Retirees Can Benefit From Roth IRAs

Sara Buscher

Follow this and additional works at: http://scholarship.law.marquette.edu/elders

Part of the Elder Law Commons

Repository Citation
Available at: http://scholarship.law.marquette.edu/elders/vol2/iss1/3

This Featured Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Elder's Advisor by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.
Retirees Can Benefit From Roth IRAs

Contrary to past beliefs, Roth IRA conversions can optimize retirement income, strengthen estates, and ease the tax bite on IRA assets.

By Sara Buscher

What the Roth IRA does is to recognize the great American dream. If you work hard and if you save hard, you can have a good retirement income that allows you to leave something for your children.

Individual retirement accounts (IRAs) regained popularity in 1997 when Congress broadened eligibility for deductible contributions, provided incentives to use IRAs for nonretirement savings, and created a new kind of IRA called a Roth IRA. Roth IRAs are the opposite of classic IRAs. Instead of an immediate income tax deduction for contributions, future distributions are tax-free five years after the first contribution or conversion. After age 70 1/2, contributions can continue to be made to Roth IRAs but not to classic IRAs, and nothing can be distributed from Roth IRAs until account owners die.

Many people, including typical elder law clients, believe Roth IRAs rarely benefit retirees. Roth IRAs are funded either by workers’ contributions or by converting classic IRAs. According to the early hype, retirees who wanted to get in on the Roth IRA action had to contribute, not convert. They could work to earn $2,000 for their own Roth IRA contributions, or they could give their working children $2,000 each to contribute to Roth IRAs.

Converting classic IRAs to Roth IRAs was generally ill-advised for anyone near, much less past, retirement.

Most analysts did not consider Roth IRAs from a retiree’s perspective. They wrongly concluded that using IRA assets to pay Roth conversion taxes is a losing proposition because they ignored minimum required distributions. This misconception, combined with the assumption that most retirees would pay conversion taxes from their IRAs, inevitably led to the myth that Roth IRAs are only for the young.

In 1997, when Dr. Gobind Daryanani, an applied mathematician, was in the process of retiring and dealing with the long-term care needs of a newly disabled daughter, he wrote software to analyze a Roth IRA conversion for himself. He said:

The [Roth IRA conversion] results nearly knocked me out of my chair. It seemed that not only would my wife and I be able to establish a trust for our [disabled] daughter, but also we would have even more funds for our retirement than originally projected. To ensure the soundness of my conclusions, I confirmed my analysis with professional financial analysts. I was surprised to find that many did not understand the Roth IRA, and

Sara Buscher is an attorney, a certified public accountant, a member of the National Academy of Elder Law Attorneys, a director of the Elder Law Section of the Wisconsin State Bar, and a former pension plan administrator whose practice includes elder law, estate planning, retirement planning, and taxation.
Elder's Advisor

certainly did not have adequate software to provide a customized client analysis. 11

According to Dr. Daryanani's 1998 book, Roth IRA conversions usually benefit older persons. The size of the benefit depends on how long withdrawals are delayed after conversion, not the owner's age. 12 If no withdrawals are made, the average estate of a 90-year-old is 59 percent greater with a converted Roth IRA. Even if withdrawals start five years after conversion for those past 60, the average estate at age 90 would be 6 percent greater. Estate planners were among the first to recognize the usefulness of Roth IRAs for their retired clients. 13

Unfortunately, in 1998, when the public was flooded with information about Roth IRAs, the benefits of conversions to retirees were generally unknown. Now that the benefits have been recognized, Roth IRA articles have disappeared from the popular press.

Many retired middle-class clients seen by elder law attorneys can benefit from an analysis to determine whether a Roth IRA conversion is worthwhile, even if conversion is not warranted. Roth IRA conversions can optimize retirement income, create a greater estate for heirs, and limit the tax bite on IRA assets at death. They may also be useful in Medicaid planning.

**Roth IRA Conversion Eligibility**

This brief generalized overview is provided to assist readers who may be unfamiliar with the Roth IRA conversion eligibility rules. Those who want detailed information about the conversion eligibility rules should do further research.

