Making the Most of Roth IRA Opportunities

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Although Roth IRAs (Individual Retirement Accounts) have been around for years, they initially were not available to many higher-income individuals due to restrictions imposed by Congress, which limited those of high net worth from contributing to these accounts. Under the Tax Increase Prevention and Reconciliation Act, Roth IRA *conversions* became available for everyone starting in 2010. This change in the law created a significant planning opportunity for many high-income retirees.

To take advantage of this opportunity, some individuals may now wish to consolidate their Traditional IRAs into one. Depending on the taxpayer's Adjusted Gross Income, it also may be possible to begin making annual contributions to a Roth IRA or non-deductible contributions to a Traditional IRA. For reasons discussed in this article, such contributions can accelerate the tax benefits of assets that will later be converted from a Traditional to a Roth IRA.

Roth IRA Basics

There are two main ways to participate in Roth IRAs – annual contributions or conversions.

• ***Annual contributions –*** Taxpayers whose Adjusted Gross Incomes (AGIs) do not exceed certain limits may make an annual contribution to a Roth IRA. Contributions are made with after-tax dollars and earnings compound on a tax-deferred basis. Withdrawals of Roth contributions may be taken tax free at any time. Withdrawals of earnings are tax free, provided the Roth has been in existence at least five years and withdrawals are taken after age 59½. Tax penalties apply on withdrawals of earnings prior to age 59½, unless a permitted exception applies – such as death, disability, medical expenses, first-time home purchase, or higher education expenses.

• ***Conversions –*** Currently, any taxpayer (single or joint filer) may convert money from a Traditional IRA to a Roth IRA. The amount converted is added to the account holder's taxable income in the year of the conversion and taxed as ordinary income. Since converted amounts then may qualify for tax-free withdrawals under the same terms as Roth IRA contributions, conversions are a way of pre-paying income taxes in an IRA.

Advantages of Roth Conversions

• A Roth IRA conversion can help to accumulate tax-advantaged assets during retirement, simplify tax compliance, and pass on estates on a tax-advantaged basis.

• Roth IRA owners may make post-tax contributions at any age. (In a Traditional IRA, contributions are not allowed after age 70½.)

• While there are no required minimum distributions (RMDs) from Roth IRAs during the owner's lifetime, a Roth IRA conversion also avoids the annual calculation of the annual RMD that is required in most Traditional IRAs after age 70½.

• Since no income tax is due on qualifying distributions from a Roth IRA during the owner's life or after death, a Roth can make life easier for heirs by leaving them tax-free assets. Although heirs are subject to annual RMDs from Roths after the original owner's death, they have some flexibility to "stretch" these distributions over several years, thus enabling the tax-deferred growth to continue for some time.

Tax Rates Can Make a Difference

One of the more challenging questions to consider is this one: *"Do you think that, on the whole, tax rates will increase or decrease during your retirement?"* Because Roth contributions and conversions effectively pre-pay income taxes, they may make sense for individuals who believe tax rates will increase during their retirement. Some people think it is a mistake to pre-pay taxes because they will lose the "time value of money" on the taxes paid. However, this is not the case, due to the following rule: *A pre-tax dollar in a tax-deferred investment will have exactly the same after-tax future value as a post-tax dollar in a tax-free investment, if you assume that tax rates stay constant.*

For example, suppose you put $1 of pre-tax money into a Traditional IRA and over 10 years it compounds (at a 4% annual return) into $1.58. You then pay federal/state income tax at a hypothetical 30% rate, leaving $1.11, after taking a taxable withdrawal. By comparison, suppose that you put 70 cents of post-tax money ($1 less 30 cents tax) into a Roth IRA and it compounds over 10 years at the same 4% to produce $1.11. Since the full amount can be withdrawn tax free, the amount available for retirement security is exactly the same as in the Traditional IRA.

While it is impossible to know whether federal, state and local income tax rates will go up or down in the future, many financial professionals feel that taxes have nowhere to go but up. Despite this, since no one can predict the future with any level of certainty, one strategy advisers sometimes recommend is to hedge against unknown future tax rate levels by dividing retirement money between Traditional and Roth IRAs.

Even for those who aren't sure about the wisdom of Roth conversions, it can be useful to contribute or convert a small amount to a Roth before retirement. People over age 59½ are allowed to take tax-free withdrawals from Roth IRAs starting five years after the account was opened. Even a small amount put into a Roth now starts that "five-year clock" ticking.

Summary

Roth IRAs have become a viable planning tool that can help to increase tax-advantaged asset accumulation and allow individuals to enjoy a certain level of tax-free income during retirement. Because changes in the tax law have made Roth conversions universally available, that makes this a good time to begin evaluating their pros and cons. Be sure to consult a financial professional for assistance with your personal situation.

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