Is the Roth IRA Conversion For Me?

By Dennis A. Suckstorf, CFP®, ChFC, AFC. Financial Advantage, Inc. (www.financialadvantageinc.com)

Prior to 2010, an individual could only convert a traditional IRA (qualified retirement plan) to a Roth IRA if his or her modified adjusted gross was below $100,000. But since January 2010, the income restriction has been lifted, and many newly eligible people are considering this tactic.

Before considering the conversion decision, let's review the advantages and disadvantages of a Roth IRA. The biggest advantage of a Roth IRA conversion is that the principal (converted amount) can be withdrawn tax-free at any time. Generally, withdrawal of the growth beyond the conversion amount will be tax-free and without penalty after age 59½.

Withdrawals by beneficiaries also are (generally) free of income tax obligations. Also, the Roth holder does not face required minimum distributions during his or her lifetime. In addition, that Roth holder can make penalty-free early withdrawals for qualified expenses, such as disability or purchase of a first home.

The major disadvantage of the conversion is that the taxable amount of the traditional IRA converted (deductible contributions plus earnings) is fully taxable as current income at the Roth owner's current tax rate. Most individuals who convert will need time to recoup from the upfront tax hit that comes with the conversion, and that's why the rules allow the payment of taxes during 2011 and 2012.

Here are some ways to look at the conversion decision. Reasons to convert

• I will have a higher tax rate in retirement than I have now.

• I cannot predict the tax rates, but I have more than 10 years to retirement, and I believe that tax rates are likely to increase.

• I have sufficient assets to live on and plan to leave the Roth conversion account to my heirs.

• I have sufficient funds outside of my IRA to pay the taxes on the conversion.

Reasons not to convert

• I am leaving my estate or IRA accounts to charities.

• I have children who will be going to college in 2011 or 2012, and I will be applying for federal financial aid in the near future.

• I will experience a significant tax event that will increase my income.

• I have Net Unrealized Appreciation from employer stock in my 401(k) account that I was going to convert to a taxable account.

• I do not have funds outside of my IRA to pay taxes.

• I will begin withdrawals from the Roth IRA within the next two to three years.

• I would elect to defer the taxes on the conversion, but I believe or know that my tax bracket will increase in 2011 or 2012.

Examples

The following examples illustrate situations in which a Roth conversion brings benefits.

Example 1: Inheritance

You are a 65-year-old retiree. You have a daughter who is 40 years old. You have an IRA worth $100,000, and your daughter is the beneficiary of the IRA. You have other assets to support your retirement, and you will most likely not need the IRA for your retirement. You are in the 25-percent effective federal and state tax bracket. If you convert, you must pay approximately $25,000 in taxes, and you choose to use funds in your taxable account so that the value of the Roth IRA is $100,000 after conversion.

If you pass away at age 90, your daughter, now 65, will inherit a Roth IRA that has grown at 6 percent per year, reaching $429,187. She will be able to take tax-free distributions from the IRA for the rest of her life. If you had not done the conversion, your daughter would have inherited a $429,187 traditional IRA and a taxable account of $107,297 (the $25,000 you paid in taxes that would have grown $107,297). Based on a complete distribution of the traditional IRA at your death and a federal plus state tax rate of 40 percent, your daughter would pay $171,718 in taxes on the traditional IRA. In this example, the Roth IRA conversion saves $64,422.

Example 2: Estate Tax

You are an 85-year-old retiree with children and grandchildren. You have an estate worth approximately $4.5 million. As part of your estate, you have a traditional IRA valued at $700,000, and you are expecting annual returns of 6 percent, on average. You have other assets to support your retirement and you will most likely not need the IRA. You are in the 30-percent effective federal and state tax bracket. You convert and pay the taxes (approximately $210,000) from funds in your taxable account, so the value of the Roth IRA is $700,000 after conversion. In addition to providing a tax-free source of income to your heirs, you have reduced your taxable estate by the $210,000 tax payment. If federal estate taxes are 40 percent and state taxes are 16 percent, you have saved your family from having to pay a 56-percent tax on at least $210,000.

