

# Every Cloud Has a Silver Lining: Converting to a Roth IRA in a Depressed Economy

*By Roy Clemons*

Roy Clemons describes how both moderate income and high-income taxpayers may derive tax and estate planning advantages by converting their traditional IRAs and other tax-deferred retirement plans into Roth IRAs.

Over the past year taxpayers have watched the value of their investments devastated due to the drastic decline in the market value of their investments. For example, based on the Dow Jones Industrial Index, the market value of investments has dropped by over fifty percent in the past year.<sup>1</sup> Because of the alarming drop in the value of their investments, taxpayers are visiting their financial advisors for recommendations on how to deal with the bad news. Holding to the adage that “every cloud has a silver lining,” taxpayers now have an opportunity to benefit in the current depressed market by converting their tax-deferred retirement accounts<sup>2</sup> to the Roth IRA, at substantial tax savings. This article will present estate planning opportunities for investing in the Roth IRA during the current down economy.

The drastic decline in the market over the past year provides an opportunity for taxpayers to convert their tax-deferred retirement accounts at substantial tax savings to the Roth IRA. Furthermore, by such a conversion, taxpayers will be favorably positioned to experience significant tax-free growth from their Roth IRA once the market recovers. Tax-free growth and tax-free distributions are the greatest advantages of

the Roth IRA. Another advantage of the Roth IRA is that it does not require minimum distributions during retirement; therefore, the Roth IRA is also an excellent tool to use for estate planning purposes.

This article presents the benefits of converting to the Roth IRA during the current depressed market for estate planning purposes by presenting two distinct examples. The first example illustrates the estate planning benefits of establishing a Roth IRA investment plan this year for a couple with average income. The second example presents the first opportunity for high-income<sup>3</sup> taxpayers to convert to the Roth IRA in 2010 for estate planning purposes. The examples illustrate estate planning opportunities for average and high-income taxpayers to pass wealth onto their heirs free of future income tax. Overall, this article will demonstrate that now is the ideal time for taxpayers to convert their tax-deferred retirement accounts to the Roth IRA for estate planning purposes.

## **Traditional IRA Tax Treatment**

The primary benefit of the traditional IRA is tax-deferral. In general, the contributions a taxpayer makes to a tax-deferred retirement account are not taxed when contributed, and the earnings from the retirement account are not taxed until withdrawn. When the eligible money is withdrawn, however, it will be fully taxable at the taxpayer's ordinary income tax rate. For example, assume a taxpayer had ordinary income of \$40,000 for the year and put \$5,000 into

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a traditional IRA. The taxpayer would pay income tax on only \$35,000 since the \$5,000 contribution is tax-deferred. Also, the taxpayer's deposit will benefit from tax-free growth as long as it remains in the tax-deferred retirement account. When the taxpayer makes eligible withdrawals at retirement<sup>4</sup> then, and only then, will the money be taxed as income at the taxpayer's ordinary income tax rate.

### **Roth IRA Tax Treatment**

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The tax treatment of the Roth IRA is much different than that of a tax-deferred retirement account, such as the traditional IRA. Unlike a contribution to the traditional IRA, a Roth IRA contribution is made on an after-tax basis. Now, assume that the taxpayer from the traditional IRA example above elects to contribute to the Roth IRA instead. The taxpayer would be taxed on the entire \$40,000 of ordinary income even though the taxpayer has made the \$5,000 Roth IRA contribution. That is, the taxpayer generates no tax savings when contributing to a Roth IRA. The benefit of investing in the Roth IRA is realized when the taxpayer withdraws money from the Roth IRA in the future. When the taxpayer makes eligible withdrawals<sup>5</sup> from the Roth IRA, none of the withdrawals of contributions or earnings are taxed. In other words, the Roth IRA offers tax-free, rather than tax-deferred, retirement withdrawals. While both the traditional IRA and the Roth IRA allow the taxpayer to accumulate wealth without paying taxes along the way on the profits, the traditional IRA ultimately burdens the taxpayer with a tax bill for those profits and contributions. On the other hand, once a taxpayer contributes to the Roth IRA, the taxpayer will never pay taxes on any eligible withdrawals.

