Is A Roth Right For You?

New Roth IRA Rules May Help Your Retirement Get Back On Track

By Don Sadler

The falling stock market has made it a rough couple of years for many retirement investors, including self-employed individuals.

But here's some good news that might help cushion the blow of retirement account losses: The benefits of a Roth individual retirement account (IRA), which have been inaccessible to many self-employed individuals and micro-business owners, may finally be within your reach.

Both traditional and Roth IRAs may have a place in your retirement portfolio, but Roths offer unique benefits that sometimes make them a better choice.

The main advantage is that withdrawals from Roth IRAs are made tax-free in retirement. In contrast, you must pay taxes on traditional IRA withdrawals at your ordinary income tax rate after you retire. Depending on your financial goals, this could make the Roth IRA a more attractive option.

However, if you earn too much money, you can't open or contribute to a Roth IRA. The modified adjusted gross income limits for 2010 are $120,000 for single filers and $176,000 for married couples filing jointly—limits that are exceeded by many self-employed individuals.

And before this year, converting a traditional IRA to a Roth IRA was prohibited for anyone earning more than $100,000 a year.

That changed on Jan. 1, 2010.

Starting this year, anyone (regardless of income) can convert their traditional IRA to a Roth IRA. But should you take that step? This article will help you weigh the pros and cons.

Tax Implications Of Roth Conversions

Suzanne Durbin, chartered financial consultant, financial advisor and partner with GV Financial Advisors in Atlanta, Ga., has been advising clients about Roth conversions.

"When the right set of circumstances converge, taking advantage of this limited window to convert your traditional IRA to a Roth IRA can be very advantageous," Durbin says. "While there are a number of complexities to understand before making a decision, this opportunity may present one of the better financial decisions you and your family can make in 2010."

But there is one significant drawback to making a Roth IRA conversion: You must pay taxes at your ordinary income tax rate on the value of the IRA at the time you convert.

Michael J. Jones, a partner with Thompson Jones LLP in Monterey, Calif., who speaks often on the topic, explains: "The converted assets are treated as being 'distributed' for income tax purposes, so when the Roth IRA conversion occurs, there's an income tax to pay."

To help ease the income tax pain, the IRS will allow you to stretch the tax payment out over two years (2011 and 2012) if you complete your Roth conversion in 2010.

"In general, the idea of stretching the tax bill out over two years can be attractive," says Durbin. "It's a matter of cash flow and the time value of money. However, if you think you'll earn more than $250,000 a year after 2010, it might be better to pay all of the tax in 2010 in case the top tax rates go up after this year."

Three Factors To Consider

Given the tax implications, do Roth IRA conversions still make sense? The answer will vary depending on several different factors.

"I can run the numbers and show people economic models, but the decision is up to each individual," Jones says.

Durbin says her firm has created a financial calculator to help clients decide, but there's one criterion that's usually a make-or-break.

"The biggest factor is usually whether or not the individual can pay the income tax from sources *other* than the IRA that's being converted," she says. "If you can, it's often a smart move."

Here's why: If you're under age 59½, you'll have to pay a 10-percent early distribution penalty on any assets that aren't rolled directly into the Roth IRA. So for example, if you owed $10,000 in taxes upon conversion and paid this out of IRA funds, you'd have to pay an additional $1,000 penalty on top of the $10,000 tax.

"When you send some of your IRA dollars to the IRS, you've reduced the size of your tax shelter by the amount of money you paid in taxes," Jones says.

There are two other main factors that Durbin says also usually play large roles in deciding whether or not to make a Roth IRA conversion.

The first is your current tax bracket; specifically, whether you're currently in a lower tax bracket than normal, perhaps due to a slowdown in your business as a result of the weak economy.

"Maybe your revenue is down this year, and you've slipped down to the 15-percent marginal tax bracket," Durbin explains. "But you've been in the 30-percent marginal bracket in past years and you think you might be back up there next year. If so, you've got a unique opportunity to move money into a Roth now at a potentially lower tax cost."

