Is It Legal to Pay Income Taxes Once and Never Again?

The answer may surprise you, but your decision may shock you.

By:

Gene Dickison of "More than Money"

Roth IRAs carry a very alluring promise – Pay income taxes once and never again. Legal? Absolutely. Should you fund a Roth IRA or convert some/all of your existing IRAs to Roth IRAs? The answer is absolutely – not as simple as it seems.

A Disclaimer Written in English that Actually Makes Sense

Let's get the disclaimer out of the way early. I am neither a CPA, nor a tax attorney, nor have I played either on television. I do not intend, and you should not expect, a detailed and footnoted compendium of IRS code citations. You should expect a clear, written in English, guide to get you started on the right track.

No article, (not even one as well written, intelligent, insightful, and yet entertaining as this), can tell you if you should convert some/all of your IRAs to Roth IRAs. There are simply too many specific answers only you are in a position to supply. There are too many "what ifs". There are too many assumptions to be – well – assumed. The intent of this article is to establish the fact base and decision making framework. Once you understand these two sets of tools you will be much better equipped to work with your financial advisors in crafting a strategy that best fits your goals.

Roth IRA Basics

The basic Roth IRA mechanism is quite simple. You establish a Roth IRA with contributions that are **not** tax deductible – you pay immediate income taxes on your contributions. If you follow the rules and retire many years later, **you pay no income taxes** on your Roth IRA withdrawals. It is the old oil filter commercial in action – you can pay me now or you can pay me later. Choose a Roth IRA and you choose to pay 'the man' now and be off the hook later.

The basic Roth IRA, around since about 1997, allows taxpayers to annually contribute maximums of $5,000 or $6,000 (depending on their age) as the IRS tax code allows.

Some taxpayers (with incomes exceeding limits set by the IRS) are prevented from contributing to Roth IRAs. Younger taxpayers (with more years until retirement) and taxpayers with lower incomes (and subsequently lower income tax bites) have often found the Roth IRA a very attractive alternative to the traditional IRA. Others choose the Roth because it fits their goals and circumstances.
As a corollary to the type of taxpayer who might find the Roth IRA most attractive, many young taxpayers (in their teens and early twenties particularly) find themselves paying no or virtually no income tax at all. The IRS permits Roth IRAs to be funded by folks other than the taxpayer themselves. Many parents and grandparents follow these rules in funding Roth IRAs for the children or grandchildren. These gifts have the potential to compound for forty or fifty years (or longer) and then provide income tax free income to these now retired children. Not many dollars out of mom and dad's (or grandmother and pop pop's) pockets might create dramatic account balances decades down the road. Lots of 'ifs' later, (like if the Congress doesn't raid the Roth accounts down the road), and some much loved kids end up very financially happy.

In recent years the Roth 401(k) option has been adopted by more and more companies. The Roth 401(k) allows taxpayers to elect significantly greater contributions to these plans. Employees may contribute up to $16,500 annually or $22,000 if they have reached age fifty. For taxpayers, young or old, who find the Roth an appropriate part of their planning for retirement, the Roth 401(k) could have a dramatic impact on their ability to accumulate dollars intended to produce tax free income in their future retirement years.

Roth Conversions – The Basics?

The law that created the Roth IRA also outlined rules for converting from traditional IRAs to Roth IRAs. Two key factors applied. First, income tax was due and payable on any amounts converted to a Roth. Second, taxpayers who had incomes above $100,000 were denied the ability to convert to a Roth IRA.

On January 1, 2010 all taxpayers became eligible to convert certain accounts to Roth IRAs. The accounts eligible for conversion include:

- Traditional IRAs
- SEP IRAs
- SIMPLE IRAs
- Distributions from a 401(k)
- Distributions from a 403(b)

Taxpayers who decide to convert can expect to enjoy a number of benefits including:

- Future withdrawals from their Roth IRAs will be free from taxes and penalties
- No Required Minimum Distributions (RMDs) are assessed against Roth IRAs
- Income taxes on social security benefits may be reduced or eliminated
- Estate taxes may be reduced
- Tax rate paid may be lower than children's rate upon inheritance
- Taxpayers converting in 2010 may choose special tax treatment

Special income tax options are available for taxpayers converting to Roth IRAs in 2010. The taxpayer may choose to defer the taxation of the converted values and recognize the income over tax years 2011 and 2012. Taxpayers who choose this option will likely see their total income tax bill rise since income tax rates are scheduled to rise in 2011. This increase is already on the books and independent of any additional tax rate increases that might occur.

