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Feature Story

Roll over?

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They say that opportunity favors the prepared, and that's particularly true this year for high-net-worth investors who have previously been locked out of the potential advantages of the Roth IRA.

The Roth IRA was named for the late Sen. William V. Roth, the Delaware Republican who created and championed an individual retirement account that allows people to invest taxable income that can be withdrawn tax-free in retirement. Though it has been around since passage of the Tax Reform Act of 1997, the Roth IRA remained unavailable to anyone with taxable annual income over \$100,000 - until this year.

Through a subsequent tax reform package enacted nearly five years ago, people with taxable incomes over \$100,000 can begin converting assets from traditional IRAs into Roth IRAs in 2010. The move could provide added flexibility upon retirement and a potentially advantageous way to pass along tax-free assets to future generations.

Here's what some investment advisers and tax experts in Greater Des Moines have to say about the changes.

Money managers say 2010 is a great year for high-income investors to consider rolling over assets from that faithful investing buddy, the individual retirement account (IRA), to a Roth IRA.

Previously, the Roth IRA was only available to those with annual household incomes of less than \$100,000. However, beginning Jan. 1, high-net-worth individuals can for the first time take advantage of a Roth IRA as part of their tax and estate planning, thanks to a tax change enacted several years ago by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

Converting assets from a traditional IRA to a Roth is the only way that people with adjusted gross incomes of more than \$100,000 can get into a Roth, as income limitations still prohibit those folks from opening a Roth account directly. The Roth IRA was created by Congress with the passage of the Tax Relief Act of 1997.

Many people could potentially benefit from the new opportunity to convert at least a portion of their investments from a traditional IRA to a Roth IRA, said Jim Sandager, senior vice president and financial advisor with Wealth Enhancement Group in West Des Moines.

"We're bringing it up in every meeting with our clients," Sandager said. "Even if they were able to convert previously, there has been so much media attention to it, it's going to be on their mind."

Certified public accountants are also advising their clients to consider moving into a Roth if they weren't able to before.

"It's a perfect opportunity to take a look at their individual situation right now and see if this is the right time to do this," said Chris Collins, a senior manager with LWB Financial. Particularly this year, some people may have losses they can use to offset the additional taxes that would be owed from a conversion, she noted.

"We're looking at each client's situation," she said. "It's not a black-and-white answer."

Added flexibility

From a planning standpoint, a Roth could provide added flexibility in how a person is able to withdraw their funds upon retirement, said Tim Hawkins, president of The Masters Group Inc., a fee-only adviser group in Ankeny.

"I think it's a no-brainer for a lot of people to shift at least a portion of their assets from the fully taxable accounts to the tax-free accounts," he said.

Traditional IRAs are funded with pre-tax earnings and are taxable when the money is withdrawn, whereas Roth IRAs are funded with after-tax earnings and can be withdrawn tax-free during retirement, after age 59 ½ or after five years have passed since opening the account, whichever is later.

Unlike the rules governing a traditional IRA, which require investors to begin making withdrawals by 70 ½ or face penalties, the Roth has no deadline for beginning withdrawals. "That certainly helps people manage forced distributions," Hawkins said. "And any distributions are free of taxes, so that's going to allow some flexibility from a planning standpoint to position income."

Additionally, for those planning on passing a portion of their assets to their children or grandchildren, having tax-free assets available through a Roth is an attractive option, he said.

One of the biggest drawbacks to converting to a Roth IRA is that investors must pay taxes on the conversion out of their savings, and funds from the traditional IRA can't be used to pay the taxes, as that would be penalized as an early withdrawal. However, those who convert in 2010 can elect to defer the tax payments until 2011 and 2012, though these will be based on their income and tax brackets for those years, which could be higher.

Investors should consider their entire financial picture with their adviser when evaluating whether a Roth conversion makes sense for them, Sandager said. Generally, a conversion may be appropriate for investors who:

- have enough money outside of the IRA or employer plan to pay the taxes;
- expect to be in the same or higher tax bracket when they retire;
- have a significant time frame before they need the assets;
- have a significant proportion of tax-deferred assets, such as a 401(k) plan.

Strategic moves

Converting to a Roth may be particularly advantageous for people under 50, but don't rule it out if you're over 50, Sandager said. "It generally takes about 10 years for the conversion to offset the tax you're paying up front," he said. "If you start getting into your early 70s, it may not be worthwhile."

Another advantage is the ability to recharacterize, or reverse the conversion if an investment loses significant value. Investors have until Oct. 15 of the year following the conversion to recharacterize.

"Let's say you have \$150,000 in large cap (stocks), \$75,000 in small cap, \$75,000 in international and \$100,000 in real estate and \$100,000 in bonds. So if you convert the large cap fund and it goes from \$150,000 to \$200,000, you would keep that the same," Sandager said. "But if the small cap goes from \$75,000 to \$30,000, you could actually recharacterize it back. You could get your tax back, and then reconvert the \$30,000 (to a Roth)."

Another popular strategy has been to make nondeductible contributions to traditional IRAs to avoid taking a big tax hit upon converting to a Roth. Hawkins said a number of his clients and their spouses began doing that after TIPRA was announced, and "now they're positioned to make the conversion with very small tax consequences," he said. Additionally, many clients continue to make nondeductible contributions to traditional IRAs and plan to make additional conversions in the future.

"I think we'll definitely see a spike this year because of the flexibility built into the tax laws," Hawkins said. "I think we'll see more people do systematic conversions later as well. But most people are intrigued by doing it this year and not having any tax consequence until 2011 and 2012."