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Exploiting a Massive, One-Time Tax Deduction

By **KELLY KEARSLEY**

The couple in their mid-70s had just purchased a condominium in a retirement community when they got some surprising news from their adviser: A portion of what they paid for their new home could be deducted as a medical expense.

"A lot of our clients are moving into these facilities and this is a huge deal for them," said Patti Brennan, president of West Chester, Pa.'s Key Financial Inc., which manages $450 million for about 400 clients.

The retirement facility is responsible for determining the amount of the deduction based on the portion of a new resident's entry fee that counts as payment for future medical care. In this case, the couple's entry fee was the $370,000 they paid for a condo, and the retirement facility attributed about 40% of that entry fee to medical expenses.

The couple had $1.2 million in their retirement accounts and $350,000 in taxable investments. Their adjusted gross income for that year would have been about $96,000, made up of planned distributions and Social Security benefits. But the huge deduction derived from the condo purchase, combined with partly deductible retirement-facility fees and some of the real-estate tax on the home they sold, added up to $167,000 of deductions. That meant they would have no taxable income for the year.

The couple was thrilled at the prospect of no tax bill, but Mrs. Brennan told them to think bigger. She explained they could take full advantage of that massive, one-time deduction through a Roth IRA conversion. "That way they would not only save on the taxes this year, but they'd also avoid taxes on the growth of their investments," she said.

To determine the amount of money to convert, the adviser assessed the couple's total tax picture and calculated how a hypothetical conversion would affect their income and subsequent tax rate. They landed on converting $90,000 from a traditional IRA to Roth IRA.

The conversion brought their adjusted gross income to $186,000. After $167,000 in deductions--plus $7,900 in exemptions--the couple's annual income was only about $11,000.

That gave them a marginal tax rate of 10% for the year, essentially allowing the couple to convert $90,000 of their retirement dollars for $1,100 in taxes. But Mrs. Brennan said the benefits extend far beyond a single tax year.

The real power comes from the couple avoiding tax on the growth of those funds, which she estimates will generate a 7% return and double every 10 years in a tax-free environment that doesn't require minimum distributions.

The adviser noted the strategy won't work for every client, especially those without offsetting deductions or in higher income brackets who may not benefit from a Roth conversion. There is also a caveat: the Internal Revenue Service requires that you keep the growth of the converted funds in the Roth for at least five years.

Patti Brennan CFP

But Mrs. Brennan said clients can try the conversion and then change their mind--as long as it is before Oct. 15 of the following tax year. The ability to recharacterize Roth funds leaves clients and advisers room to modify or reverse an overzealous conversion.

"For them, not doing this would have been a missed opportunity," Mrs. Brennan said.

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Because Roth IRA conversions may not be appropriate for all investors and individual situations vary we suggest that you discuss tax issues with a qualified tax advisor.

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