Example 3: Retirement Savings

You are 35 years old, married with two children. You and your wife work, and you make sufficient income to support our lifestyle. You have a federal and state combined tax bracket of 28.8 percent. You have a traditional IRA valued at 25,000, and you are expecting returns of 8 percent. You have sufficient funds in a savings account to pay the taxes on the conversion (approximately $7,200). If you make the conversion now, the value of the Roth IRA at age 70 will be $369,634. You will be able to withdraw funds from the account tax-free for your retirement. If you do not convert the IRA, the traditional IRA will be valued at $369,634, but you will be required to take minimum distributions from the account whether you need them or not, and you will be required to pay taxes on the distributions at a tax rate that is currently unknown.

The Mechanics of Roth Conversions

By Louis Kokernak, CFP®, CFA Haven Financial Advisors (www.havenfinancial.com)

While investors are considering conversion of traditional IRA assets to Roth IRAs, they and their advisors must understand the rules of the programs. Without a good grounding in the rules, opportunities might be missed or extra tax obligations might be incurred.

Let's begin by describing the mechanics of a Roth IRA conversion.

An investor may convert some or all of his traditional IRA accounts, SEP-IRAs, 401ks, or 403b balances to a Roth IRA. These source accounts are tax-deferred. Ordinary income tax must be paid on any pre-tax assets that are transferred. Once transferred, however, the gains on investments in the target Roth IRA account are free of tax. The new laws opened up this opportunity to people at all income levels, and in fact, income limits on conversion are permanently repealed.

Since its inception in 1998, only families with incomes below certain levels have been allowed to contribute or convert funds to Roth IRAs. Notably, however, the means test remains in place for annual Roth IRA contributions. There is a way around the means test for contributions to Roth IRAs.

Here's how:

A high-income earner can make a nondeductible traditional IRA contribution in 2010 and beyond. The next day, this traditional IRA could be converted to a Roth IRA under current law. Through this two-step process, high-income earners can effectively fund a Roth IRA without tripping the means test restrictions. (Congress is aware of the loophole and may decide to either close it or simply abolish the means test, but it's a viable strategy as of this writing.) The second important aspect of the new Roth IRA law is that taxes due on the converted assets can be distributed over the following two tax years: 2011 and 2012.

In fact, that is the default tax treatment, unless the investor opts to pay all the taxes in the 2010 tax year. A family can both income-average and defer the income recognized from a Roth IRA. Tax deferral sounds good at first glance…but caution should be exercised. There is a high likelihood that tax rates will be going up in the near future. At some point, the massive fiscal stimulus the U.S. economy has received will have to be paid for. Despite the impasse in Congress today, there is a very real possibility that at least the marginal tax rate in the top bracket will return to its level prior to the Bush tax cuts: going up from the current 35 percent to 39.6 percent. (Also note that the healthcare reform bill includes a 5.4-percent surtax on individual incomes in excess of $500,000.) It seems very possible that deferring income from 2010 to later years will probably place it in a higher tax bracket.

There are some positives, however. The extra income is split into two equal pieces and may therefore keep the investor out of the next tax bracket. Secondly, the taxes are simply due later: Payments will be due in April 2012 and April 2013, for a conversion done this year!

Weighing Taxes in a Roth Conversion

By Kevin Mahoney, CPA FIM Group (www.fimg.net)

Is a Roth IRA conversion right for you? Your unique circumstances—and your predictions about the future—will influence your decision. Here are a few factors to consider.

It is well-known that income taxes are not paid on a traditional IRA account until funds are withdrawn. As long as withdrawals are made after age 59½, they are taxed as ordinary income. Withdrawals can be delayed until age 70½, at which point annual required minimum distributions (RMD) must be taken. In contrast, contributions to Roth IRAs do not result in a current income tax deduction. However, as long as withdrawals are made after age 59½, no income taxes are due. In addition, Roth IRAs are not subject to the RMD requirements. So, judging your future tax liability plays an important role in helping you decide whether a Roth conversion makes sense for you. In general, a Roth IRA is better than a traditional IRA, if the following conditions hold:

• Future income tax rates are the same as current income tax rates;

• A person's annual income is constant over the time period;

• There is an estate tax liability due on the IRAs upon the death of the account owner.

