Lowering Taxes On IRA Payouts

Advance Planning Tips

Not all inherited IRAs are alike; help parents convert to Roth IRA

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FOR INVESTOR'S BUSINESS DAILY

Created in 1974, IRAs have become a key part of retirement finance for many Americans.

The Investment Company Institute reports that 39% of U.S. households headed by someone 65 or older have an IRA.

Many 40-, 50- and 60-somethings will inherit those IRAs. After, they'll have to take taxable distributions. To trim the eventual tax hit, offspring can give seniors money for Roth IRA conversions.

Say that a hypothetical Ed Lee is retired and has an IRA. His estate plan calls for most of his assets to go to his wife Jan. And Lee has named his son Al as the beneficiary of his traditional IRA. He'll get the account when Lee dies.

Then Al must take at least the required minimum distributions (RMD), based on his life expectancy. At age 58, for example, Al's life expectancy will be 27 years, based on IRS tables.

If the inherited IRA has $500,000 then, Al's RMD will be $18,519 ($500,000 divided by 27).

That $18,519 will be taxable income for Al. If Al has ample earned income, he'll owe tax on the RMD in a high bracket.

But Al can minimize the future damage by giving money to his father now, before he inherits anything. Then Lee can do partial Roth IRA conversions each year.

The gifts from his son pay for the tax on the converted

amounts. No Gift Tax

Say the senior Lees expect taxable income of $50,000 a year, after deductions. Al's $3,300 gift this year will not exceed the $14,000 annual gift tax exclusion in 2013, so no one has to file a gift tax return.

The older Lees are in the 15% bracket. This year that bracket applies to as much as $72,500 on a joint tax return. So Lee can use the cash gifts to convert $22,000 of his traditional IRA to a Roth IRA. The tax on that would be $3,300.

Lee will report $22,000 of taxable income from this conversion. That will bring the taxable income on his joint return to $72,000, still within the 15% bracket.

Why convert? Roth IRAs have no RMDs for the original owner, so a sizable account may be left from Lee to his son Al.

If Al waited until he inherited the traditional IRA, he would not be allowed to convert it to a Roth.

For the father, after a Roth IRA conversion, withdrawals are fully tax-free after five years if he is 59-1/2 or older. For a beneficiary, withdrawals generally are tax-free.

Tax-free Roth IRA withdrawals won't swell your AGI and increase your exposure to various taxes and phaseouts. The 10% early withdrawal penalty doesn't apply, regardless of your age.

This lets Al inherit a Roth IRA, with tax advantages, that he could not create via conversion on his own.

The five-year rule still applies. “Roth IRA earnings cannot be withdrawn, tax-exempt, until five years have elapsed since the original owner opened his first Roth IRA,” said Choate.

The deceased participant's original contributions to the Roth IRA can be withdrawn tax-free at any time, says Boston attorney Natalie Choate. Money withdrawn from the account is deemed to come from them first.

So Al can withdraw his RMDs taxfree because they will be coming out of those previously-taxed contributions.