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The Roth IRA is a Tremendous Wealth Transfer Vehicle

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This article marks the debut of a periodic column discussing financial issues.

There are two types of pension assets. Traditional pensions, where the contributions are tax-deferred and distributions are taxed, and Roth IRAs, where contributions are not tax-deferred and distributions are not taxed.

Your brokerage statement lists the value of your traditional IRA at a million dollars. This does not make you a millionaire because a traditional IRA includes an unpaid income tax liability.

The distinction between the nominal value reported on a brokerage statement and the after-tax value is important when estate planning with pension assets. If your goal is to maximize the wealth transferred to your heirs, you need think in terms of converting your traditional pensions to Roth IRAs.

Converting a traditional pension to a Roth IRA has the effect of increasing the pension's nominal value to the after-tax value. Conversion in and of itself does not change your present net worth even though you send a large check to the government. If you have a million dollar traditional IRA plus \$400,000 in cash, you have a million dollars after-tax. If you have a million dollar Roth IRA and no cash after conversion, you are still worth a million dollars after-tax.

Money in a pension grows a little faster than money in a taxable account. A million dollar Roth IRA grows faster than a million dollar traditional IRA plus \$400,000 in cash because the Roth IRA shelters the whole after-tax value whereas the traditional IRA shelters only part of the value. If you are looking for ways to stuff big bucks into your pension, consider a Roth conversion.

Another advantage of a Roth conversion is that you can delay distributions from a Roth IRA until your death, or even until the death of your surviving spouse, whereas you must begin distributions from a traditional pension about age seventy. This provides somewhat faster growth during your lifetime but the more important benefit is for your heirs since they receive a larger portion of your ultimate net worth in the form of a pension if that pension is a Roth IRA.

The nature of your bequest is important, if your heirs are willing or forced to spend your bequest gradually over their lifetimes, because a pension is tax advantaged even after your death whereas an investment portfolio is not.

Suppose that you have a million dollar traditional IRA and enough other investments to pay the deferred income tax. These assets are surplus to your needs. Suppose, optimistically, that you are able to defer the income tax on the taxable investments. (The deferred tax on capital assets is forgiven at death since the basis "steps-up" to fair market value.) When you die, the after-tax value may have grown to four million, with about half in the form of an IRA.

If your heirs choose to take distributions gradually, the value of the IRA is effectively doubled and you will have left your heirs about six million dollars.

Suppose, instead, that you convert the traditional IRA to a Roth IRA. The after-tax value at death is again four million dollars. Because your bequest is entirely in the form of a pension - you were not required to take distributions after age seventy - your heirs receive the equivalent of eight million if they choose to take distributions gradually. The extra two million dollars comes from your decision to convert the traditional pension and illustrates the tremendous wealth transfer possibilities of the Roth IRA.

Financial planning, like medicine, is an imprecise science and the result illustrated in this vignette cannot be guaranteed. But it is clear that pension assets are especially valuable to your heirs and that a larger portion of your ultimate worth will be in the form of pension assets if you convert to a Roth IRA.

There are "side effects" from a Roth conversion. The principle downside is that a physician cannot convert except between retirement and age seventy, or while a resident, since income must be under a hundred thousand dollars in the conversion year.

It is easy to pooh-pooh the value of pension benefits earned while a resident but a ten thousand dollar pension converted at age thirty could be worth a million dollars late in life.

Other downsides are that the tax authorities do not share the pain during market declines and that the wealth transfer benefit requires a stable tax policy stretching a half century into the future. Congress might change the rules and reduce the wealth transfer benefit of the Roth IRA by means testing distributions or by making distributions subject to the alternate minimum tax.

We have skipped many important details. For example, one cannot directly convert a traditional pension to a Roth IRA, but must first roll the pension over to a traditional IRA. This was a disadvantage for those with 457-type pensions but the tax laws now allow rollovers from governmental 457 plans to traditional IRAs. For more on the vignette described above and on the Roth IRA generally, see www.lingane.com/tax/roth.htm.

In our next article, we will discuss how aggregate community property agreements facilitate estate planning with pension assets. We welcome your suggestions for future columns.

Mr. Lingane is licensed as a tax professional by the federal government and as a planning professional by the Certified Financial Planner Board of Standards. His Lafayette practice emphasizes planning and compliance for individuals, trusts and estates. Contact Peter at peter@lingane.com or (925) 299-0472.

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