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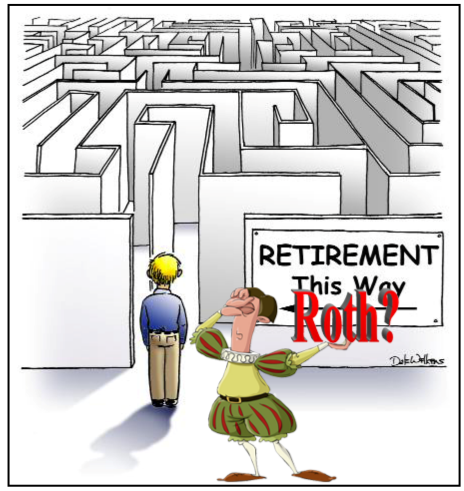
To Roth or not to Roth? It depends

Navigating the Retirement Maze



"Whether 'tis nobler in the mind to suffer
The slings and arrows of outrageous taxes,
Or to take action against a high future tax bracket
And by choosing a Roth diminish it…"

OK, I'm obviously no Bard, but I want to highlight a situation about which many pre-retirees seem to be unaware. Namely, that a Roth IRA can be a smart way to accumulate and grow wealth so that, once retired, one can bypass the tax bill that typically accompanies retirement fund withdrawals. I'll describe what it is, how it differs from the traditional IRA, and when it makes the most sense to use one.

Roth 101

The Roth IRA was established by the Taxpayer Relief Act of 1997. Like a traditional IRA, a Roth IRA can be funded up to $5,500 per person per year – $6,500 for those over age 50 – for couples with a combined modified adjusted gross income (MAGI) of $181,000 or less, and individuals up to $114,000. In 2010, the Tax Increase Prevention and Reconciliation Act (TIPRA) created another alternative for contributing to a Roth, which I'll discuss below.

The main difference between the two IRAs is analogous to that commercial where the mechanic says: "You can pay me now, or you can pay me later." With a traditional IRA, you deduct your current year's contribution from your taxable income, thus reducing your tax bill. Your day of reckoning comes when you eventually withdraw funds and pay taxes at your then federal and state rates. With a Roth IRA, you don't get a tax deduction in the year that you contribute to it, but it grows tax-free and there is no tax when you withdraw funds.

When to Roth

Because of this difference in tax collection dates, the main factor determining which type of IRA is more tax-efficient is your marginal tax rate the year you contribute compared to your rate when you eventually withdraw funds. If the two are the same, then both types of IRA yield identical after-tax results. However, if your rate the year you contribute is lower than during withdrawal, you will end up with more after-tax income if you use a Roth IRA. Conversely, if your marginal tax rate when you fund your IRA is higher than when you take money out, you'll come out ahead by using a conventional IRA.

The big unknown is what your tax rate will be when you start spending down your IRAs. If the tax reforms currently being proposed in Congress – reducing marginal tax rates while eliminating many deductions and tax credits – ever comes to fruition, then funding a Roth before that occurs could be unattractive. According to the Kiplinger Tax Letter, these reforms are currently stalled, and unlikely to happen prior to 2018, if at all.

Another approach is to compare your current income to what you estimate it would be during retirement. Most financial planning software can help you do this. A large disparity between the two can provide some guidance as to which type of IRA makes more tax sense.

To convert or not to convert…

In 2010, a provision in TIPRA allows traditional IRAs to be converted into Roth IRAs, paying taxes on the amount converted. This permits anyone to fund a Roth IRA, regardless of their income level.

The tax efficiency rules for Roth conversions are identical to those described above for Roth contributions, but with a few additional wrinkles. The amount you convert increases your income by that amount, which can have tax consequences: move you up into a higher tax bracket, trigger the 3.8 percent Medicare surtax, increase Medicare premiums, and phase out deductions and exemptions. One way to sidestep these issues is to do partial Roth conversions in successive years, converting only amounts that won't result in additional tax liabilities. Another tip: Don't pay the taxes due out of the conversion, or you'll reduce your IRA balance by that amount, plus pay a 10 percent penalty on the taxes if you're under 59 1/2.

The topic of Roth conversions has more aspects than I can cover in this column, including no RMDs and penalty-free early withdrawals. Your accountant or financial planner can help you determine the best IRA strategy for your situation.

The Roth that keeps on giving

Here's a Roth plan that I tell my clients is a no-brainer. If your children or grandchildren are in a zero or low tax income bracket and you would like to gift something to them, take this approach: 1) Have them put a substantial percentage of their earnings into a Roth account (up to the lesser of their earned income or $5,500); 2) Gift them that amount. They end up with the same amount of money, and have the beginnings of a retirement account that will be tax-free when eventually withdrawn. $5,500 compounded at 7 percent over forty years is $82,000. You may not be around when they reach retirement age, but it's something by which they'll remember you.

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