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Roth IRA Strategies For 2010+

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The year 2010 has seemed like a long way off for a long time, but it is now (almost) here, which means that some great financial strategies that have been just theory up until now can finally be implemented. One of the big changes for 2010 is that the earnings limit for converting a Traditional IRA to a Roth IRA will be eliminated. Unfortunately, that doesn't mean much if you don't have a good understanding of Roth IRAs, so this paper will boil down the key advantages of Roth IRAs and describe some possible strategies for using them. If you don't qualify for contributing to a Roth IRA or you don't have a Traditional IRA that can be converted, you can still utilize many of the Roth IRA strategies if your employer offers a Roth 401(k).

Tax-Deferred vs. Tax-Free

Traditional IRAs (and 401Ks) are tax-deferred, meaning that contributions are not taxed but any money withdrawn in the future will be taxed as ordinary income. The tax has simply been delayed. Contributions to a Roth IRA (or Roth 401K) are taxed, so no financial benefit is seen when money goes in, but that is the end of taxes. All qualified withdrawals, no matter how large the account grows, are tax-free. A more accurate description is that the tax on tax-deferred accounts is backend-loaded (withdrawals are taxed), and the tax on what I'm labeling as tax-free accounts is frontend-loaded (contributions are taxed).

The big question is, "Which is better?" The argument for a tax-deferred account is that you can theoretically contribute more because of the immediate tax break, and therefore your money "grows faster". However, this doesn't help if you are able to contribute the maximum amount. The argument for a tax-free account is already part of the description. "Tax-free" just sounds better than "tax-deferred". The truth, as with almost all financial questions, is "it depends".

When is Tax-Free better than Tax-Deferred?

The choice between a Roth IRA (tax-free) and a Traditional IRA (tax-deferred) is really a bet on future tax rates. If taxes are higher in the future than what you're paying now, then you win the bet with a Roth IRA. If taxes are exactly the same, it really doesn't matter. Here's proof:

	Traditional IRA	**Roth IRA**
Contribution	$5000	$5000
Tax on Contribution (25%)	$0	($1250)
Net Contribution	$5000	$3750
Value after 10 years (10%/year)	$12968.71	$9726.53
Tax on Withdrawal (25%)	($3242.18)	$0
After-tax Value	$9726.53	$9726.53

The trick is guessing what your future tax rate will be. It's a safe bet that tax rates will be going up from where they are now. On the other hand, your income requirements MAY be lower in retirement, but don't forget costs due to travel, medical bills, long-term care, etc. There may be some years when your expenses are lower, and others when they are higher.

Roth Strategy #1: Saving More For Retirement

For 2009 and 2010, the maximum contribution allowed for a Traditional or Roth IRA is $5000 ($6000 if over the aged of 50), but this amount is reduced if you earn more than $166,000 and file a joint tax return, and is gone completely if you earn more than $176,000. For a Traditional or Roth 401K, the contribution limit is $16,500, or $22,000 if you are over age 50. Although the limits are the same, a dollar in a Roth account is worth more than a dollar in a tax-deferred account because the taxes have already been paid for the Roth dollars. If you are contributing the maximum amount to your IRA or 401K and would like to save more, contributing to a Roth allows you to prepay the taxes, effectively allowing you to save more for retirement. The "return" on this additional savings will depend on both the investment return as well as any difference between your current tax rate and future tax rate, so both should be considered.

Roth Strategy #2: Income Tax Diversification

If you have many years to go until retirement, or even if you plan to have many years before retirement is "done", there is really no way to determine what tax rates will be in the future. Adding to the uncertainty of future tax rates is the uncertainty of what expenditures and resulting income will be required in the future. Will inflation pick up significantly, causing more income to be required? Will there be individual years with high expenses due to a special vacation or medical expenses or long-term care needs? A proven method to help protect against future uncertainty is to keep your options open, and this applies to taxable and non-taxable income as well. You don't want extra income required in a particular year to drive you into a higher tax bracket and compound the problem, so a "bucket" of tax-free money to pay for lumpy expenses could end up smoothing out the tax obligation in future years. The best way to fund this tax-free bucket is with a Roth IRA.

Roth Strategy #3: Education Funding

One of the best savings vehicles around for education is a 529 account. A 529 account allows you to save and invest for future education expenses, with all qualified withdrawals being tax-free. The only drawback is that withdrawals must be used for educational expenses. A Roth IRA can be used in a similar way, but if all the money is not needed for education, the money can continue to be saved for retirement.

Here's how it works. IRA funds that are used for college education expenses are exempt from early withdrawal penalties. Since there is no tax deduction for contributions to a Roth IRA, the taxes have already been paid. When it's time to withdraw funds for college, the contributions come out tax-free and the growth is taxed as normal income. Any money not needed for education simply stays in the Roth IRA. Retirement plans are sheltered from consideration when applying for financial aid.

Tax Implications of Roth IRA Conversions

A conversion from a Traditional IRA (or 401K) to a Roth IRA can be viewed as withdrawing funds from the Traditional IRA and opening a new Roth IRA. Normally, if money is withdrawn from an IRA before the age of 59½ the IRS would charge a 10% penalty. However, if the money is withdrawn due to a conversion the penalty is waived, although taxes still need to be paid. The amount being converted is considered to be normal income, so there is a potential this could drive you into a higher tax bracket.

Special Rules For 2010

If the conversion is done in 2010, you can elect to pay the taxes in 2010, or split the tax 50/50 between 2011 and 2012. Splitting the taxes will obviously avoid having a single tax burden come due at one time, and may help you stay below a particular tax bracket, but it could also result in higher taxes. The IRS views the split as doing one half of the conversion in each year. This means that if taxes are raised in 2012, one half of the conversion will be taxed at the higher rate. If the conversion does not push you into a higher tax bracket or cause deductions to be phased out, it's probably better to pay the taxes earlier. For conversions done after 2010, all of the taxes must be paid in the year of the conversion.

Changing Your Mind

If you convert a $100,000 IRA in January of 2010, and by April 15, 2011 the Roth IRA is only worth $80,000, there would likely be some "buyer's remorse", since taxes would be owed on the full $100,000 distribution. However, a Roth IRA conversion can be re-characterized back to a Traditional IRA before April 15 and the IRS will forget the whole thing happened. In fact, by filing a tax extension, you can wait until Oct 15 of the following year to determine whether the Roth IRA conversion was a good deal or not, so there is potentially a 20-month period to change your mind on a Roth IRA conversion. This enables the strategy of creating two (or more) Roth IRAs with the intention of keeping only the best-performing IRA.

Conclusion

Taxes are going up in the future, perhaps significantly. Given that fact, and the uncertainty of future income requirements, a Roth IRA conversion or beginning new contributions to a Roth IRA or Roth 401(k) may be a good idea for many investors. If you are thinking of this, please schedule an appointment to discuss your specific situation.