

Should You Consider Transferring Your Retirement Fund to a Roth IRA?

By The Investment Strategies Committee

2010 is being called the year of the Roth Individual Retirement Account (IRA) in retirement planning circles. What a Roth IRA is and whether senior lawyers should consider transferring their retirement assets to one is discussed by Walter Burke (WTB), former chair of the Senior Lawyers Division, in response to questions posed by Bruce Mann (BAM), chair of the SLD Investment Strategies Committee.

BAM: A traditional IRA, like other qualified retirement plans, permits you to make deductible contributions to a retirement plan, avoid taxes on the income or gains in your plan portfolio, and only pay taxes at ordinary income tax rates when you withdraw assets or money from the plan. How is this different from the way a Roth IRA works?

WTB: Both the Roth IRA and traditional IRA are similar in the fact that they are great investment vehicles to save for retirement. However, beyond that, there are some major differences.

The biggest difference between the traditional IRA and Roth IRA is the way the U.S. government treats the taxes. Contributions and earnings in a traditional IRA are tax deferred until withdrawn (early withdrawal penalties may apply if you are under age 59½). The distributions out of a Roth IRA, whether contributions or earnings, are tax free, provided certain requirements are met.

In a traditional IRA, contributions may be tax deductible depending on your modified adjusted gross income and other factors. Contributions to a Roth IRA are not tax deductible.

There is no limit on making contributions to a traditional IRA; however, you must have earned income to contribute. To be eligible to make contributions to a Roth IRA, your modified adjusted gross income must be below certain limits and also depends on your tax filing status.

Mandatory distributions are required from a traditional IRA after the age of 70½; however, distributions are not required from a Roth IRA.

BAM: I understand that Roth IRAs have been an available investment option since 1998. Why the sudden interest in them? Has the law changed to make them more attractive?

WTB: It is correct that Roth IRAs were first introduced in 1998. The renewed interest has to do with changes in the tax legislation making them more attractive. The changes were enacted in 2006 under the Tax Increase Prevention and Reconciliation Act of 2005. All taxpayers, regardless of taxable income, will be able to convert a traditional IRA, whose earnings will be taxed,

to a Roth IRA, whose earnings are not taxed after a five-year holding period.

In 2010, the single biggest change is in the ability to readily convert funds from retirement accounts to a Roth IRA. That is called a *conversion*. However, the new tax law did not change the existing provisions for Roth *contributions*. The difference is that to be considered eligible to make a Roth contribution, income levels must meet certain IRS guidelines discussed later.

BAM: In a previous issue of *The Voice of Experience*, I discussed taking some of the equity out of your home to invest for your retirement. If I decide to do this or have other funds available for investment that aren't already in a qualified retirement plan, can I contribute them too without paying tax on the amount I contribute? If not, does it make sense for me to contribute them to a Roth IRA before investing them?

WTB: First, let's be clear on the rules for contributions versus conversions. As of January 1, 2010, anyone can convert a retirement plan regardless of income, thanks to the aforementioned tax legislation. Before the rules changed, only people with modified adjusted gross incomes of \$100,000 or less could convert their accounts. However, contribution eligibility is still based on income levels. Individuals can make a nondeductible contribution to a Roth IRA, provided they have earned income in the amount of the contribution, and can even do this if they choose to take equity from their home, as you stated. However, they must meet income-eligible guidelines and are subject to the IRS Roth IRA phase-out rules. Tax filers will be able to contribute less to their Roth IRA when they have a MAGI (modified adjusted gross income) above \$105,000, or above \$167,000 for married couples filing jointly (up \$1,000 from last year). Single filers with a MAGI above \$120,000 or those who are married filing jointly with a MAGI above \$176,000 are not eligible for Roth IRA contributions.

Furthermore, in 2010, Roth IRA contribution limits are set at \$5,000. For taxpayers over the age of 50, they can contribute up to \$6,000, which is commonly referred to as the catch-up contribution.

BAM: Because the annual limit on total contributions to IRAs has been either \$5,000 or \$6,000, but there has been no limit on tax-free transfers from a qualified retirement plan, such as a law firm's 401K, profit sharing, money purchase or defined benefit plan to a traditional IRA, many of us have a large part of our retirement funds in a "rollover IRA," where we can direct individual investments rather than rely on the decisions of the plan's advisor. Do you have the same flexibility in mak-

ing investment decisions in a Roth IRA that you have in a traditional IRA?