Taxpayers who have a mixture of IRA types need to pay particular attention to special conversion rules. Non-deductible IRAs (where the taxpayer has already paid income tax on the contributions) add a considerable wrinkle to how conversions are affected. Taxpayers with these non-deductible IRAs should review them with their tax preparation professionals prior to taking any conversion actions.

Taxpayers who are considering converting accounts with a current or former employer will find the rules a bit more relaxed. Previously, such taxpayers were required to rollover these funds to a traditional IRA first and then convert to a Roth. Now they may roll their funds directly into a Roth IRA. All other conversion rules apply.

Taxpayers should take some comfort in their ability to elect a **'do over'** after converting to a Roth IRA. The IRS codes permit a taxpayer to re-characterize back to their traditional IRA on or before October 15th of the year following the conversion. This will give some taxpayers up to twenty-one months to see if their conversion is still in their best interest. If they decide it is not, they can undo the event. The rules also allow taxpayers who have undone their conversion, to reconvert after thirty days have past from the first of the year following the conversion.

Roth Conversions – Is There More?

Taxpayers are not required to convert all of their eligible accounts. IRS rules permit partial conversions. Whether a taxpayer decides to convert all of their accounts, or effect a partial conversion, will depend on a number of factors. Two of the most appropriate to consider are the taxpayer's current tax bracket and the tax bracket the taxpayer expects to be in during retirement.

The IRS permits taxpayers to pay the tax with funds from either 'inside' the IRA they are converting or 'outside'. There is no disagreement among experts on this point. Taxpayers receive significantly increased financial advantage when the tax bill is paid with funds outside the IRA. This permits the maximum number of dollars to be maintained within the tax-free income environment of the Roth. Taxpayers without outside resources to pay their tax bill on a conversion should consider this a strong warning against such a step.

Evaluating the wisdom of a Roth conversion requires making some assumptions about the following:

- Current expected income tax liability
- Future expected income tax liability
- Changes in tax laws going forward
- Expected need for the income generated by the IRAs (Roth or Traditional)
- Expected rates of return on the investments inside and/or outside the IRAs
- Life expectancies of taxpayer, spouse, and heirs

If you look at this list, and wonder who has a crystal ball fine tuned enough to give even murky guesses – join the club.

In the year of the conversion, a taxpayer's income may rise significantly. That additional taxable income will have an effect for many taxpayers on the taxation of their social security benefits and the cost of the Medicare Part B premiums. Though these increased costs may be one time events (or multiple if partial conversions are elected over multiple tax years) the impact must be factored into the decision to convert – nor not.

Taxpayers who have children in or approaching college, may well find that a Roth conversion event creates real problems for them in qualifying for financial aid. Most financial aid applications exclude retirement plan assets when considering eligibility. They will certainly not exclude significant blocks of taxable income. The impact on financial aid could be reason enough to defer a conversion effort.

For taxpayers who are past age 70 ½, another potential issue arises. If you are required to take a Required Minimum Distribution (RMD) you may not convert that amount to a Roth. As an example, if your traditional IRA contains $500,000 and your RMD this year is $20,000 you would be required to take and pay tax on the $20,000 and that amount would not be eligible for conversion into a Roth.

One question that concerns many considering the pain of paying a large income tax bill in anticipation of years of tax free income is whether Congress will change the tax laws down the road and tax the income from Roth IRAs. One source of comfort might be that this type of change has always (up to this point in time) allowed existing account holders to be 'grandfathered' in and thus protected.

Does that mean Congress **must** grandfather? Not at all.

Is it PC to Conduct Taxpayer Profiling?

Is there a taxpayer profile we can identify for whom a Roth conversion is an absolute sure thing? By now we both know that with this many moving parts the answer has to be no, but . . . let's see how close we can get. If you are a taxpayer who:

- Has accounts eligible for conversion and
- Has no plans to take income from those account for ten years if ever and
- Believes the income tax bite to be taken up front is quite reasonable and
- Has the funds outside the converted accounts to pay the tax bite and
- Believes that future income tax rates are going to rise significantly and
- Has an estate tax that would be cut by paying conversion taxes now and
- Has heirs that would greatly benefit from tax free income years from now, then . .

You just might be the one.

Since the perfect taxpayer profile will be rare indeed, don't despair if you don't match the profile perfectly. Sit with your financial advisors, evaluate your specific situation, pray over your decision, and make the best choice you can with the information you have at hand.

And remember – you've still got your "do over"!

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