Q 6:28 What variables affect decisions regarding Roth IRA conversions and financial planning other than technical requirements and elections?

In addition to the technical requirements and the elections a taxpayer may make, Roth IRA conversion analysis is driven by the following factors:

- Tax rates at time of contribution and deduction
- Tax rates at time of distribution and taxation
- Rate of return (growth)
- Deferral period
- Inflation rate
- Current and future cash flow needs

The degree to which any factor affects the decision to convert a traditional IRA to a Roth IRA cannot be determined easily. A small percentage change in one variable may cause the advantage of such a conversion to disappear.

Each variable has a different sensitivity influence on the result, depending on the circumstances. That sensitivity has been effectively demonstrated in a comprehensive series of case studies prepared by Gobind Daryanani, Ph.D., after reviewing software from many sources and developing his own algorithm and proprietary software. [G. Daryanani, *Roth IRA Book: An Investor's Guide* (Bernardsville, N.J.: Digiqual Inc., 1998)] The case studies look at how a small (2 percent to 4 percent) increase in an assumption—future tax rates, for example—can affect decision making. Daryanani defines *sensitivity* as the percentage change in the advantage or disadvantage of a Roth conversion (or contribution) resulting from a 1 percent change in the variable.

> **Example.** Felicity, age 40, calculates that by converting her traditional IRA to a Roth IRA she will have about $100 more per year to spend (taking inflation into account) when she begins withdrawals at age 75. If, however, Felicity starts distributions earlier, say at age 74, the conversion would provide only about $90 extra per year. There is a 10 percent sensitivity to a one-year reduction in the deferral period; here, the sensitivity to that variable is not particularly high.

The following conclusions regarding the relative advantage of a Roth IRA over a traditional IRA are based on a number of observations from various case studies:

A Roth IRA will do significantly better than a traditional IRA even if a tax deduction from a traditional IRA contribution is available *and* that amount is invested. In most cases, individuals do not invest their tax savings; thus, the loss of the current year's deduction will not be significant. The Roth IRA will be an even better choice if the tax savings are *not* invested.

> **Example.** Angela can contribute $4,000 to a deductible traditional IRA. She has a marginal tax rate of 35 percent. If Angela invests her tax savings of $1,400 ($4,000 × 0.35), she will have $5,400 invested (of which $1,400 is in a taxable account and $4,000 is in the traditional IRA and taxable upon

withdrawal). If Angela contributes \$4,000 to a Roth IRA, she will have only \$4,000 invested. Even so, Angela is better off with a Roth IRA. Assuming an annual growth of 10 percent for 20 years, Angela would be \$2,245 (\$26,910 – \$22,425) ahead with a Roth IRA and no outside savings.

Roth IRA: \$4,000 × 1.10^{20} = \$26,910 available from Roth IRA (no taxes)

Traditional IRA with tax savings invested:

\$4,000 × 1.10^{20} = \$26,910; \$26,910 – taxes (35%) of \$9,418

= \$17,492 from traditional IRA

\$1,400 × $(1.10 - 0.035)^{20}$ = \$4,933 from invested tax savings

1. \$17,492 + \$4,933 = \$22,425 available from traditional IRA with tax savings invested

Even if Angela contributed to a traditional IRA and invested her tax savings in a tax-exempt investment portfolio, it would still be better to convert her traditional IRA to a Roth IRA. If she earned 7 percent tax-free on her outside savings, Angela would generate only \$5,418 (\$1,400 × 1.07^{20}) from her invested tax savings of \$1,400, or \$22,910 (\$17,492 + \$5,418) in total. In this case, the Roth IRA would be better by \$4,000 (\$26,910 – \$22,910).

As the example illustrates, even if traditional IRA tax savings are invested, the Roth IRA may still be the better choice. The tax-free growth in the Roth IRA can offset lower taxes paid during the retirement years when withdrawals are made from a traditional IRA. Of course, the lower those taxes, the longer the Roth IRA has to be held for its owner to break even.

2. Significantly lower tax rates at retirement may make the traditional IRA more advantageous.
3. It takes five years of tax-free growth in the Roth IRA to nullify the advantage of a 5 percent lower average tax at retirement.
4. The Roth IRA advantage increases as the duration of the deferral period increases. Conversely, the traditional IRA advantage increases as the deferral period decreases.
5. An estate will be worth significantly more if Roth IRA assets are left intact until age 80.
6. Inflation affects all IRAs almost equally.
7. Higher rates of return favor the Roth IRA.
8. A plan that makes matching contributions of 50 percent to 100 percent (e.g., a 401(k) plan or a 403(b) plan) will be a better choice than the Roth IRA. At lower percentages, 0 percent to 25 percent, a Roth IRA is generally a better choice.
9. Roth IRA assets are generally the last assets that should be used for retirement income.

Specific observations regarding Roth IRA conversions are as follows:

1. A Roth IRA conversion will generally provide an advantage if the conversion taxes are paid from outside assets.
2. A partial conversion may be appropriate. For example, if funds are needed within five years, a taxpayer may be better off not converting all of his or her traditional IRA. Penalties may also have to be considered (see Qs 4:17–4:22). In addition, if tax rates are lower in retirement and funds from a traditional IRA are needed within 15 years, a partial conversion may be better.

Income and Estate Tax Advantages

Q 6:29 Can a Roth IRA conversion affect a taxpayer's enjoyment of the charitable deduction and investment tax credit carryforwards?

Yes. If a taxpayer has favorable tax attributes such as charitable deduction carryforwards or investment tax credit carryforwards, conversion to a Roth IRA may be desirable.

A charitable deduction, for instance, may not exceed a percentage of the taxpayer's AGI. The deduction percentage further depends on whether the gift was a gift of cash or a gift of appreciated property; for example, if a taxpayer made a contribution of appreciated property to a charity, the deduction is limited to 30 percent of the taxpayer's AGI. By converting to a Roth IRA, a taxpayer increases his or her AGI for purposes of calculating the charitable deduction.

Example. Ian makes a contribution of $130,000 of appreciated securities to a charity. Before a Roth IRA conversion, Ian and his wife, Simone, have AGI of $100,000. If Ian and Simone do not make a Roth conversion election, the charitable deduction will be limited to $30,000, which is 30 percent of their AGI of $100,000. If they convert $200,000 to a Roth IRA, they will be able to deduct $90,000 ($300,000 of AGI × 30% charitable deduction limitation). That allows Ian and Simone to use their charitable deduction earlier than they would otherwise.

Note. A Roth IRA conversion may make it possible to use deductions that would otherwise be lost under the carryforward rules. A charitable deduction carryforward, for example, must be used within five years. Without a Roth IRA conversion, a portion of the charitable deduction could be lost.

Q 6:30 What is meant by the terms *exclusion trust, credit shelter trust, bypass trust*, and *family trust*, and may a Roth IRA be used to fund any such trust?

The terms *exclusion trust*, *credit shelter trust*, *bypass trust* (B trust), and *family trust* refer to a trust designed to use a taxpayer's estate tax exemption. Creating such a trust in 2009 allows $3.5 million of property to be sheltered from federal estate taxes in each spouse's estate by using the applicable exclusion. This is a dollar amount that each taxpayer may exclude from the federal estate