Legacy Advisors Group

M & A UPDATE®

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Individual Retirement Accounts: Roth or Traditional

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Introduction

There are a myriad of retirement accounts to choose from these days. Under the Internal Revenue Code, taxpayers and eventual retirees face an alphabet soup of retirement plans to choose from.

Among the more popular retirement plans is the Individual Retirement Account (IRA), which an individual can set up at a bank, an investment firm, or even an online account. People can create and fund these accounts entirely on their own at little or no cost to them. This is in contrast to employer sponsored retirement plans such as the 401(K), SEP, SIMPLE, and defined benefit plans, which an employer would have to undertake and fund in tandem with an employee. There are two kinds of IRAs, traditional IRAs (which offer a tax deduction when funded) and Roth IRAs (which do not offer the upfront tax deduction, but distributions are taken free of tax). The scope of this article focuses on the IRA and whether converting a traditional IRA to a Roth IRA is a good idea.

Background

Traditional IRA contributions, as stated above are deductible from taxable income in 2011 up to $5000. The traditional IRA grows tax deferred until the money is distributed to the holder of the account, at which time the distributions are taxed at the ordinary income rate of the individual receiving the distribution. Roth IRA contributions are not deductible from taxable income, but the Roth IRA appreciates tax free until the time of distribution. When the proceeds are distributed, the amounts are tax free to the account holder. Considering the Roth IRA potentially has 30 to 40 years of appreciation for a young couple, the Roth carries some huge potential tax benefits.

This dichotomy of IRAs leaves individuals to face a perplexing question regarding which IRA is better. On one hand, the individual gets a current tax savings, which is favorable from the vantage point of a current cash position. Looking at the Roth IRA, the individual gets tax free income at a time when the individual's income tax bracket may be elevated as opposed to earlier in life and their

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A CASE STUDY

The Tax Court has held that a fractured hip is no excuse for the late filing and payment of estate tax. In this case, the decedent's nephew and the family's tax professional were appointed as co-administrators of the estate. The time for filing the return and payment of the tax were both extended by the IRS. The tax professional fractured his hip, resulting in a hospital stay. The estate tax return was filed late, showing a liability and balance due, which was also late. The IRS then assessed penalties for failure to file the return on time and failure to pay the tax on time. The Court found that the tax professional's injury was insufficient as reasonable cause for failing to file the return on time because the tax professional was still able to meet with the nephew a few times a week to take care of other estate business. The Court also found that there was no reasonable cause for the late payment because a reasonable person in the nephew's position would have found another professional to see to the filing of the return and payment of the tax.

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career when their tax bracket is generally lower.

Considerations

As stated above, the traditional IRA has the advantage of tax deductible contributions while facing the detriment of income taxes upon distribution. The Roth IRA has the opposite effect with contributions being nondeductible and the distributions being nontaxable. Generally speaking, the Roth wins from the point of income tax savings. Both IRA annual contributions are limited to $5000 this year and next. The difference is that the Roth holder might pay $1000 more in taxes in the year of contribution than the traditional IRA account holder who receives a deduction. The traditional IRA account holder, on the other hand, has the detriment of paying taxes on the IRA distribution after it has had 30 years to appreciate.

The Roth IRA is also superior from an inheritance standpoint as well. Generally, traditional IRAs are treated as ordinary income. to beneficiaries. Paying tax at a regular income tax rate on an inheritance is a high tax to pay. Roth IRAs on the other hand, are not taxable to the recipient. Just as they would not have been taxable to the owner of the Roth IRA, it is not taxable to the heir as well. The advantage for tax free inheritance goes to the Roth IRA.

The traditional IRA carries penalties when early distributions are taken. The Roth IRA provides limited exceptions in which distributions can be taken without penalty. The big difference in flexibility is that a Roth IRA has already been taxed. When principal only amounts are taken early from a Roth IRA, the principal is not added to the taxable income of the taxpayer (unlike the traditional IRA early distribution which would be taxable in full). The Roth IRA is good as far as flexibility is concerned.

Conclusion

After having read this, do you regret not converting your traditional IRA to a Roth IRA? Do you think that opportunity has passed because it is no longer 2010? If you regret not converting your traditional IRA to a Roth, you have until October 18, 2011 to make the election to convert.

In short, Roth IRAs are generally better than traditional IRAs for most people. While the merit of the traditional IRA cannot be forsaken, generally Roth IRA accounts are better for the younger person. While the Roth IRA carries better income tax, inheritance, and flexibility points, the traditional IRA cannot be written off entirely. The traditional IRA is still a good retirement investment vehicle superior to that of general savings accounts, non-tax protected investment accounts, and savings bonds. Both Roth and traditional IRAs offer good tax savings up front and are, to a degree, resistant to bankruptcy proceeding. Overall, the Roth IRA wins, but the traditional IRA still has merit for many. If you have questions, please contact The Center.

