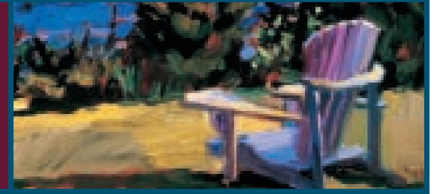
Individual Retirement Accounts (IRAs)



Roth IRA Conversion Strategies

Taking a Powerful Retirement Savings Vehicle in New Directions

Chances are you've heard the words "Roth IRA" at some point since you've started to think about planning for retirement. Much like its counterpart, the Traditional Individual Retirement Account (IRA), which many investors are more familiar with, a Roth IRA offers an advantageous way to save for retirement by allowing any investment growth to accumulate in a tax-advantaged vehicle.

How does a Roth IRA differ from a Traditional IRA?

The key difference between a Traditional IRA and a Roth IRA is that while Traditional IRAs can provide a potential tax break when you contribute, Roth IRAs are designed to give you a break when you withdraw.

In addition, Roth IRAs offer:

- Earnings that accumulate tax free. Once you've had the account for five years, withdrawals made after age 59½ are free from federal income taxes
- Higher income limits. If your income exceeds the Traditional IRA's deductibility limits, you may still be eligible to make a full Roth IRA contribution
- Contributions that can be withdrawn tax and penalty free at any time. Earnings can be withdrawn early, with no penalty tax, under certain circumstances
- No age limits on contributions and no required minimum distributions (RMDs). In other words, you can continue making contributions as long as you have earned income, and you never have to take IRS-required distributions

Choosing to convert retirement assets to a Roth IRA can be an important part of your retirement and legacy planning strategy as you and your financial advisor work toward keeping more of your money for you and your heirs. In addition, recent legislative changes have expanded conversion opportunities, allowing a greater number of investors to take advantage of them.

Four Roth IRA Conversion Strategies

While you and your advisor may decide on a Roth IRA conversion as the optimum way to grow your assets and generate the income you'll need in retirement, it can also be a powerful planning tool that helps you reach other goals. We've outlined four conversion strategies below.

Wealth Transfer Strategy

Designed for those who will not need Roth IRA assets to cover expenses in retirement and have non-IRA money available to pay the tax generated by the conversion, this strategy transforms a Roth IRA from a retirement savings vehicle to one designed to transfer wealth to future generations.

The specific Roth IRA benefit it exploits is the fact that you never have to withdraw money from your Roth IRA. This allows the account to continue to grow tax free throughout retirement, and gives your beneficiaries tax-free access to this portion of their inheritance, though they will be required to withdraw required minimum distributions (RMDs).

Using Market Volatility Strategy

While it's difficult to successfully time the market, you can potentially put its volatility to work for you when it comes to choosing a good time to convert to a Roth IRA. If you and your advisor plan to convert your assets to a Roth IRA at some point, market drops that drag your retirement savings down may present ideal conversion opportunities. Why? Simply put, the smaller the conversion, the smaller the tax bill.

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Plus, as the markets recover (and historically, they have over time), any earnings will accumulate tax free, and remain so for any qualified distributions you choose to take.

Maximizing Tax Incentives Strategy

In order for taxpayers to take advantage of certain special tax attributes, such as business losses or college tax credits, they must have taxable income. If you find yourself in a position where you need to generate taxable income, a Roth IRA conversion may potentially be the answer.

The key to this strategy is working with your tax or financial advisor to ensure you convert just enough to generate taxable income, not an even larger tax bill. As with any tax strategy, you always should consult with an expert.

Tax Hedging Strategy

You and your advisor may conclude that your income tax rate will likely be higher in the future for a number of reasons. This could happen once you begin to draw income from your retirement accounts (whether via RMDs or other sources), if you are relatively young and expect salary increases, or if you think tax rates will increase in the future. If this is the case, converting to a Roth IRA and paying the taxes sooner rather than later may save you money while allowing you the potential of continued growth without the burden of taxes.

This strategy may also be effective for those who plan to leave at least some money in retirement accounts as part of their legacy plan, and believe that the income and estate tax on a Traditional IRA will be higher than the tax bill from a Roth IRA conversion. Paying the taxes now may mean more money for your beneficiaries and less for the tax man.