For those individuals whose estate may be subject to estate taxes upon their death, the Roth conversion would result in a lower taxable estate, since the income taxes paid upon the conversion would reduce the total assets of the estate. In addition, married taxpayers may want to consider a Roth conversion as a way to reduce future income taxes for the surviving spouse. Since the surviving spouse will be required to pay taxes at higher single-taxpayer rates, converting to a Roth IRA will not only eliminate future RMDs but would also result in any withdrawals being income tax-free.

Finally, a Roth IRA is generally more "income tax-friendly" to a non-spouse beneficiary, since any withdrawals are not subject to income taxes.

IRA Conversion Can Get Your Wallet in Shape for Retirement

By **Rick Rodgers**, CFP® Rodgers & Associates (www.rodgers-associates.com)

Retirement Planning Roth IRA conversions can be attractive, but you must keep a close eye on tax consequences and Social Security. Let's say you retire at 59, and your new taxable income is $25,000 from pensions, investment earnings, and/or part-time work. You could convert $40,000 from a traditional IRA to a Roth IRA and stay within the 15-percent tax bracket ($68,000 maximum in 2009 when filing jointly). You could move a total of $120,000 ($40,000 per year for three years) into a Roth IRA by the time you reach age 62. You have to pay taxes on the funds you move to a Roth—but remember that you would eventually pay taxes on this money and anything it earns if it is left in your traditional IRA.

So where is the savings? The $120,000 in the Roth IRA would generate income of about $116,000 over 10 years if it earned 7 percent per year. Not having to pay the taxes on $116,000 would save you $17,400 in the 15-percent bracket. (If you are in a higher bracket or if tax rates rise, so do the savings.) Why Three Years?

There's a reason that this example ends the strategy after three years. If you plan to draw Social Security at 62, the $40,000 of additional income (from the voluntary Roth IRA conversion) may cause your Social Security benefits to become taxable. This would reduce the savings of conversion. According to the Social Security Administration, about one-third of recipients have to pay income taxes on their benefits. The basic rules are as follows:

• If you file a federal tax return as an "individual," and your combined income* is between $25,000 and $34,000, you may have to pay taxes on 50 percent of your Social Security benefits. If your combined income* is more than $34,000, up to 85 percent of your Social Security benefits is subject to income tax.

• If you file a joint return, you may have to pay taxes on 50 percent of your benefits if you and your spouse have a combined income* that is between $32,000 and $44,000. If your combined income* is more than $44,000, then up to 85 percent of your Social Security benefits is subject to income tax. If you are married and file a separate return, you probably will pay taxes on your benefits.

The following is a short list of factors to consider when contemplating a Roth conversion:

1. Determine whether your contributions have been in a deductible IRA or nondeductible IRA. Only the earnings in a nondeductible IRA will be subject to income taxes when converted. Contributions are not taxable, but you need to be aware of the pro-rata rule if you don't convert all of your IRAs. Will you need these assets for living expenses, or will they be left to beneficiaries?

2. Do you have separate funds to pay the taxes on deductible contributions?

3. Will you need the use of these funds prior to the five-year holding period after conversion?

4. Would converting put you into a higher tax bracket?

*On the 1040 tax return, your "combined income" is the sum of your adjusted gross income plus nontaxable interest plus one-half of your Social Security benefits.

Roth IRA Strategies for 2010 and Beyond

By **Martha Schilling**, AAMS®, CRPC®, ETSC, CSA Schilling Group Advisors (www.SchillingGroupAdvisors.com)

Even you don't qualify for contributing to a Roth IRA or don't have a Traditional IRA that can be converted, you can still utilize many of the Roth IRA strategies if your employer offers a Roth 401(k).

Strategy #1: Save more for retirement.

For 2010, the maximum contribution allowed for a Traditional or Roth IRA is $5,000 ($6,000 for people over age 50), but this amount is phased out for Adjusted Gross Incomes between $166,000 and $176,000 (married filing jointly). For a 401(k), the contribution limit is $16,500 (or $22,000 over age 50). Although the limits are the same, a dollar in a Roth account is worth more than a dollar in a tax-deferred account because the taxes have already been paid for the Roth dollars. If you are contributing the maximum amount to your IRA or 401(k) and would like to save more, contributing to a Roth allows you to prepay the taxes, effectively allowing you to save more for retirement. The "return" on this additional savings will depend on both the investment return as well as any difference between your current tax rate and future tax rate, so both should be considered.