The Roth IRA also allows the taxpayer greater flexibility. Taxpayers can generally withdraw contributions at any time tax-free, without penalty. Also, first-time homebuyers can pullout \$10,000 in growth penalty-free and tax-free if the money has been in the Roth IRA for at least five tax years. Finally, an individual investing in the Roth IRA can benefit from tax-free growth beyond retirement. More specifically, unlike tax-deferred retirement accounts, taxpayers are not required to receive distributions from the Roth IRA upon reaching age 70.

### **A Depressed Market: The Ideal Time to Convert to a Roth IRA**

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The largest barrier to converting from tax-deferred retirement accounts to the Roth IRA has generally been the prohibitive tax cost of conversion. Upon conversion from a tax-deferred retirement account to the Roth IRA, the taxpayer must pay ordinary income tax on the entire amount converted. For example, assume a taxpayer in the 25 percent income tax bracket contributed \$5,000 per year to a traditional IRA for the past five years, and during that time assume the traditional IRA generated a return of 10 percent. After five years the traditional IRA would be worth \$30,000, and the tax cost to convert to the Roth IRA would be \$7,500 ( $.25 \times \$30,000$ ).

As the preceding example demonstrates, the cost of conversion is positively associated with the growth in the retirement account because taxes are due on

**Tax-free growth and tax-free distributions are the greatest advantages of the Roth IRA.**

both contributions and growth. Therefore, when the market is experiencing significant growth, individuals will have a disincentive to convert to the Roth IRA. On the other hand, when the market is experiencing a significant decline, taxpayers have the opportunity to convert to the Roth IRA at substantial tax savings.

Retirement savings have been devastated by the recent decline in the market value of investments, but this presents an ideal opportunity for taxpayers to convert their eligible tax-deferred retirement accounts to the Roth IRA. The primary benefits of converting to the Roth IRA in the current depressed market are the following:

- The opportunity to never pay tax on a portion of the original contributions to the tax-deferred retirement account
- The opportunity for the retirement account to grow and be distributed free of any future income tax
- The opportunity to allow the Roth IRA to grow tax-free indefinitely (that is, beyond retirement)

A significant benefit for converting to the Roth IRA in the current depressed market is the ability to never pay income taxes on the amount converted that is less than the original tax-deferred contributions. That is, when taxpayers convert from an eligible tax-deferred retirement account to the Roth IRA, they must pay ordinary income tax on the amount converted. If the current value of the taxpayer's tax-deferred retirement

account is less than the contributions originally made to the account, the amount converted to the Roth IRA will never be taxed.

The second benefit of converting to the Roth IRA is the ability to enjoy tax-free growth and tax-free distributions from the Roth IRA. Contributions and growth will never be taxed while in the Roth IRA, and they will never be taxed when the taxpayer takes eligible distributions from the Roth IRA. Therefore, once a taxpayer transfers funds into the Roth IRA, the taxpayer will never pay income taxes on any future growth or eligible withdrawals. This tax advantage of the Roth IRA is touted as its largest benefit over tax-deferred retirement accounts.

The third benefit of converting to the Roth IRA is the ability to retain the funds in the Roth IRA indefinitely. In tax-deferred retirement accounts, taxpayers must begin making withdrawals upon reaching 70.5, but with the Roth IRA there is no age at which the taxpayer must begin withdrawing funds. An example dealing with high-income individuals will demonstrate that the magnitude of tax-free growth of the Roth IRA beyond retirement provides a very effective means for accumulating assets to pass on to heirs free of future income tax.

Next, the benefits of converting to the Roth IRA in the current depressed economy will be demonstrated via two examples. The first example will demonstrate the benefits of conversion to the Roth IRA for a couple with average income for estate planning purposes. The second example will illustrate the first opportunity for high-income taxpayers to convert to the Roth IRA in 2010, and it will also illustrate the benefits of converting to the Roth IRA for estate planning purposes.

### **Example 1: Roth IRA for a Couple with Average Income**

This example illustrates the potential benefits for a couple with average income to convert to the Roth IRA for estate planning purposes. For purposes of this example it is assumed that the couple has alternative retirement resources other than the IRA. Assume that the couple examined has the following attributes:

- The couple earns an income of \$61,000<sup>6</sup> which approximates the average income for a typical U.S. couple.
  - Both husband and wife have annual earned income exceeding \$5,000, and are able to contribute \$10,000 annually, after-tax to the Roth IRA.