First, one must own a classic IRA that can be converted. Such IRAs include those funded by annual contributions and rollovers from pension plans, 401(k) plans, and 403b plans (tax-sheltered annuities for employees of nonprofit educational institutions and hospitals, government employees, and certain organizations qualifying as charities for tax purposes). Inherited classic IRAs cannot be converted except for those rolled into spousal IRAs by surviving spouses. 14

Second, the individual's or couple's income tax return in the year of conversion must reflect modified adjusted gross income of less than $100,000, not including income resulting from a Roth IRA conversion. 15 A married couple must file a joint return in the year of conversion so that both spouses' income is aggregated for this income test. 16 Minimum distributions are included in the income subject to the $100,000 limit, but starting in 2005, they will be excluded. 17

**Retirement Planning Concepts**

Most retirement planning is aimed at accumulating enough wealth during working years to fund a desired standard of living at retirement. For our already or soon-to-be retired clients, the question is no longer how much should be saved, but how much can be spent. Two other common issues are protecting assets from financial catastrophe, which can result from the divorce of a child or the dreaded nursing home stay, and, for those who are fortunate, transferring wealth to the next generation.

**Goals and Priorities**

The top priority is ensuring that a couple or individual has enough to live on throughout retirement. Transferring wealth to the next generation is a goal only after retirement income needs are met. The older and younger members of families seen in my practice almost always agree with this order of priority, although it is seldom discussed.

A retirement income goal is the starting point. For example, a couple whose home is paid for may need an annual after-tax income of $24,000. 18 Income requirements are determined by establishing a budget or using a rule of thumb. Generally, first-year retirement income should be 70 to 80 percent of income at retirement to maintain the same standard of living. Many times, what clients can afford dictates their level of retirement income.

Optimizing retirement income means using income and assets to provide inflation-protected income for life at the highest possible level. The length of retirement, inflation, and taxes must be considered.

Retirement can easily last 30 years because people are living longer and retiring earlier. According to TIAA-CREF, the largest pension and annuity company in the United States, well over 40 percent of their 65-year-old retirees will live until at least age 90. 19 The average age at retirement dropped from around 65 in the late 1960s to around 62 in the 1990s. 20

Inflation averaged 3.4 percent per year over the last 10 years. 21 In the longer term, inflation averaged between 3.0 percent and 4.0 percent, making
3.5 percent a realistic estimate. Retirees must be educated to understand that beating inflation is as important as avoiding taxes.

Recurring, inflation-indexed income, such as Social Security, reduces the amount of annual investment income needed during retirement. To maximize income, investments earning the least should be spent first so that those earning the most have more time to grow. Since clients can choose how to invest any of their assets, those assets that are taxed at the highest rates should be used up first, leaving those assets taxed at the lowest rates to be tapped last. Consequently, equities and stocks, the riskiest and highest-yielding investments, should be held in the tax-deferred or tax-free vehicles that will be tapped last, while the safest low-risk investments should be in taxable accounts.

**Evaluating Types of Retirement Income**

Retirement income should be evaluated for inflation protection and taxes. Sources of income include Social Security benefits, wages from working during retirement, pensions and annuities, interest and dividends from nonretirement investments, investment income, and growth in tax-advantaged assets, such as IRAs, pension funds, 401(K) plans, and 403(B) tax-sheltered annuities.

There are few recurring inflation-indexed sources of income other than Social Security benefits. Government pensions are typically inflation-indexed, but those from private-sector employment are not. Income earned from working keeps up with inflation, but it is usually less than what the retiree earned before retirement and often temporary. Occasionally, trust funds and annuity contracts provide indexed payments.

Sources of retirement income that remain constant, such as most annuity payments and private-sector pensions, must be adjusted to reflect the loss of purchasing power during retirement. If inflation averages 3.5 percent annually, a retiree’s expenses in 20 years will be twice what they are today. A 1 percent reduction in annual cost-of-living adjustments on an $800 Social Security benefit results in a loss of almost $30,000 over 20 years, or more than three times the annual benefit, according to actuaries.23

The initial monthly payment from a constant pension or fixed annuity is worth less than an identical benefit with inflation protection. As a conservative rule of thumb, a constant income stream is worth only two-thirds as much as one that has inflation protection.24 To illustrate, a $10,000 fixed life annuity is worth $6,667 in comparison to a $10,000 Social Security benefit at the start of retirement. Inflation adjustments for different time periods using Dr. Daryanani’s methodology are shown in Table 1.