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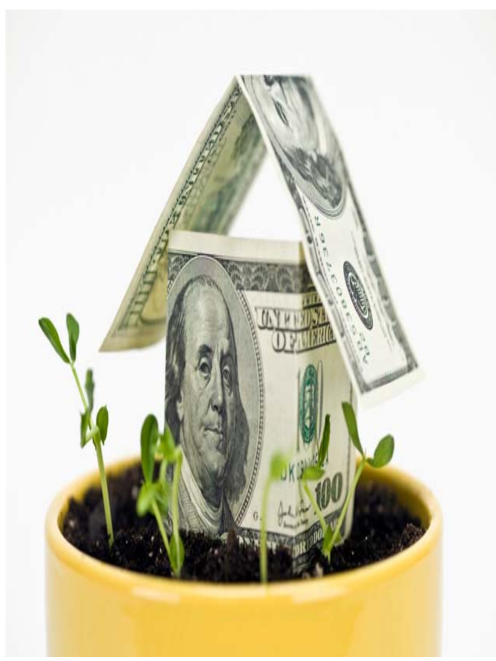
A CASE STUDY CONTINUED:

Editor's Comment: This case demonstrates the high priority that should be given to tax matters, especially deadlines. Missed deadlines for filing returns and submitting payments are easily prevented, but can result in large liabilities in the form of penalties. This was also poor planning on the part of the tax professional involved. The IRS should have been consulted immediately after the injury occurred to try and work out an extension. Even if the IRS would not have allowed an extension, the estate would have known that the return and payment were still due by the original extended deadline given, preventing the late filing and late payment penalties. In this case, it would have saved the estate nearly $500,000!



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Points of Interest

- **Among the more popular retirement plans is the Individual Retirement Account (IRA), which an individual can set up at a bank, an investment firm, or even an online account.**
- **There are two kinds of IRAs, traditional IRAs and Roth IRAs.**
- **If you regret not converting your traditional IRA to a Roth . . . you have until October 18, 2011 to make the election to convert.**

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Avoiding Common Mistakes in Selling Your Business – Loss of Confidentiality

Mike Ertel, CBI/ M&AMI/ CM&AA

A nightmare scenario for most business owners is to learn that rumors are spreading among their employees, customers, vendors, bankers and competitors that their business is for sale.

It's only human nature for most people to suspect the worst until confronted with the truth, and we've all seen examples where long term, loyal employees start lining up & seriously considering their other employment options; long term, loyal customers begin qualifying back up sources "just in case;" vendors and bankers begin to reconsider if they might be over extended in the event of a sale; vendors' sales reps soon spread the rumor to all who'll listen, including your fiercest competitors; and competitors use the opportunity to undermine your customers' confidence that you will always be there when they need you, etc.

In short, there is enormous downside risk from leaking the news that you're thinking of selling, and almost no upside. For this reason, most thoughtful business owners entrust the marketing and sale of their business to an experienced intermediary who knows how to CONFIDENTIALLY market your business to the most likely and most qualified buyers, while screening out the nosey tire kickers.

At Legacy Advisors Group, we're in regular, direct communication with hundreds of qualified & motivated, individual and corporate buyers – both domestic and international – for small- to medium-sized companies. We're experienced in CONFIDENTIALLY finding just the right buyer for this sized business.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at: mertel@legacyadvisorsgroup.com

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Frequently Asked Questions…

Q: For the purpose of retiring, are there some states that are better than others from a tax standpoint?

A: Yes. Some states are better than others when dealing with taxes that are common to retirees on fixed incomes. Because every situation is different, retirees are best advised to do their research when choosing a state for tax reasons.

Q: Is it possible to have Roth and traditional IRAs as part of a comprehensive plan?

A: Yes. Individuals can have an assortment of Roth IRAs, traditional, and even employer retirement plans as their overall retirement plans. However, when funding the IRAs, it is important to mention the combined limit for both IRA types remains the same at $5000 per year.

Q: Are Roth and traditional IRAs taxed differently in an estate?

A: Yes and no. In an estate setting all property is considered part of the estate. As such, all property contained within the estate is subject to estate tax. Once the estate is taxed, the distributed property is subject to tax on its own character of gain. A Roth IRA is not subject to income tax as its character holds from one generation to the next. The traditional IRA's character remains ordinary income in nature, and in so far as the traditional IRA is income, it is subject to income tax.