

Inheriting a Roth IRA

An inherited Roth IRA is truly a “gift that keeps on giving.” It is an exceptional estate planning tool.

When deciding whether or not to convert your traditional IRA to a Roth IRA, most people (or their advisors) “run the numbers.” The cost and benefits of a Roth conversion is compared to the status quo - maintaining the traditional IRA. Assumptions are made about investment returns, future income tax rates, life expectancy, etc.

In most cases, using reasonable assumptions, the Roth IRA conversion usually looks like the better choice, although the psychological hurdle of paying a big income tax bill now still prevents many IRA owners from doing the conversion. (Maybe it’s not just psychological - I suppose income taxes could be lower in the future, although that seems to conflict with the reality principle.)

If the beneficiaries intend to liquidate the IRA right away and spend it, the calculation might be close. But transferring a Roth IRA to your beneficiaries on your death can be a VERY valuable opportunity, if they do not miss it. If the beneficiaries, instead of withdrawing the Roth IRA immediately, maintain the Roth IRA as an inherited IRA and take the minimum required distributions over their life expectancies, then they are getting a terrific benefit.

A person who inherits a Roth - unlike the original owner of the account - is required to take a minimum required distribution each year, beginning in the year following the year of death. The beneficiary must withdraw a percentage of the funds annually, based on his/her age. Comparing the traditional IRA against the Roth IRA for the lifetime of the owner and his/her spouse is not enough. To understand what it means to a beneficiary to inherit a Roth IRA, the projections have to keep going.

The beneficiary has an asset which will grow at a compounded rate tax-free for his/her lifetime and any withdrawals made will be completely tax free. There is simply nothing else like it. No other investment will give this kind of return tax-free. Inheriting a Roth IRA is much more valuable than inheriting any other asset. Any other asset - whether it be stocks and bonds, real estate or cash - will be subject to income tax on its income and growth. Traditional IRA distributions will be subject to income tax.

The younger the beneficiary is when the IRA is inherited, the longer the beneficiary can stretch out withdrawals, giving more time for tax-free compounded growth of the investments inside the Roth. The beneficiary’s inheritance could get bigger as he or she gets older. It is like giving your beneficiary a tax-free, lifetime annuity.

Since younger beneficiaries with a longer opportunity for stretching out distributions get the most benefit, consider naming grandchildren as your Roth IRA beneficiaries. If you are concerned about leaving a substantial sum to young children, there are solutions. You can name a Custodian under the Uniform Transfer to Minors Act (UTMA) to receive distributions, and then the

custodian can accumulate the withdrawals and use them as needed for the child until the child is 21. If you set up a trust as a beneficiary for the benefit of the minor child, the trustee can hold the accumulated distributions until the beneficiary reaches more mature years - age 30, 35 or any other age you would like to specify. For a trust to be able to be used with the stretch-out of distribution, the trust must be carefully drafted to comply with complex IRS rules.

If you cannot bring yourself to pay the current income tax required to convert your traditional IRA to a Roth, and you have reason to believe your life expectancy is limited, then do the Roth conversion in anticipation of death. The income tax due as a result of the conversion will be paid by your executor as a debt of your estate and will be deductible for inheritance and estate tax purposes. Your beneficiaries will get the benefit of inheriting a Roth IRA - the best asset to inherit.