All sources of income should be adjusted for taxes using an average income tax rate, not the highest rate that applies to the last dollar of income. For Social Security benefits, the taxable amount must be determined first. Half of the Social Security benefits are taxed when half of the annual benefit plus other income exceeds $25,000 ($32,000 for a couple).25 Up to 85 percent is taxed if half of the annual benefit plus other income exceeds $34,000 ($44,000 for a couple).26 The after-tax Social Security benefit is the untaxed por-

<table>
<thead>
<tr>
<th>Term or Remaining Life in Years</th>
<th>Inflation at 3.5%</th>
<th></th>
<th>Inflation at 4.0%</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Purchasing Power</td>
<td>Purchasing Power</td>
<td>Purchasing Power</td>
<td>Purchasing Power</td>
</tr>
<tr>
<td>At End of Term</td>
<td>Average During Term</td>
<td>At End of Term</td>
<td>Average During Term</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>84.2%</td>
<td>92.1%</td>
<td>82.2%</td>
<td>91.1%</td>
</tr>
<tr>
<td>10</td>
<td>70.9%</td>
<td>85.5%</td>
<td>67.6%</td>
<td>83.8%</td>
</tr>
<tr>
<td>15</td>
<td>59.7%</td>
<td>79.9%</td>
<td>55.5%</td>
<td>77.8%</td>
</tr>
<tr>
<td>20</td>
<td>50.3%</td>
<td>75.2%</td>
<td>45.6%</td>
<td>72.8%</td>
</tr>
<tr>
<td>25</td>
<td>42.3%</td>
<td>71.2%</td>
<td>37.5%</td>
<td>68.8%</td>
</tr>
<tr>
<td>30</td>
<td>35.6%</td>
<td>67.8%</td>
<td>30.8%</td>
<td>65.4%</td>
</tr>
</tbody>
</table>
tion plus the rest reduced for income tax at the average rate. Annuity contracts and IRAs purchased with after-tax dollars are also partially taxable. Classic IRAs and most government pensions are fully taxable.

Table 2 uses an average of all states' income tax rates. Some states have no income tax, and others, such as Wisconsin, have higher rates.

**Evaluating the Income Potential of Investments**

Generally, income returned by investments is a function of the risk and the cost of investing. The riskier an investment, the higher its yield. Thus, it is not surprising that large company stocks returned an average of 11 percent per year, compared to 3.7 percent for 30-day Treasury bills from 1925 to 1997. Rates of return for different types of investments are shown in Table 3.

Investment risk can be limited by holding investments for a longer period of time. From 1947 to 1992, the odds of losing on S&P 500 stocks held for only one year were 22 percent. According to the same study, the odds of losing dropped to 5 percent if the S&P 500 index stocks were held for five years. The risk of loss was eliminated if the stocks were held for at least 10 years. The odds that these stocks would return less than 10 percent were about one in three if held for five years.

![Table 2. Income Tax Rates for Married, Filing Jointly, and Single Taxpayers](image)

![Table 3. Ten-Year Average Annual Total Rate of Return (6/30/98) by Asset Class](image)

*Source: Part of a table at page 63 of THE ROTH IRA BOOK. The state average rate is an average for all 50 states.*
Diversification also limits risk. The effect of diversification is shown in another study over the period from 1946 to 1993. By moving from all stocks to 50 percent each in stocks and bonds, the size of the average loss in a down year was cut in half (from -9.4 percent to -4.0 percent), while the average annual return dropped by less than a fourth (from 11.7 percent to 9.1 percent). Keeping everything invested in bonds carries a higher risk of loss and bigger losses with a lower rate of return than investing 20 percent in stocks and 80 percent in bonds.

Higher investment income will be obtained by keeping costs low. Taxes, which were discussed previously, are probably the biggest single cost. Other costs include asset management and transaction costs. A buy-and-hold strategy used to limit risk also reduces trading costs. Average mutual fund expense ratios are higher for stock funds than for money market funds, because asset management costs are highest for portfolios that are more actively traded. As of June 30, 1999, the average expense ratio for stock growth funds was 1.44 percent, 1.36 percent for growth and income (balanced stock and bond) funds, and 0.68 percent for money market funds.

Foreign investments carry added costs due to currency exchange rates. Index funds do better than most actively traded mutual funds because their buy-and-hold strategy lowers transaction costs.

To defer taxes, retirees often buy annuity contracts, but they carry some of the highest transaction costs. Because these are insurance products wrapped around mutual funds, they have added costs to cover marketing, commissions, and higher risk because people with longer-than-average life expectancies are more likely to buy them.

When compared to directly held comparable investments, deferred variable annuity contracts lose as much as 25 percent of the appreciation, mainly because they turn capital gains into income taxed at ordinary rates. Variable annuities incur annual expenses of at least 1.25 percent. At this expense level, it would take 359.9 years for a variable annuity, earning an average 7 percent annual rate of appreciation, to break even with a like investment held outright. The break-even period drops to 20 years if the investments grow 20 percent per year.