WTB: An investor does have the same flexibility in making investment decisions in a Roth IRA as a traditional IRA. The only difference is the actual registration or type of IRA. The investment choices available should be virtually identical if held on the same investment platform. As an example, if you have both an IRA account and a Roth IRA account held at the same custodian, such as a discount brokerage firm like Charles Schwab, you will have the ability to invest in the same types of assets within each type of IRA.

BAM: I understand that it may make sense to transfer investment assets I own that are not in a qualified retirement plan to a Roth IRA, but what about the assets I have in my rollover IRA? If I transfer money from my existing rollover IRA to a Roth IRA, I'll have to pay income tax now on the amount I withdraw to make the transfer, rather than only paying the tax when I take it out as part of the minimum amount I have to withdraw each year after I reach 70½. I'll also have to pay income taxes on any amount I transfer to the Roth IRA. Why would it make sense to do this?

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WTB: It might make sense to consider paying the taxes on the conversion from other assets if this will not impact or deplete other savings and assets needed for your own retirement. In this case, paying the taxes now leaves a great tax savings legacy for your heirs whereby they inherit a tax-free asset that is allowed to continue to grow tax free. When they choose to take withdrawals presumably at a much later stage, they will be able to take this without the tax burden. Additionally, if you expect your income tax bracket to be higher in retirement, you may want to pay the taxes now at a lower rate. And because Roth withdrawals are not counted as income, it will not affect whether your Social Security benefits are taxed as it would if it were coming from a taxable IRA.

BAM: I understand that it may make sense to withdraw funds from my traditional IRA and make contributions to a Roth IRA now if I expect income tax rates to go up in the future, but I anticipate that much of my IRA will be part of my estate when I die. How does the estate tax impact my decision whether to withdraw assets from my traditional IRA or transfer them or other assets I have that aren't in a qualified retirement plan to a Roth IRA?

WTB: Assets held outside retirement accounts, such as taxable brokerage accounts, are not eligible for a Roth conversion. The taxable assets would have to be consid-

ered a Roth IRA contribution. In this case, the contributions to the Roth IRA are limited to the annual amounts of \$5,000 or \$6,000, as discussed.

Retirement assets, whether they are converted to a Roth or not, are still part of the overall estate and will be taxed accordingly. The benefit lies in the timing of the conversion. If converted much later in life, the assets used to pay the taxes for the conversion are essentially removed from the individual's taxable estate and effectively reduce the amount of the estate tax. However, if the conversion is done years before the estate tax is a consideration, the Roth IRA may have had time to accumulate earnings and grow to a sizable estate asset once again. The worst-case scenario in estate planning is having a large taxable estate that also holds a large tax-deferred retirement asset. Without proper planning, the combined estate tax and income tax on that amount can exceed 80 percent.

For many people, the driving force may be whether you can afford to pay the taxes on the conversion, rather than consideration for estate taxes. If it is affordable and you don't necessarily need the money for retirement, the option to convert is more attractive.

BAM: To summarize, what are some factors that should be considered before converting to a Roth IRA?

WTB: I'd start out by considering whether you need the money for retirement. For people who are unsure whether they will need all of their retirement money, it could pay to convert a portion of their IRA for large or unanticipated expenses later in life. Roth IRAs do not require account owners to withdraw money, and this essentially could be considered a savings account. The Roth IRA, after a number of years of growth, may provide a hedge against longevity and also be used to offset medical expenses. And, if you never have to tap into the Roth IRA, it can become an attractive legacy.

BAM: If you don't need the money for retirement and want to maximize the amount passed on to your heirs, is there a benefit in converting a traditional IRA to a Roth IRA?

WTB: A Roth IRA is a good way to fund a family legacy. Let's discuss an example of creating a legacy by funding a Roth IRA. An individual funds a Roth IRA and lists his eight-year-old granddaughter as the beneficiary. (If the individual makes too much money to make the initial Roth IRA contribution, he can fund a nondeductible IRA and then convert that to a Roth IRA.)

If the conversion is on a nondeductible contribution to an IRA, the contribution amount will not be taxed in the conversion, only the earnings in the IRA are taxed, and if the conversion is done shortly after funding, there are essentially no taxes at all. High earners can make nondeductible contributions to traditional IRAs and convert them to a Roth IRA each year and pay little in taxes.

