A 'TAX FREE' ROTH CONVERSION

BY JAMES C. SOFT

"No such thing!" would be the likely response from astute tax lawyers and CPAs. And they would be correct. Mostly. This article will suggest some outside the [traditional financial planning] box thinking that can accomplish the equivalent of a *tax free* Roth conversion. But first, some background.

Prior to 2010 if an individual taxpayer made more than $100,000 modified adjusted gross income (AGI), he or she could not convert a Traditional IRA to a Roth IRA. However, in 2010 the rules changed and now all taxpayers can convert regardless of AGI.

So, why convert?

Good question. At the risk of oversimplification, there are three very good reasons to prefer a Roth IRA over a Traditional IRA.

First, when it comes time to take distributions from your retirement plan, Roth IRA withdrawals are tax free while Traditional IRA withdrawals are generally fully taxable. To say it another way, the growth inside a Roth IRA is tax free growth, whereas the growth inside a Traditional IRA is tax deferred growth.

Second, there is no required minimum distribution at age 72 from a Roth IRA. Many seniors resent the fact that they are required to take money out of their Traditional IRA following age 72. Forcing someone to take money out of a Traditional IRA not only pushes up the tax bracket but also subjects more Social Security benefits to income taxes. This mandatory withdrawal is particularly frustrating for senior citizens in an economic climate that includes market volatility and low interest rates.

Third, while you can't contribute to a Roth IRA if you make too much money, a majority of individuals can contribute—even in retirement! In 2020, the limit for singles is $139,000 and for married couples, the limit is $206,000. And the amount you can contribute changes periodically. In 2020, the contribution limit is $6,000 a year unless you are over 50—in which case, you can deposit up to $7,000.

Why doesn't everyone convert?

Here's the catch. Since your Traditional IRA is funded with pre-tax dollars, converting Traditional IRA assets to a Roth IRA is a taxable event. In other words, when money is taken out of the Traditional IRA the taxpayer will likely experience increased taxable income by the amount withdrawn from the Traditional IRA.

Is there any way to get money from a Traditional IRA into a Roth IRA without increasing the tax bill?

Yes! Through charitable gift planning, the taxpayer can generate income tax deductions equal to the amount of income withdrawn from the Traditional IRA. This can result in a dollar for dollar offset without giving up the earning power or use of the asset given to charity.

A Charitable Life Estate enables the taxpayer to make a gift of a personal residence or farm but still retain use of the asset for life. This type of arrangement generates an immediate deduction that is historically large due to our current low interest rates. The taxpayer continues to use or farm the property, but concurrently generates a large charitable deduction that facilitates a "tax free" Roth conversion!

Another option is a Charitable Life Income Gift, such as a Charitable Gift Annuity or Charitable Remainder Trust. By taking low yielding assets and using them to fund a Charitable Life Income Gift, the taxpayer generates yet another charitable deduction to offset the tax from the Traditional IRA withdrawal. Further, in our current low interest rate environment, chances are good that the rate of payment from the Charitable Gift Annuity or Charitable Remainder Trust will exceed rates being realized on most other fixed income assets (such as CDs, Treasury Bonds, etc.).

It seems likely that most people would choose a Roth IRA over a Traditional IRA if they knew they weren't going to have to face increased taxes on the conversion. So, consider engaging a charity to help you convert your Traditional IRA into a Roth IRA…*tax free!*

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