Using these numbers and a hypothetical $50,000 converted to a Roth, the tax savings could be as much as $7,500.

The other factor is the current value of your IRA. If your account has suffered losses over the past couple of years, converting while the value is lower could result in a smaller tax bite.

"If all three of these factors exist for you, then making a Roth IRA conversion is almost always a winner," says Durbin.

The NASE Consultants Can Help

Get your retirement planning questions answered by professional consultants. It's all online. It's all confidential. And it's all included in the cost of your NASE Membership. Visit www.NASE.org. Click "Knowledge Center."

TaxTalk

The certified public accountants answer questions about tax issues surrounding retirement accounts, contributions, withdrawals and more.

ShopTalk 800

Micro-business consultants help you compare different retirement plans to find one that's right for you.

EstateTalk

Licensed attorneys answer questions about coordinating your estate and retirement planning.

ABCs of Finance

Chief financial officers help you understand the various investment choices for your retirement accounts.

Who Benefits From A Roth Conversion?

Jones says that younger people, or at least anyone under 60, tend to be better candidates for Roth IRA conversions because there will be more time for them to recover the taxes they paid before they retire.

"Also, there are no required minimum distributions (RMDs) with Roth IRAs when you reach age 70½ like there are with traditional IRAs," he adds. "This may give you more flexibility with regard to taking money out of your IRA after you retire."

Durbin adds that there's another category of individuals for whom Roth IRA conversions can be especially beneficial: the wealthy who intend to leave the assets in their IRAs to their children or grandchildren.

Some wealthy individuals don't need to withdraw funds from their IRAs to meet their living expenses during retirement, Durbin explains. But, they'll be forced to begin making RMDs from traditional IRAs when they reach age 70½, as noted above.

"Converting to a Roth will enable them to 'prepay' the income tax for their heirs, while avoiding unwanted annual taxable income for the balance of their own lives," Durbin says.

Paying the tax now also creates real potential benefits with regard to a family's gifting strategy, says Durbin. Individuals can only give away up to $1 million during their lifetime before gifts become subject to gift tax.

"If you pay a $400,000 conversion tax, it's essentially the same thing as giving this money to your children or grandchildren because you're paying the tax for them, but it doesn't count as a taxable gift," Durbin explains. "You're prepaying a tax for them that doesn't count against your annual or lifetime gifting limits."

A Roth Conversion Do-Over

In addition to having to pay taxes, Jones points out another potential drawback to Roth conversions: What if the IRA's value falls sharply soon after the conversion is made? Then you'll have paid a relatively large amount of taxes on what is now a much smaller account, maybe even smaller than the taxes that were paid.

"To me, this is the scariest thing about Roth IRA conversions," says Jones. "Individuals must write a large check to Uncle Sam and then hope the account appreciates in value."

If it doesn't appreciate, the IRS will allow you to perform what's called an IRA recharacterization—in effect, a do-over that reconverts the Roth back to a traditional IRA.

For example, let's say you were to convert a $100,000 traditional IRA to a Roth IRA in 2010 and pay federal and state income taxes totaling $40,000. But over the next year, the markets take another tumble and by early 2011, the Roth IRA is only worth $80,000.

Now you've paid $40,000 in taxes not on a $100,000 account, but on an $80,000 one. If this forces you to rethink the wisdom of your conversion, you can recharacterize the Roth IRA—or in other words, switch it back to a traditional IRA and get back all of the taxes you paid. IRA recharacterizations can be done once each year.

The Final Analysis

IRAs are long-term investment vehicles for most people.

Deciding whether or not making a Roth IRA conversion is the right strategy for you can be difficult. You should consult your financial or tax advisor for guidance on your particular situation.

But after a rocky couple of years for retirement investing, Roth conversions may offer a once-in-a-lifetime, government-approved opportunity to get your retirement savings on the upswing again. ■

Don Sadler is a freelance writer who specializes in business and personal finance. He has established both traditional and Roth IRAs and contributes as much as he can to them each month.

Starting this year, anyone (regardless of income) can convert their traditional IRA to a Roth IRA.