

ROTH IRAs - Contributions, Conversions and Other Considerations

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Should I consider converting my traditional IRA to a ROTH IRA in 2010?

Effective January 1, 2010, taxpayers will have the ability to convert their traditional IRAs (deductible or non-deductible) into a ROTH IRA regardless of how much money they make. The current law (2009) only allows for conversions to ROTH IRAs when adjusted gross income is \$100,000 or less. In addition, the 2010 law contains a special provision allowing taxpayers to split the tax burden of conversion over the next two years (2011 and 2012).

The decision to pay current income tax for lifetime tax free growth by converting to a ROTH IRA is one that requires review and analysis to your particular situation. Some considerations include:

- Whether you have funds outside your IRA to pay for the current tax consequences. Paying the tax from existing IRA funds will not make the conversion to ROTH attractive given additional tax and potential penalty calculations.
- Comparisons of your current tax bracket vs. the tax bracket when you anticipate withdrawing funds come retirement.
- Outlook for 2010 tax year. Are you anticipating lower income in 2010 due to the loss of a job, previous sale of a business in 2009, etc.?
- Whether or not you have a long time horizon.
- Consideration to convert some part if for no other reason than to hedge potential income tax changes and provide diversification in your taxable/non-taxable portfolio.
- The attractiveness of having the ability to avoid required minimum distributions for legacy purposes. (Unlike traditional IRAs, ROTH IRAs do not require withdrawals at age 70 ½).
- Weigh the opportunity cost of what the money could have earned had it remained invested in a taxable account.
- Timing of rollover in a "down market".
- How much you have in non-deductible IRAs vs. deductible IRAs (including SEPs, previously rolled 401ks, etc.)

Can I simply rollover my prior year non-deductible IRAs at minimal or no tax consequence?

The answer to this question depends on the make-up of all your IRA accounts. Unfortunately, under IRS rules, you cannot earmark to convert only previously made non-deductible contributions. Instead, the amount the taxpayer converts is deemed to consist of a pro-rata portion of the taxable and non-taxable dollars in the IRA. This is often the most important and misunderstood part of the law. The IRS makes you aggregate all your traditional IRAs (including SIMPLE Plans, SEPs, etc.) when calculating the taxes due whenever you take a distribution from (or convert) any of the IRAs. For example, if a taxpayer has made non-deductible IRA contributions and they also have an IRA rollover from a 401(k), they will have to aggregate the accounts. The non-deductible IRA cannot be treated separately. Knowing this, taxpayers may choose to move the rollover IRA back to a 401(k) if eligible.

By way of example, a taxpayer who has most of his or her retirement money in a employer 401(k) and has been making non-deductible IRA contributions over the years (with no other IRA accounts), would be a perfect candidate to take advantage of the conversion to ROTH availability in 2010. Tax will only be due on the appreciated portion of the rollover. All original non-deductible contributions would not be taxed under this scenario. Should this taxpayer have other traditional IRA or SEP plan money, the aggregation rules will apply accordingly. Traditional IRA balances are aggregated so that the amount converted consists of a prorated portion of taxable and nontaxable money.

The decision to convert often requires further analysis in determining what the tax impact will be given your mix of IRA monies. We recommend that clients use this as an opportunity to review their history of rollover, deductible, and non-deductible retirement monies. Form 8606, "Nondeductible IRAs," is the form filed with your tax return each year you made nondeductible contributions and take distributions.

ROTH IRAs vs. Traditional IRAs - Comparative Analysis:

THE SIMPLISTIC COMPARISON:

Example: Mr. Smith is age 60 and has a \$100,000 IRA which grows annually at 10%. He is in the highest 35% tax bracket which will remain constant until retirement. In 10 years all the money is withdrawn and any necessary taxes are paid. Both options yield the same result:

<u>Regular IRA</u>		<u>Roth IRA</u>
\$100,000	35% tax>	\$65,000***
<u>@10%</u>	10 years	<u>@10%</u>
\$259,370		\$168,591
<u>-\$90,779</u>	<35% tax	
\$168,591		

***since ROTH contributions receive no upfront tax benefit, this figure uses after tax monies.

COMPARISON WITH DIFFERENT TAX RATES:

Assuming \$100,000 in IRA monies with 5 years to retire and an estimated rate of return of 5%:

Current tax bracket = 35%	Retirement tax bracket = 25%	
Total after taxes =	\$136,790 (Traditional IRA)	\$127,628 (ROTH IRA)
Current tax bracket = 25%	Retirement tax bracket = 35%	
Total after taxes =	\$113,010 (Traditional IRA)	\$127,628 (ROTH IRA)

Should years to retirement change from 5 years to 25 years, you can see a more dramatic impact:

Current tax bracket = 35%	Retirement tax bracket = 25%	
Total after taxes =	\$331,837(Traditional IRA)	\$338,635 (ROTH IRA)
Current tax bracket = 25%	Retirement tax bracket = 35%	
Total after taxes =	\$282,867 (Traditional IRA)	\$338,635 (ROTH IRA)

While no one really knows where tax brackets will be when they retire, our current state of relatively low tax rates coupled with an increasing deficit lead many to believe that future tax rates will be on the rise. Anticipated tax rates in conjunction with other factors such as time horizon, diversification, etc. should all be considered.

Are there other ways to put ROTH money away for tax free growth?

Yes. While beyond the scope of this discussion, more and more employers are adding ROTH 401(k) features to their retirement plans. This is a terrific way to allow for employees to contribute on a free growth basis without any income limit restrictions. In addition, self-employed individuals have the option to set-up Solo ROTH 401(k) which is also a great way to put in significant tax free growth dollars for retirement.

How can Newburg & Company help me with my retirement goals, etc.?

As part of your year-end tax planning, we can review your current retirement asset mix and evaluate the impact of making a ROTH conversion in 2010. In addition, we can assist you with developing a game plan for retirement and reviewing any other retirement options that might be available for you to meet your retirement goals.

Please contact our office for more information or to schedule an appointment.