When a deferred annuity is converted to payout status, or a single premium immediate annuity is purchased, insurance companies charge added fees. These annuitization costs, in addition to the administration and management fees covered by annual expenses, consume from 5 to 10 percent to as much as 20 percent to 25 percent of the purchase price. So, if an immediate annuity is bought for $100,000, somewhere between $75,000 and $90,000 is actually used to fund the annuity payments. If the annuity guarantees payments for life, the annuity fund will be almost always invested in the insurance company's fixed account, which in turn will be invested in bonds and real estate, but not stocks.

The remaining sections of this article provide guidelines on when to consider Roth IRA conversions for optimizing retirement income, avoiding or minimizing taxes at death, and planning for Medicaid.

### Optimizing Retirement Income

Generally, whether a Roth IRA conversion optimizes retirement income depends on asset growth rates, tax rates, and how soon withdrawals must start. Conversion is more profitable:

- for assets with higher growth rates and clients who are willing to invest in such assets,
- where the tax rate for years following conversion would have been equal to or greater than the conversion tax rate, and
- where withdrawals can be delayed.

### Identifying Situations Where Roth IRA Conversion Optimizes Income

A client who is living on IRA income from bank accounts is not a conversion candidate. A client's tolerance for risk is going to be a key factor. If the client is afraid to invest in bonds or the stock market, the client will also be afraid that tax laws will change. Regardless of how good a Roth looks on paper, the client probably will not be interested.

A Roth IRA is always better if the post-conversion average tax rate that would have applied without conversion is equal to or greater than the rate during the conversion year. Even when the average post-conversion tax rate would have been lower, a Roth may outperform a classic IRA, depending on the size of the tax rate difference and how long withdrawals from the Roth can be delayed. For example, if the conversion tax rate is 25 percent, a Roth never makes sense if the post-
conversion rate is 12 percent or less. However, if the post-conversion rate is 19 percent, a Roth breaks even and begins to outperform a classic IRA if withdrawals can be delayed 13 years. If the post-conversion tax rate is 22 percent, the Roth surges ahead after withdrawals are delayed six years.

**Optimal Full Versus Partial Conversions**

If IRA withdrawals are needed for living expenses, the optimal partial conversion is that portion of the classic IRA that would remain untouched at the end of the breakeven period, after accounting for withdrawals during the breakeven period. Assuming IRA withdrawals start at age 65, Dr. Daryanani found that individuals below age 50 almost always benefit from full conversion, while those over age 60 most often benefit from partial conversion. Generally, he advises

- consider full conversion if the IRA will be untouched for 15 years or more,
- no conversion if IRA withdrawals are needed during the next five years, and
- partial conversion if withdrawals must start sometime during the next 5 to 15 years.

Full conversion results in optimal retirement income where large portions of clients’ traditional IRAs were funded by after-tax dollars. This will be the case where clients contributed to IRAs after their income was too high to qualify for deductible contributions, or where they made voluntary after-tax employee contributions to pension plans that were rolled into IRAs at retirement. In these cases, the tax on conversion will be small, as only the investments accrued inside the IRA will be subject to tax.

The client should consider conversion if he or she has a large tax deduction that would otherwise be wasted. Using the large deduction to offset income generated by conversion makes sense. Wealthy clients may use charitable deductions for this purpose. For elder law clients, large medical expenses, such as nursing home costs, may be a source of such deductions. Other large medical deductions might include expenses due to entering a continuing care retirement community or remodeling a home to provide better access for someone who is physically disabled.

Many of my retired clients who worked for the government have inflation-indexed pensions and Social Security benefits sufficient to live on. If most of their savings are in IRAs or 403(B) and other supplemental retirement plans, they do not want to be forced to withdraw money and pay taxes on those withdrawals after reaching age 70 1/2. Sometimes, they will decide to take the money out early in retirement before they begin drawing their government pensions and Social Security benefits. If they are determined to pay income taxes on these tax-deferred funds, they probably are better off converting, taking their pensions, and allowing the converted Roth to grow tax-free for their children.