- The couple's income tax rate is 25 percent.
- Husband and wife are both 25 years old and plan to retire at 65.
- The couple has contributed \$25,000 to a traditional IRA over the past five years.
  - Over the past year the value of the couple's traditional IRA reached a high of \$30,000, and has just hit a recent low of \$13,800.<sup>7</sup>

Due to the 50-percent-plus decline in the value of their traditional IRA, the couple approaches their financial advisor for recommendations on what to do about their retirement savings plan. The financial advisor explains to the couple that the recent drop in the value of their retirement account provides an excellent opportunity to convert their traditional IRA to the Roth IRA and establish an estate planning strategy that will potentially yield millions of dollars to pass on to their heirs. The adviser explains the specific benefits of converting to the Roth IRA during the current depressed market and establishing a future Roth IRA investment plan.

The first benefit explained to the couple is that their tax cost for converting to the Roth IRA has been substantially reduced due to the recent depressed market. For example, if the couple would have converted to the Roth IRA when their traditional IRA was valued at \$30,000, they would have owed income taxes of \$7,500 ( $25\% \times 30,000$ ). If the couple converts to the Roth IRA now, while their traditional IRA is currently valued at only \$13,800, their tax bill for conversion will be reduced to \$3,450. So relative to the retirement accounts high value for the past year, the couple will save 54 percent in income taxes by converting now while the market is depressed. Furthermore, the couple will never pay tax on the conversion amount, because it is less than the contributions they originally made to the traditional IRA. That is, the couple will never pay income tax on \$11,200 ( $\$25,000 - \$13,800$ ) of the contributions that were made to the traditional IRA. Therefore, this example shows that the current tax savings of converting to the Roth IRA during a depressed market are significant.

The financial adviser goes on to also explain that the immediate tax savings, while significant, are not the primary benefit of converting to the Roth IRA. The primary benefit of converting to the Roth IRA is the future tax-free growth and tax-free distributions. The advisor explains that the market has always recovered from major declines, and when the recovery occurs it happens rapidly. For example, since the stock market crash of 1929 the market has experienced 17

significant down markets. After hitting its low point in each of these downturns, the market has always recovered, rewarding taxpayers with a median return of over 46 percent in the following year.<sup>8</sup> Therefore, converting while market values are depressed will ideally position the taxpayers to benefit from the market's recovery.

The financial advisor suggests that the couple not only convert due to the immediate tax savings, but that they also increase their future contributions to the Roth IRA to accumulate significant funds to pass on to their heirs. The adviser recommends that the couple makes monthly contributions up to their eligible contribution limit of \$10,000 per year through retirement. If the couple converts their traditional IRA this year to the Roth IRA and establishes the proposed monthly Roth IRA contribution strategy, their investment will grow substantially and the tax savings upon withdrawal will be significant. The following example shows the potential benefits to the couple of establishing such an investment plan using the Roth IRA.

Assume that the couple follows the recommendation of the adviser. The couple converts their traditional IRA with a current value of \$13,800 into a Roth IRA and makes additional monthly contributions to the Roth IRA of \$833 (\$10,000 a year) until reaching the age of 70. Also, assume that the Roth IRA has a long-term inflation adjusted return of 6.8 percent.<sup>9</sup> If the couple maintains the funds in the Roth IRA until reaching age 70, then their investment will grow to nearly \$3.3M, and the income tax due upon withdrawal at retirement will be zero. The total tax costs of the Roth IRA investment strategy will include the after-tax cost of the contributions, \$3,333 (25% × \$13,333) per year for 45 years, and the conversion costs in the current year, \$3,450 (25% × \$13,800). In present value terms, the tax cost of the Roth IRA investment strategy will total \$129,000.<sup>10</sup> On the other hand, assume that the couple implemented the identical strategy, but instead retained the funds in the traditional IRA and made all additional contributions to the traditional IRA. By implementing the traditional IRA investment strategy, the income tax due on the \$3.3M upon withdrawal in present value terms would equal about \$568,000.<sup>11</sup> Therefore, although

**The largest barrier to converting from tax-deferred retirement accounts to the Roth IRA has generally been the prohibitive tax cost of conversion.**

contributions to the Roth IRA are made after-tax, the couple would save in present value terms \$439,000 in income taxes by implementing the Roth IRA strategy. This example demonstrates that for couples with average income, the tax savings and the estate planning advantages with the Roth IRA are substantial.

