spouse beneficiaries can receive distributions from the Inherited Roth IRA income tax-free (certain conditions apply).

Because laws regarding Inherited Roth IRAs can vary by state, you should discuss your personal situation with a professional tax and/or estate planner. You should also discuss your plans with your beneficiaries early on. With a clear understanding of the rules associated with an Inherited Roth IRA, beneficiaries can take the proper steps to possibly receive the greatest benefit from the account. Over time, leaving Roth IRA assets to your heirs could result in a significant legacy for them if they choose to take advantage of it.

Visit troweprice.com/rothconversion to determine whether a Roth IRA conversion is appropriate for you. You’ll find tools and calculators as well as additional commentary on the topic from Christine Fahlund.

**Roth IRA Conversion Rules for 2010**

In 2010, the IRS is providing a one-time exception for taxpayers. If you convert all or part of your Traditional IRA this year, you can include the entire taxable amount—all but your after-tax contributions—as income on your 2010 tax return. Or you can opt to include half the income on your 2011 tax return and the other half on your 2012 return.

If you expect to be in a lower income tax bracket in either 2011 or 2012—or in both years—you may decide on the latter option; however, if you are concerned that your marginal income tax rate in 2011 and/or 2012 may be significantly higher than it is this year, you may decide to include the entire taxable amount due on the conversion on your tax return for 2010.

**Note:** This opportunity is available only for conversions made in 2010. If you make conversions in January 2011 or thereafter, you must include the entire income amount on your tax return for the year in which the conversion occurred.
Passing on a Roth IRA to Heirs Could Reap Huge Benefits

In this hypothetical example, the owner of a Roth IRA, who converted $100,000 in tax-deductible contributions and earnings from a Traditional IRA at age 65 and paid $28,750 in income taxes, passes away at age 85.

Since he took no distributions, the balance in the account which he leaves to his son, age 55, grew to $320,714 in the year following the owner’s death. The table shows the total benefits to him at various ages.

The analysis assumes the beneficiary only withdraws required minimum distributions (RMDs) each year, although he may choose to withdraw more than the required amounts at any time. Withdrawals are income tax-free.

Dollar amounts have not been adjusted for inflation to reflect current purchasing power.

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**Age of Roth IRA Beneficiary**

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<th>Age of Roth IRA Beneficiary</th>
<th>Cumulative Tax-Free Distributions</th>
<th>Remaining Roth IRA Balance</th>
<th>Total Roth IRA Benefit</th>
<th>Advantage Over After-Tax Traditional IRA†</th>
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†After-tax Traditional IRA includes sum of cumulative after-tax withdrawals and balances in a Traditional IRA, plus the balance in a taxable side account that otherwise would have been used to convert assets to a Roth IRA, plus any subsequent earnings. Although this taxable account is not subject to RMD rules, such withdrawals were made for this comparison.

Assumptions: The example assumes no additional IRA contributions are made; an 8% annual rate of return before retirement at age 65 and a 6% rate thereafter; and an ordinary federal income tax rate of 25% before and after retirement with a state tax rate of 5%, for a combined effective rate of 28.75%. The conversion pushes the 65-year-old investor into a higher tax bracket in the year of conversion only. Net income and long-term gains in the taxable side account are subject to a federal tax rate of 15% and a state rate of 5% for a combined effective rate of 19.25%. All Roth IRA withdrawals are free from taxation; all Traditional IRA withdrawals are subject to federal and state taxes. Withdrawals are made over a 30-year period with 4% withdrawn the first year and the annual withdrawal amount increased by 3% each year for inflation. Withdrawals from the Traditional IRA take into account RMDs. Also, all Traditional IRA contributions are deductible; therefore, the entire conversion amount is subject to taxes.

We assume that the taxes due on the amount converted are paid from a separate taxable account. Therefore, to do a valid comparison, the taxable side account reflects the value of keeping the “tax savings” that would have been paid in the IRA conversion invested in this separate taxable account, growing at the same rates of return and applying the same withdrawal schedule as noted above. The advantage of a Roth IRA would be considerably greater, of course, if these tax savings had been spent rather than invested.

Source: T. Rowe Price.