Keeping More for You and Your Heirs

Regardless of the strategy behind your conversion, it's important to work closely with your financial advisor when it comes to deciding how much to convert.

As discussed above, the main factor to consider is your likely future income tax rate. Based on this, many advisors will calculate an amount designed to trigger a tax rate equal to or less than this future rate.

A second factor is time. As discussed earlier, because you never have to withdraw the money from a Roth IRA, the more money you convert, and the earlier you convert it, the greater the potential impact of time and compounding (earnings generated from earnings). This may mean more retirement savings available for you and/or additional wealth for your beneficiary.

In fact, depending on the age of your beneficiaries when they inherit, the amount you and your advisor choose to convert may have the opportunity to grow substantially before your beneficiary's RMDs begin—RMDs which are tax free, remember.

Considering Roth IRA conversion?

If you're considering converting retirement assets from a Traditional IRA or an employer-sponsored retirement plan, such as a 401(k), you and your advisor should consider the following questions.

- Do you expect tax rates to increase over time?
- Do you expect to be in a higher tax bracket when you retire?
- How will you cover the taxes incurred by a conversion?
- Will you need your IRA assets to cover annual living expenses in retirement?
- Is leaving a legacy part of your financial goals?
- Have your retirement savings suffered losses due to market conditions?
- Do you think you may need to withdraw any of your contributions before age 59½?
- Would you like to continue contributing to an IRA after age 70½?

Legislative Changes Expand Conversion Opportunities

During your discussions with your financial advisor, be sure to ask about the Pension Protection Act of 2006 (PPA) and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). These laws have greatly increased the number of investors eligible to take advantage of Roth IRA conversions.

PPA Allows Roth IRA Conversions from Employer Plans

Before the PPA, transferring assets from an employer-sponsored qualified retirement plan, such as a 401(k), was an involved process that could potentially lead to errors and delays. Investors were required to first roll the assets into a Traditional IRA and then convert that account into a Roth IRA. Now, you can simply roll eligible distributions directly into a Roth IRA, making it much easier and faster to access a Roth IRA's benefits. Of course, you will still owe taxes on the conversion.

The law permits such direct conversions for original account owners, as well as beneficiaries, including non-spouse beneficiaries. However, plans are not required to provide this option to non-spouse beneficiaries, who may still need to follow the two-step process described above. Consult your employer for details on your plan.

TIPRA Removes Income Ceiling on Conversions

For 2008 and 2009, those with a modified adjusted gross income (MAGI) greater than $100,000 and are either single filers, heads of household and those married and filing jointly, as well as married couples filing separate returns, remain ineligible for Roth IRA conversions. However, beginning in 2010, TIPRA removes these limits for conversion; income limits for Roth IRA contributions will still apply.

TIPRA also contains a provision that can relieve tax liabilities on IRA conversions executed in the year 2010. Presently, assets converted to a Roth IRA from a Traditional IRA are subject to federal income tax in the year of conversion. The new rule will allow investors who convert in 2010 to pay these taxes over the following two years. Keep in mind that this provision applies only to conversions made in 2010. Any tax incurred by conversions made after 2010 will be due in the year of the conversion.

Make the Most of TIPRA

If your MAGI is over $100,000, you may want to consider making non-deductible contributions to a Traditional IRA between now and 2010, and converting that account to a Roth IRA once the rule takes effect January 1, 2010. You will only have to pay taxes on earnings, as the contributions were made using after-tax money, and the tax burden will be split over two years.

However, if you own other Traditional IRAs funded with deductible contributions, your transaction will be subject to a special pro rata rule, which requires that IRA contributions represent a proportionate share of both previously untaxed contributions, and contributions on which the investor has already paid taxes. When converting a Traditional IRA to a Roth IRA, this rule is used to determine the portion of the converted funds subject to federal income tax.

NEXT STEPS

Contact your financial advisor to discuss your complete retirement savings and income strategy, including legacy planning.

- Consider whether a Roth IRA conversion makes sense
- Determine the optimum time and amount to convert

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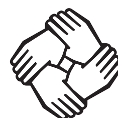

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