Although the benefits of the Roth IRA are substantial, it has not been available to high-income individuals. Couples with over \$169,000 in modified adjusted gross income (MAGI) are not allowed to contribute to a Roth IRA, and couples with MAGI over \$100,000 are not allowed to convert their tax-deferred retirement accounts to a Roth IRA. However, in 2010 Congress provides a window of opportunity for even high-income individuals to convert their eligible tax-deferred retirement accounts to the Roth IRA. The next example will present an estate planning opportunity in 2010 for high-income individuals to convert to the Roth IRA from their eligible tax-deferred retirement accounts.

### **Example 2: Conversion in 2010 for High-Income Taxpayers**

The preceding example demonstrates that a couple with an average income has the opportunity to utilize the Roth IRA to grow their estate planning savings over the years free of any future income tax. Unfortunately, the Roth IRA has not been available to high-income individuals prior to 2010. However, the *Tax Increase Prevention and Reconciliation Act of 2006* removed the income limit<sup>12</sup> for converting qualified deferred-tax retirement accounts to the Roth IRA in 2010. The primary benefits offered by the provision include the following: 1) high-income individuals have the ability to convert qualified deferred-tax retirement accounts into Roth IRAs; and 2) individuals making such Roth IRA conversions may pay income tax owed equally over the two following years (2011 and 2012). The following example will demonstrate the benefits of the provision that permits, in 2010, high-income individuals to convert their eligible tax-deferred retirement accounts to Roth IRAs. The high-income couple examined has the following attributes:

- The couple has earned income of \$200,000.
- The couple's income tax rate is 35 percent.
- Both husband and wife are 25-years old.

- The couple had a 401(k) plan at a previous employer that they rolled over into a traditional IRA.
- The couple's traditional IRA reached a high of \$100,000 and has just hit a recent low of \$46,000.<sup>13</sup>
- The market has not recovered from its recent low in 2010.

The high-income couple visits their financial planning advisor to enquire about the opportunity to convert their traditional IRA to the Roth IRA in 2010. The couple also informs the advisor that they do not need the traditional IRA to fund their retirement needs and would like recommendations on using the Roth IRA for estate planning purposes. The financial advisor explains to the couple that the recent drop in the value of their traditional IRA, combined with the removal of the taxpayer income limits for conversion in 2010, provides an opportunity to convert to the Roth IRA and establish an estate planning strategy that potentially will generate millions of dollars to pass on to their heirs free of any future income tax.

The first benefit explained to the couple is that their tax cost for converting to the Roth IRA in 2010 has been substantially reduced due to the recent depressed market. If the couple would have converted to the Roth IRA when their traditional IRA was valued at \$100,000, they would have owed income tax of \$35,000 ( $35\% \times 100,000$ ). On the other hand, if the couple converts to the Roth IRA now while their traditional IRA is currently valued at only \$46,000, their tax bill for conversion will be reduced to \$16,100 ( $35\% \times 46,000$ ). So, relative to the retirement accounts high value, the couple will save over 54 percent in income taxes by converting now while the market is depressed. Furthermore, the couple is allowed to spread this tax costs equally over the following two years, reducing the present value of the conversion tax costs to \$15,909.

The financial adviser goes on to further explain that the immediate tax savings while significant are not the primary benefit of converting to the Roth IRA. The primary benefit of converting to the Roth IRA is the future tax-free growth and tax-free distributions. For example, assume that the couple converts their traditional IRA with a current value of \$46,000 to the Roth IRA and decides to retain the funds in the account to pass on to their heirs. Furthermore, assume the retains the assets in the Roth IRA until reaching age 70, and assume that the Roth IRA has a long-term inflation adjusted

return of 6.8 percent.<sup>14</sup> If the couple maintains the funds in the Roth IRA for the entire 45 year period their \$42,000 Roth IRA will grow to \$888,000 and the income tax due when the funds are passed to their heirs will be zero. Therefore, the total present value of the income taxes paid on the Roth IRA equals less than \$16,000 (*i.e.*, the present value of the cost of conversion to the Roth IRA). On the other hand, assume the couple left the \$42,000 in the traditional IRA. If the cash would have been retained in the traditional IRA the income tax due on the \$888,000 would have been equal to \$217,000 in present value terms.<sup>15</sup> Based on the facts of this example, the couple would save in present value terms over \$200,000 in income taxes by converting their traditional IRA to the Roth IRA in the current year. Overall, this example demonstrates that not only is the Roth IRA an excellent account to use to accumulate retirement savings, but also to pass assets on to heirs, since tax-free growth throughout the retirement years is a major benefit of the Roth IRA.<sup>16</sup>