Spreading conversion costs over more than one year can lower the taxes and cost of financing a conversion in two ways. First, if taxable income before conversion is near the top of a tax bracket, then spreading the cost can lower the average tax rate applicable to the conversion. Second, by delaying the payment of conversion taxes, a taxpayer may gain more on investments during the deferral period than he or she will pay in taxes. During 1998 only, a special rule allowed individuals to spread the conversion cost over four years. According to one expert, this saves about 3 percent of the total conversion cost on a present value basis. Drawing conversion taxes from the Roth IRA as 1998 installments became due was generally 4 to 10 percent better than using distributions from a retained classic IRA. Now that the client must pay full cost for the year of conversion, converting one-fourth each year for four consecutive years would be nearly as profitable.

In other cases, a traditional IRA may be better and conversion is not warranted, particularly if the tax rate during retirement is much lower than during the conversion year, or if large withdrawals are needed early in retirement. Clients with low risk tolerance probably are not good conversion candidates. To obtain the full tax benefits of the Roth IRA, the converted IRA must be left untouched until the end of the five-year qualifying period.

**Some Examples from The Roth IRA Book**

The first example shows the benefit of converting a small IRA that is primarily a savings account. Assume a 70-year-old has a $10,000 IRA growing at 9 percent per year subject to an average income tax rate of 21 percent. This IRA is a savings account, not needed to fund existing living expenses. If he lives to age 86 and his conversion tax is 25 percent, or $2,500, which is paid from an
outside asset at age 86, the Roth will be worth $36,425. To compare the Roth IRA to the classic IRA, subtract $6,660 (the amount to which the $2,500 conversion tax would have grown after taxes over 16 years) for a net balance of $29,765. In comparison, the classic unconverted IRA, with minimum required distributions invested in a taxable account, would have grown to $25,320. Thus, the Roth would be 18 percent ahead at age 86. The Roth would trail the classic IRA for nine years until age 79. In subsequent years, the Roth IRA would move ahead. If the designated beneficiary chooses to spread minimum required distributions over his or her lifetime, the Roth would continue to outpace the classic IRA.

In another example, a couple, both age 75 and both assumed to live until age 90, have a $300,000 classic IRA, which can be converted to a Roth IRA, and $250,000 of other investment assets. Their investments earn 9 percent per year and they want $71,000 of annual retirement income after taxes. Given their Social Security and pension income, their investments must provide $38,000 a year, in today’s dollars, to meet their goal. If they pay a 38 percent conversion tax, or about $57,000, from their non-IRA investments and their postconversion tax rate is 25 percent, they can have an inflation-indexed payment of $38,712 per year in today’s dollars. This income level is 21 percent better than they could achieve without converting. They would exhaust their non-IRA assets at age 83, then use the Roth IRA until age 90.

Some Real-Life Examples
In what appears to be a classic case for Roth conversion, a couple took early retirement. They had almost $600,000 in IRAs, another $120,000 in investments, about $250,000 in real estate, a sizable pension, and no debts. The husband was 62 and the wife, 57. Their combined joint life expectancy was 31 years, with the wife expected to live 20 to 22 years. They wanted after-tax income of $64,600 per year until both died. After considering their recurring inflation-indexed income from Social Security and private pension after taxes, they needed investment income of $42,300, or about two-thirds of their total desired income. Their average federal and Wisconsin income tax rate with no conversion was 26 percent. All income figures are for the first year of retirement. It was assumed this income would increase 3.5 percent per year to keep pace with inflation and that the couple would earn, on average, 9 percent per year on their investments.

The first issue this couple needed to confront was whether their planned level of investment withdrawals was too high. If they followed this course, they would exhaust their investments in 15 years, followed by 16 years of living on Social Security and a fixed pension that was declining in purchasing value. If they withdrew $30,000 after taxes, with an annual increase of 3.5 percent, they would have after-tax inflation-adjusted recurring income of $52,300 for about 31 years.

Assuming they paid Roth conversion taxes from the classic IRA, their optimum conversion percentage was 25 percent, thereby increasing their tax rate in the conversion year to 38 percent. They would first use their non-IRA investments for four years, the classic IRA for the next 16 years, and finally the Roth IRA for the rest of the wife’s life. The present value of total after-tax, inflation-adjusted IRA distributions was about $956,000, with 25 percent converted to a Roth versus $936,000 with no conversion. This plan would optimize their retirement income, providing annual inflation-adjusted withdrawals of $30,862 in current dollars.

