PLANNING FOR YOUR FUTURE

To Roth or not to Roth? That is the question.

By Bernard A. Krooks, Certified Elder Law Attorney

Recent changes in the tax laws affecting Roth IRAs now make this retirement savings plan available to individuals who previously could not participate due to income limitations. Here are some factors to consider in determining whether to convert your existing traditional IRA to a Roth IRA.

What are the benefits of a traditional IRA? A traditional IRA allows you to contribute pre-tax dollars to your account. You pay taxes (on the original contribution, plus any increase in value) when you take distributions from the retirement account. The idea is, you will presumably be in a lower tax bracket when you are retired, and taking distributions, than you are as an employed person paying in to the account. A downside to the traditional IRA is that after you reach age 70½, you must take a minimum distribution from the IRA each year. The amount of the distribution is calculated annually and is based on the value of your retirement account and your life expectancy. If you are taking mandatory distributions each year, that will reduce the amount remaining in the account to pass along to your heirs when you die. Special rules apply to spouses who inherit IRAs from another spouse.

Why would I want to create a Roth IRA, when I already have a traditional IRA? A Roth IRA is funded with after-tax dollars. This means that as the account increases in value over the years, it increases tax-free. Unlike the traditional IRA, there are no mandatory distribution requirements for the account owner – meaning that more money remains in the account to pass along to your heirs. Although distributions will be mandatory for your heirs, the distributions are tax-free. If you have other sources of income, and you plan to use your retirement account mostly as a vehicle of passing money along to your heirs, rather than to fund your own retirement, a Roth IRA may be preferable to a traditional IRA.

Why are you telling me about a Roth IRA now? Until recently, a Roth IRA conversion has only been available to taxpayers whose annual income is less than $100,000. Effective January 1, 2010, taxpayers whose income exceeds $100,000 can convert their traditional IRAs to Roth IRAs. This means having to pay the tax on the account with the conversion. However, there is a special rule for 2010 conversions that allow you to spread out the taxable income over two years commencing in 2011.

Why might converting from a traditional IRA to a Roth IRA be a good option?

• If you believe that the income tax rate will only increase in the future, you might decide that it makes sense to pay the tax now, rather than pay it at a higher rate years down the road.

• If you have sufficient wealth that you don't think you will drop into a lower tax bracket upon retirement – or if you plan to leave your retirement account to your kids and they will be in a higher tax bracket – it might make sense to pay the tax now.

• If your traditional IRA has suffered a big decline in value over the last couple of years (and whose hasn't?), you may find it more appealing to convert it to a Roth IRA and pay the tax now, in the hope that the account will increase in value (tax-free) over the coming decades.

You are making a bet, though, that Congress won't change the rules at some point in the future. Additionally, you will need to have money available in order to pay the tax on the conversion – preferably, money coming from a source other than your traditional IRA.

What factors should I consider in making the decision? Here are a few:

• The availability of funds to pay the taxes now;
• Your willingness to pay taxes now, rather than later;
• Whether you are already taking distributions from your IRA;
• When you plan to retire; and
• Whether you intend to live off your retirement account or pass it to heirs.

There are a whole set of complex rules pertaining to the Roth IRA conversion, including penalties for withdrawing funds from a Roth IRA within the first five years of establishing an account. Therefore, we encourage you to carefully review all of your options with your trusted advisors, to see if converting your traditional IRA to a Roth IRA is right for you.

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