Strategy #2: Protect yourself from higher tax rates.

If you have many years to go until retirement, or even if you plan to have many years before retirement is "done," there is no way to know what tax rates will be in the future. Adding to the uncertainty of future tax rates is the uncertainty of your own income and expenditures in the future. A proven method to help protect against future uncertainty is to keep your options open, and this applies to taxable and nontaxable income as well. By funding a Roth IRA, you create a tax-free "bucket" from which you can make withdrawals for one-time needs (such as medical expenses or a gift to children), without triggering a higher tax obligation.

Strategy #3: Add flexibility to education funding.

One of the best education savings vehicles is a 529 account, offered by every state in the country. A 529 account allows you to save and invest for future education expenses, and all qualified withdrawals are tax-free (that is, withdrawals used for educational expenses). Consider funding those same education expenses with a Roth IRA instead. When it's time to withdraw funds for college from a Roth IRA, your contributions come out tax-free, and the growth is taxed as normal income. Any money not needed for education simply stays in the Roth IRA. And remember that your retirement plans are sheltered from consideration when applying for financial aid.

Understanding Roth Re-characterizations

By **Louis Kokernak**, CFP, CFA, Haven Financial Advisors (www.havenfi nancial.com)

While much of the focus of recent analysis of Roth IRAs has been on conversions, it's also possible to "re-characterize" or "negate" a conversion as late as October 15 of the following year. Through this process, some or all of the original amount invested in a Roth IRA may be sent back to where it came.

Why might an investor want to undo a Roth IRA conversion? The most likely reason would be poor market performance.

Suppose that an eager investor executed a Roth IRA conversion of all $100,000 of his eligible assets on January 1, 2010. By October 2011, imagine that the value of those assets had plummeted by 40 percent. That is a scenario that invites re-characterization. The investor might be reluctant to pay a tax based on a $100,000 distribution for assets that are subsequently worth only $60,000.

Investors with larger IRA accounts might choose to create multiple Roth IRA accounts and segregate them by asset class.

Why? In this way, the investor can keep the accounts that have increased in value and re-characterize the accounts that depreciated. By funneling like-performing assets into multiple accounts, the investor (and his advisor) increase the likelihood that their respective performances will diverge.

The late re-characterization deadline allows investors to exercise some hindsight to cherry-pick accounts that have not performed well and revert them to tax-deferred status. Consider an investor with a $1-million IRA currently invested in 50 percent stocks and 50 percent bonds, and assume that this investor has enough cash on-hand to pay the taxes for conversion. This investor has a tax rate of 30 percent.

By splitting the conversion into two $500,000 accounts, one of which is 100-percent stocks and the other of which is 100-percent bonds, he can revert one or both accounts if investment progress is unsatisfactory. The graph on this page shows how the split operates. Now, consider what happens if stocks and bonds perform differently over the next year. Stocks increase by 20 percent, and bonds fall by 20 percent. The investor decides to retain the stock based Roth IRA. He pays his 30-percent tax, but only on the $500,000 that he invested initially ($150,000). Already, the Roth IRA is worth $600,000; so the effective tax rate of the conversion was 25 percent. Meanwhile, the investor decides to re-characterize the bonds-based Roth IRA. At the end of a year, the overall portfolio stayed the same in value--the two IRAs were collectively worth $1 million in October 2011. But the investor has used hindsight to negate the taxes on the poorer performing asset.

Planning Note:

When an investor does a Roth re-characterization, the IRA funds used to pay taxes may not be returned to the original account. This last point reinforces a good financial planning rule. Pay taxes on Roth IRA conversions with outside funds.

Remember that earnings in a Roth are not taxed, and that's why it is desirable to keep these accounts as large as possible. Convert only enough tax-deferred assets so that you can pay the tax bill with cash on-hand. Using funds from the conversion to pay taxes will reduce the size of a key sheltered asset and will hamstring any effort to re-characterize it later.