My second example is one that at first glance appears not to benefit from a Roth IRA conversion. The client is a 76-year-old woman whose husband is 78 and terminally ill. She lives frugally and would be happy to have an after tax inflation-adjusted investment income of $12,000 per year, in addition to Social Security after her husband’s death. She can expect to live about another 12 years. The couple has $54,000 in the husband’s classic IRA and $78,000 in other investments. He takes minimum distributions using his life expectancy and that of his wife, with his life expectancy recalculated after his death. This means that his life expectancy drops to zero in the year following his death, but his wife can roll over the IRA and choose to have minimum distributions calculated over her own life expectancy and convert to a Roth IRA.

If we consider a Roth conversion, we find that converting about half and using some non-IRA assets to pay the conversion tax can optimize the wife’s income. The husband would be required to take his minimum distribution in the year of conversion, but the distribution would cease in the next year. During the rest of her life, she could have
a recurring after-tax inflation-adjusted income of $12,000 per year in today's dollars. Her tax rate at conversion and after was 15 percent, and her investments returned 7 percent before taxes. She could delay tapping the Roth IRA for 10 years while she used up the non-IRA assets and classic IRA assets. The Roth would then last another four plus years, exhausting when she reached age 91. Without conversion, she would run out of money two to three years earlier.

**Medicaid Planning**

IRAs can present difficulties in Medicaid planning under the spousal impoverishment prevention rules. Briefly, if one spouse is in a nursing home and the other still lives at home, and thus qualifies as a community spouse, she can keep some cash and investment assets as a community spouse resource allowance (CSRA). States may vary the CSRA limit within a federal range of $16,392 to $81,960. Most but not all states count the value of IRAs and other tax-deferred investments against the community spouse resource allowance. The value counted against the limit is not reduced for unpaid income taxes, thereby penalizing these assets in comparison to other investments such as bank accounts.

Frequently, converting the IRA into an irrevocable nonrefundable immediate annuity contract for the benefit of the community spouse or institutionalized spouse can accelerate Medicaid eligibility. Most states follow the federal Health Care Financing Administration's (HCFA) nonbinding guidelines, which create a safe harbor for annuities that do not make payments for a period extending beyond the life expectancy of the annuitant. This safe harbor is accomplished by limiting the guarantee period, (the period that annuity payments will continue beyond the death of the annuitant) to the annuitant's life expectancy according to HCFA's tables.

Disadvantages of using annuities include loss of access to funds, loss of inflation protection, locking in of an internal rate of return related to interest rates at the time the annuity is purchased, and loss of the opportunity to use a Roth IRA conversion. Recent input from the annuity insurance industry to Wisconsin's legislature regarding an interest rate safe harbor for Medicaid annuities sets an internal rate of return 1.5 percent below Treasury bill rates. When counseling clients about annuity purchases, it is important to compare apples to apples, as shown in Table 4.

<table>
<thead>
<tr>
<th>Quoted Rates of Return</th>
<th>Federal State Tax Rate</th>
<th>After 20.00%</th>
<th>18.00% 2.00%</th>
<th>15.00% State Tax Rate</th>
<th>After 15.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>T-Bill Rate (long-term)</td>
<td>6.00% 5.88%</td>
<td>7.50% 6.00%</td>
<td>7.06%</td>
<td>4.50% 3.83% 4.50%</td>
<td>9.00% 7.65% 9.00%</td>
</tr>
<tr>
<td>Annuity-Fixed Rate</td>
<td>4.50% 3.60%</td>
<td>4.50% 3.83%</td>
<td>4.50%</td>
<td>3.33% 4.50%</td>
<td></td>
</tr>
<tr>
<td>Balanced Portfolio</td>
<td>9.00% 7.20%</td>
<td>9.00% 7.65%</td>
<td>9.00%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
pay out over a short period, such as two or three years, to accelerate Medicaid eligibility, are making sure the community spouse will have an opportunity to invest at higher rates after her husband's death.

The main advantage of using an annuity to accelerate Medicaid eligibility is that it will preserve retirement income for the community spouse to live on after the institutionalized spouse's death, but not necessarily by using the annuity to fund payments over the community spouse's life expectancy. This strategy is especially important if pension income of the institutionalized spouse ceases at his death. If the institutionalized spouse owns the IRA, it will need to be liquidated and taxed sometime after eligibility is otherwise obtained or annuitized. If the community spouse owns the IRA, it does not have to be liquidated, and a Roth conversion can be considered.

Generally, a Roth IRA conversion is preferable to an annuity purchase where the payment of conversion taxes would reduce the value of assets below the CSRA. If it appears that the institutionalized spouse may live for a long time, with income being allocated to the community spouse, then a Roth conversion of a community spouse IRA with taxes paid from outside the IRA should be considered. According to Choate, it is “the move of choice” where benefits would otherwise have to be paid out right after death.

