

Roth IRA – New Rules

New tax rules are about to give more people access to a Roth individual retirement account, one of the most effective vehicles in which to accumulate money for retirement or heirs.

In the past, Roth IRAs were off limits to the people that could most benefit from them. Starting January 1, 2010 income limitations were lifted for transferring money from a traditional IRA to a Roth. The conversion will allow tax free growth for anyone willing to pay the income tax due upon such a transfer.

Under the new rules, high-income taxpayers are still locked out of contributing to a Roth IRA. Income limitations on funding these accounts will remain in effect. However, the government's decision to allow high earners to convert will give these individuals an opportunity to take advantage of a loop hole in funding the Roth on a continual basis.

The strategy... each year, these taxpayers can open a traditional IRA (which has no income limits) and contribute the maximum (currently, \$6,000 for individuals age 50 and older) on a pretax or after-tax basis. Then, they can convert the assets to a Roth IRA.

Why bother with a conversion? Roths have several advantages over traditional IRAs.

The biggest advantage concerns taxes. Withdrawals from Roth IRAs are tax-free as long as an account holder meets the rules for minimum holding periods. In order to make penalty-free withdrawals on your converted amounts you have to hold those assets in a Roth for five years, or until you turn age 59½, whichever comes first. Each conversion has its own five year clock.

No required distributions is another benefit. With a traditional IRA, at age 70 ½ individuals must begin taking distributions

from their accounts and paying pay taxes on those withdrawals. Roth accounts aren't subject to mandatory distributions, so the money in a Roth can grow tax-free for more years.

If you are planning to leave your IRA to heirs, Roths have yet another advantage. Although people who inherit both traditional and Roth IRAs must make annual withdrawals from those accounts (based on their life expectancies), Roth beneficiaries owe no income tax on the money.

Tax Bill Upfront

There is a cost to converting to a Roth... the income-tax bill. When you withdraw money from your traditional IRA, you will have to pay income tax on the withdrawal, or, more precisely, on the portion of it that represents pretax contributions and earnings.

In 2010, Uncle Sam is offering a special deal: to taxpayers who convert. They can choose to report the amount they convert on their 2010 tax returns, or they can spread it equally across their 2011 and 2012 returns. (If you are worried that Congress may raise tax rates, consider paying the tax bill in 2010.)

To determine whether it makes financial sense for you to convert, it's important to consider various factors. For example, converting may be the right move if you expect to pay higher taxes in the future (due to a higher tax rate) or if the value of your IRA account has dropped. In either case, by converting to a Roth today you'll lock in a lower tax bill than you would otherwise pay.

To estimate your potential tax bill, first calculate your cost basis. Expressed as a percentage, this is the ratio of two numbers: after-tax contributions you have made to your IRAs (if any), and the total

balance in all your IRAs.

For example, if you contributed \$40,000 after-tax to your IRAs and have a total of \$250,000 in those accounts, your basis would be 16% (or \$40,000 divided by \$250,000). As a result, if you plan to convert \$100,000 to a Roth, 16% of that \$100,000 (or \$16,000) could be transferred tax-free.

Before conversion, give your tax professional and us a call to see how the Roth IRA fits into your investment and estate plan. We will do the analysis to see if paying the tax now makes sense for you.

Maximize the Benefit

If you determine that it makes sense to convert, the following strategies can help you maximize the benefit:

The key to the conversion is having the money to pay the taxes due from a source other than your IRA. That allows you to retain a bigger sum in your tax-sheltered retirement plan.

Keep in mind that you don't have to convert your entire IRA. The amount to be converted could also depend on how much money you need from your IRA for income in retirement.

Put converted holdings into a new account, rather than an existing Roth. That way, if the value falls after you've paid the tax bill, you can change your mind and recharacterize the account (meaning you move the money back into a traditional IRA) and wipe out your income-tax liability.

You have until Oct. 15 of the year following the year of conversion to recharacterize the account. For example, if you were to convert your IRA to a Roth in 2010, you would have until Oct. 15, 2011 to recharacterize it. Later on, you could choose to convert the assets to a Roth again.