## Summary

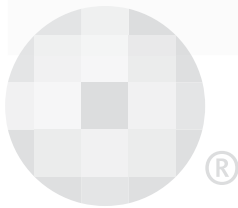
This article evaluated the benefits of converting to the Roth IRA during a depressed market and supported the adage that "every cloud has a silver lining." Although taxpayers have watched the value of their retirement savings dwindle this year, this downturn has created an opportunity for taxpayers to convert their retirement accounts to the Roth IRA at substantial tax savings. Converting to the Roth IRA in the current year also has estate planning benefits.

The article illustrated the potential benefits for taxpayers that convert their tax-deferred retirement accounts while the market is depressed. Furthermore, by converting to the Roth IRA now taxpayers will be favorably positioned to experience significant tax-free growth from their Roth IRA once the market recovers. The article also focused on the benefits of tax-free growth and tax-free distributions that have been dubbed the greatest advantages of the Roth IRA. Also illustrated was that the Roth IRA is an excellent tool to use for estate planning purposes due to the fact that it does not require mandatory withdraws during a taxpayer's retirement years. Overall, the purpose of this article was to demonstrate that now is the ideal time for taxpayers to convert their tax-deferred retirement accounts into the Roth IRA for estate planning purposes.

### ENDNOTES

- <sup>1</sup> The Dow Jones Industrial Index (INDU) reached a high in the past year of \$13,192 on May 2, 2008 and a current low of \$6,440 on March 9, 2009. Available online at [www.marketwatch.com/quotes/indu](http://www.marketwatch.com/quotes/indu).
- <sup>2</sup> "Tax-deferred retirement accounts" will be used throughout this article, and they include both eligible tax-deferred retirement plan assets from a previous employer and individual retirement accounts other than a Roth IRA (e.g., the traditional IRA).
- <sup>3</sup> For the purpose of this article, high-income is considered a taxpayer with modified adjusted gross income (MAGI) over \$100,000. Taxpayers with MAGI of \$100,000 or more are not allowed to convert their tax deferred retirement accounts to a Roth IRA prior to 2010.
- <sup>4</sup> In general, distributions may be made penalty-free from a tax-deferred retirement account after the taxpayer has reached age 59 ½. If the taxpayer withdraws the funds before age 59 ½, then in most cases the taxpayer will be required to pay both income tax and a 10-percent penalty on whatever earnings have accrued.
- <sup>5</sup> In general, to be considered an eligible withdrawal the Roth IRA must have been open for at least five tax-years and the taxpayer is older than age 59 ½.
- <sup>6</sup> Average income is based on the mean income for a couple in 2000 of \$56,604 (Census 2000) adjusted for inflation.
- <sup>7</sup> The couple's investment account closely follows the movement of the Dow Jones Industrial Index.
- <sup>8</sup> Source: Capital Research and Management Company.
- <sup>9</sup> Based on the long-term inflation adjusted returns from 1871–2001 (see Jeremy J. Siegel, *STOCKS FOR THE LONG RUN: THE DEFINITIVE GUIDE TO FINANCIAL MARKET RETURNS AND LONG-TERM INVESTMENT STRATEGIES* (4<sup>th</sup> ed. 2007).
- <sup>10</sup> Includes the present value of 45 annual pre-tax payments plus the conversion cost in the current year of \$3,450.
- <sup>11</sup> Equals the future tax liability of \$814,000 discounted to the current year.
- <sup>12</sup> Prior to 2010, taxpayers with modified adjusted gross income (MAGI) in excess of \$100,000 could not convert a tax-deferred retirement account to a Roth IRA.
- <sup>13</sup> The couple's investment account closely follows the movement of the Dow Jones Industrial Index.
- <sup>14</sup> Based on the long-term inflation adjusted returns from 1871–2001 (see Jeremy J. Siegel, *STOCKS FOR THE LONG RUN: THE DEFINITIVE GUIDE TO FINANCIAL MARKET RETURNS AND LONG-TERM INVESTMENT STRATEGIES* (4<sup>th</sup> ed. 2007).
- <sup>15</sup> Equals the future tax liability of \$311,000 discounted to the current year.
- <sup>16</sup> Taxpayers must begin taking distributions from the traditional IRA upon reaching age 70 ½.

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