The estate-planning issues applicable to elder law attorneys indicate, at a minimum, that durable powers of attorney should authorize agents to convert Roth IRAs, and make elections with regard to minimum distributions and updates of beneficiary designations consistent with the client's estate plan.

**Avoiding Taxes at Death**

IRAs and pension accounts, unlike stocks and capital gain assets, do not get a step-up in tax basis at death. Instead, because they represent income in respect of a decedent (IRD), beneficiaries inherit any income tax liability. The value of the IRAs, including the unpaid income taxes, is also included in the gross taxable estate. Therefore, without proper estate planning, the value of an IRA can be taxed twice and significantly reduced.

Attorney Natalie B. Choate, a nationally recognized expert on estate planning for IRAs, provides a free on-line publication about Roth IRAs at http://www.ataxplan.com. Rather than reinventing the wheel here, readers are directed to that site. Choate discusses how a Roth conversion can create estate planning flexibility to fund various trusts, such as unified credit bypass trusts, QTIP and QDOT trusts for surviving spouses, and generation-skipping trusts. By squeezing the income out of these assets before death, the total value of the taxable estate is lowered, and none of the unified credit or generation-skipping exemption is wasted on the unpaid income taxes. The deathbed Roth IRA conversion is also highly recommended. According to Choate, it is “the move of choice” where benefits would otherwise have to be paid out right after death.

The estate-planning issues applicable to elder law attorneys indicate, at a minimum, that durable powers of attorney should authorize agents to convert Roth IRAs, and make elections with regard to minimum distributions and updates of beneficiary designations consistent with the client's estate plan.

**Endnotes**


4. See generally I.R.C. § 408A (Roth IRAs were created by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 302(a), 111 Stat. 788 (1997), effective with the 1998 income tax year).

5. If conversion takes place on the last day of a tax year, tax-free withdrawals can start four years and one day after conversion. See I.R.C. § 408A(d)(2)(B). Furthermore, each taxpayer has one five-year period based on the earliest regular Roth IRA contribution or Roth IRA conversion contribution. For example, a taxpayer, over age 591/2, who first contributed or converted in 1998, can take totally tax-free distributions starting
January 1, 2003, even from accounts converted in later years. See Treas. Reg. § 1.408A-6, Q&A 2. If withdrawals are made during the five-year period, they are treated as coming first from the contributions and then converted amounts that will be tax-free. See I.R.C. § 408A(d)(4).

6. See I.R.C. §§ 408A(c)(4) and (5); see infra note 10. The minimum distribution rules that apply after the death of the Roth IRA owner assume that the owner never reached age 701/2, regardless of his or her age at death. See Treas. Reg. § 1.408A-6, Q&A 14. The beneficiary may stretch payments out over his or her own life expectancy, provided the tax-free distributions begin in the calendar year following the owner's death. Otherwise, the entire account must liquidate by the end of the fifth calendar year following the owner's death. Surviving spouses can avoid these rules by rolling the inherited IRA into a spousal IRA, just as they do with classic IRAs.

7. See All I Want for Christmas Is a Roth IRA, Retire with Money, Nov. 1998, at 3.


9. See DARYANANI, supra note 1, at 127.

10. Generally, minimum taxable distributions must be withdrawn from IRAs and qualified retirement plans starting the April 1 following the calendar year in which the taxpayer reaches age 701/2. See Barbara Freedman Wand, Advising Clients Regarding Lifetime Distributions from Qualified Retirement Plans, 1 Elder's Advisor, Summer 1999, at 67–70.

11. DARYANANI, supra note 1, at xii.

12. See id. at 120.


14. See I.R.C. §§ 408A(e), 408(d)(3)(C). If an account owner dies during the five-year qualifying period following conversion, the beneficiary can receive qualified treatment for distributions that are delayed until after the end of the deceased owner's five-year period. See Treas. Reg. § 1.408A-6, Q&A 7(a). For example, if a Roth contribution, whether regular or rollover, is made in 1999, and the owner dies in 2004, the beneficiary can take a tax-free distribution in 2005. If the beneficiary is a surviving spouse who treats the inherited Roth IRA as his or her own, then the earlier of the surviving or decedent's spouse five-year qualifying periods applies to all Roth IRAs owned by the survivor. See Treas. Reg. § 1.408A-6, Q&A 7(b). Special rules apply to 1998 conversions with four-year spreads.