Let's assume the Roth IRA starts with a balance of \$5,000. At some point, the granddaughter will inherit the IRA and can continue its tax-deferred status in a beneficiary Roth IRA, also commonly referred to as a stretch

IRA. If left alone, invested at a modest 4 percent rate of return for sixty years until she is age 68, this account could grow to a value of over \$52,598 (or to \$506,285 at an 8 percent rate of return). This small contribution over time can grow into a significant family legacy and is a compelling reason to convert, allowing the tax-free stretch of the IRA over the lifetime of the beneficiary.

BAM: Okay, but what if the conversion is from a traditional IRA or other retirement plan to a Roth IRA and the contributions to the traditional IRA or retirement plan were deductible? Won't I have to pay taxes in the year of the conversion?

WTB: Yes, but for Roth IRA conversions executed in 2010 only, the tax bill may be paid over the following two tax years. To split the taxes owed on a 2010 Roth IRA conversion over two years, you must file IRS Form 8606 with the tax return. For individuals in the top tax brackets, choosing to pay the tax in 2010 may make more sense to avoid the higher income tax rates scheduled for 2011.

If you are planning on doing the conversion, you may want to do it sooner rather than later while the market is still in the recovery phase, with the benefit of converting while your account balances are lower and therefore the tax bill will be lower. If this strategy backfires and the market goes down, you have the ability to do a Roth IRA recharacterization, essentially undoing the conversion.

BAM: If the conversion is taxable, what will I have to pay?

WTB: The taxes on a Roth conversion are based on your current marginal tax rate. Be careful to consider the *new* marginal tax rate that the conversion will bump you up into. Remember, the conversion amount will be included in your current income; therefore, you may be bumped into a higher tax bracket. Secondly, if you are using the IRA assets to pay the taxes and are under the age of 59½, you must be prepared to pay the 10 percent early-withdrawal penalty on those assets utilized for taxes (not the full conversion amount).

Let's consider the costs to convert a \$50,000 IRA with no additional contributions (see chart below). It is always important to run the numbers to understand the full conversion cost.

BAM: If I elect to split the tax between 2010 and 2011,

do I run the numbers based on my 2010 marginal tax rate for both years? What if there's an increase in the marginal tax rate for individuals in 2011?

WTB: If you elect to split the tax, the 2010 marginal tax rate would only be used for the first half. Therefore, half of the tax will be due with your tax return filed in 2011. The second half would be due on your tax return filed in 2012. This is not only a function of your individual tax rates but also a function of governmental policy and where tax rates will be in the future.

Considering the current budget deficits and the costs of the bailouts and stimulus, many believe tax rate increases are inevitable. If you share that belief, you may want to realize all income from the conversion in 2010 and pay the tax at the presumed lower rate when filing in 2011.

BAM: If I convert a traditional IRA to a Roth IRA, can I withdraw earnings from the Roth IRA immediately without paying taxes?

WTB: No, the five-year holding period applies to Roth conversion amounts as well as regular Roth IRA accounts. You must wait until January 1 of the fifth year before you can have tax-free access to any of the earnings on the Roth conversion account. If you will need the money before then and still want to convert, keep enough in the traditional IRA to cover those withdrawals.

BAM: If I roll over a traditional IRA to a Roth IRA, some of the amount converted may represent contributions made by me with "after tax dollars" because they weren't deductible when they were made. Do I have to pay the conversion tax on that amount as well as the amount contributed to the traditional IRA on a deductible basis?

WTB: Be careful not to pay the tax twice. It may make sense to work with a tax advisor to compute the percentage that will be taxable. If all of your contributions have been after tax, then your conversion on the contribution amounts are not taxed, but earnings may be.

In conclusion, there are a number of factors to be considered before making a decision. The decision to convert may rest on your preference for paying taxes as well as expected income in retirement. There are many pros and cons, all of which need to be examined. Working with a tax advisor can help with this decision, and using a financial calculator is a desirable tool as well. **VOE**

Marginal Tax Rate	IRA Balance	Money Withdrawn to Pay Taxes	Balance Converted to Roth
28%	\$50,000	\$14,000	\$36,000
Years Required to Restore Original Account Balance			
4% Rate of Return		8% Rate of Return	
8.2 years		4.09 years	