16. See I.R.C. § 408A(c)(3)(B)(ii). Note that a few exceptions apply for couples who are separated or divorcing.


18. The average annual expenditure of a household age 65 and over was $24,721, according to the 1998 Consumer Expenditure Survey, Table 3, published by the U.S. Department of Labor, Bureau of Labor Statistics.


21. See DARYANANI, supra note 1, at 36 (citing the Department of Labor Statistics).

22. A longer holding period is needed for tax-deferred investments holding high-growth assets to overcome the difference between ordinary and capital gains income tax rates.

ARTICLE | Retirees Can Benefit From Roth IRAs

24. See DARYANANI, supra note 1, at 29.

25. See generally I.R.C. § 86.

26. See id.

27. Income returned by investments includes capital gains and appreciation as well as interests and dividends for purposes of this discussion.


29. See id.

30. See id. at 15–9.

31. See TIAA-CREF Advertisement, Tr. & Est., Nov. 1999, at 19 n.3 (quoting a Morningstar study).


33. See id. at 12.

34. See id. at 16.


36. See DARYANANI, supra note 1, at 133.

37. See id. at 133–35.

38. See id. at 132.

39. See id. at 136.

40. See id. at 138.

41. If a tax-sheltered annuity under I.R.C. § 403(b) has a grandfathered balance as of December 31, 1986, required minimum distributions on that balance can be delayed until age 75.


43. See BRENTMARK SOFTWARE, INC., ROTH OPTIMIZER USER’S MANUAL at 20 (1998) (the Roth Optimizer was developed by Dr. Gobind Daryanani).

44. See supra notes 5 and 6.

45. See DARYANANI, supra note 1 at 122–27.

46. See id. 101, 116–17.

47. Whenever annual income is referred to in today’s dollars or current dollars, it means the income amount in 1999, and is assumed to increase each subsequent year by the stated inflation assumption, 3.5 percent, throughout the person’s remaining life expectancy.


49. The present value of distributions from the amount used to pay the Roth IRA conversion taxes was subtracted from the Roth IRA present values to correctly compare conversion to no conversion.


51. This analysis assumed inflation at 3.5 percent and average investment returns of 7.5 percent per year.

52. See generally 42 U.S.C. § 1396r-5.

53. Most community spouses are female, and therefore female pronouns will be used to identify the community spouse.

54. The CSRA limits are adjusted each year for inflation. This article reflects 1999 limits.


57. See id. at 7 (citing HCFA Transmittal No. 64). The author is aware that Wisconsin, Minnesota, and California have created their own safe harbor rules that vary from the HCFA guidelines.

58. The HCFA tables provide differing life expectancies for men and women. These tables are almost identical to the pre-1986 income tax tables, which were based on a 1937 actuarial study. See Unisex Annuity Tables, 51 Fed. Reg. 9978, 9979 (1986) (to be codified at 26 C.F.R. pt. 1) (proposed March 24, 1986).

59. Wis. Stat. § 49.453(4) (as amended by 1999 Wis. Legis. Serv. Act 9) provides a safe harbor for annuities with guaranteed life payments if the internal rate of return is at least equal to 1.5 percent below the Treasury bill rates published monthly by the Internal Revenue Service pursuant to I.R.C. § 1274. This language was recommended in LRB Policy Paper #486 by Wisconsin's counterpart to the federal Congressional Budget Office after the State Medicaid Agency recommended using the prime lending rate to establish a safe harbor. This proposal was intended to crack down on private annuity contracts drafted by elder law attorneys. Ironically, it would have prevented commercial annuity contracts from qualifying for the divestment exception. According to the budget policy paper, the prime lending rate on May 11, 1999, was 7.75 percent, but conventional annuities currently provide a significantly lower rate of return in the range of 4 to 5 percent, the latter being the then current certificate of deposit rate.

60. At the time of the initial eligibility determination, assets owned by either spouse may be allocated to the community spouse resource allowance. See 42 U.S.C. § 1396r-5(c). However, within a reasonable time after eligibility is determined such assets must be titled in the name of the community spouse. See 42 U.S.C. § 1396r-5(f)(1). Wisconsin uses one year. See Wis. Admin. Code § 103.075(5)(d)(3).

61. I.R.C. § 691(c) provides for an income tax deduction of the federal estate taxes paid on the asset, but the net effect is still a hefty tax.


63. Id.