

## Making a Good Deal for Retirement Even Better

*New tax rules are about to give more people access to a Roth IRA, one of the best savings plans for later life. Here's how the changes work—and how to get ready.*

Robert Woods has been “chomping at the bit,” he says, to open a Roth individual retirement account. Next year, the 54-year-old American Airlines pilot finally will get the chance.

Starting Jan. 1, the income limits that have prevented many individuals, including Mr. Woods, from converting a traditional IRA or employer-sponsored retirement plan to a Roth will be eliminated. The change—one of the biggest and most important on the IRA landscape in years—will widen the entryway to one of the best deals in retirement planning. With a Roth IRA, virtually all income growth and withdrawals are tax-free.

The new rules come at a time when many IRAs have plummeted in value, meaning the taxes on such conversions (and you do pay taxes when you convert) will likely be lower, as well. And with taxes at all levels expected to rise in coming years, the idea of an account that's safe from tax increases appeals to many people heading into retirement.

“It's potentially quite a big deal,” says Joel Dickson, a principal with Vanguard Group in Valley Forge, Pa. “We're getting a lot of questions, and investors certainly should be thinking about it.”

Here's a look at how the new rules work, how to take advantage of them—and the possible pitfalls.

### Nuts and Bolts

At the moment, many people make too much money to use Roths. Individuals whose modified adjusted gross income for 2009 is \$120,000 or more can't contribute. For couples who file joint tax returns, the cutoff is \$176,000.

You aren't allowed to convert traditional IRA assets to a Roth if your household's modified adjusted gross income exceeds \$100,000. A married person who files a separate tax return is prohibited from



converting—no matter how much or how little he or she makes, says Ed Slott, an IRA consultant in Rockville Centre, N.Y.

But while the income limits for funding a Roth will remain, the rules for conversions are about to change.

As part of the Tax Increase Prevention and Reconciliation Act enacted in 2006, the federal government is eliminating permanently, starting Jan. 1, the \$100,000 income limit for Roth conversions, as well as the restriction on spouses who file separate tax returns. That should make it easier for people with higher incomes to invest through Roth accounts. The changes also should enable more retirees—who rolled over their holdings from 401(k)s and other workplace savings plans into IRAs—to convert to Roths.

Of course, there's still the matter of taxes. When you convert assets from a traditional IRA or workplace plan to a Roth, you have to pay income tax on all pretax contributions and earnings included in the amount you convert.

The law does provide some wiggle room, however: You can report the amount you convert in 2010 on your tax return for that year. Or, you can spread the amount converted equally across your 2011 and 2012 tax returns, paying any resulting tax in those years. For example, if you convert \$50,000 next year and choose not to declare the conversion on your 2010 return, you must declare \$25,000 on your tax return for 2011 and \$25,000 on your return for 2012. The two-year option is a one-time offer for 2010 conversions.

The fact that Uncle Sam is allowing you to stretch out your tax bill could help people who convert keep their nest eggs intact. Financial planners uniformly say it makes no sense to convert to a Roth unless you can pay the taxes from a source other than your IRA. If you need to tap your IRA for the tax money, you're defeating, in part, the purpose of the conversion: to maximize the long-term value of the Roth.

One other note: If you are age 70½ or older and taking required minimum distributions from a traditional IRA or workplace plan, you can't convert that required withdrawal to a Roth. However, after you take your required minimum distribution for the year, you can convert remaining traditional IRA assets to a Roth. For 2009, Congress has waived required withdrawals in an attempt to help retirees rebuild savings. But required withdrawals resume in 2010.

So, if you're over the income limits for contributing to a Roth, what's the simplest way to fund one when the conversion rules change? If you haven't already done so, open a traditional IRA (which has no income limits), contribute the maximum amount allowable (\$6,000 in 2009 for individuals age 50 and older), and convert the assets to a Roth next year.

John Blanchard, a 41-year-old executive recruiter in Des Moines, Iowa, has “maxed out” IRA contributions for himself and his wife since 2006 in anticipation of the 2010 rule change. He plans to convert about \$34,000 in holdings next year. “If they would let me do more, I would do more,” he says. “This planning is purely for retirement.”

You could continue this strategy each year after that—opening a traditional IRA and converting it to a Roth. In fact, you would have to use this approach if your income exceeds the limits for making Roth contributions.

But how do you do this—over a number of years—without winding up with multiple Roth accounts? Mr. Slott recommends holding two Roths. When you first convert the assets, put them in your “new” Roth. That way, if that holding suffers a loss in the first year, you can recharacterize it as a traditional IRA so you don’t have to pay tax on value that no longer exists. (More on that below.) If the account increases in value before that deadline expires, you could then transfer the assets to your “old” Roth—after the time to recharacterize expires. Each year, you could repeat those two steps.

### Why It’s a Good Idea...

Why convert? Roth IRAs have several big advantages over traditional IRAs:

- For the most part, withdrawals are tax-free, as long as you meet rules for minimum holding periods. Specifically, you have to hold a Roth IRA for five years and be at least age 59½ for withdrawals to be tax-free. Early withdrawals are subject to penalties.
- There are no required distributions. With traditional IRAs, you must begin tapping your account after reaching age 70½. In doing so, you increase your taxable income starting in your 70s.
- Your heirs don’t owe income tax on withdrawals. That can be a big deal for middle-aged beneficiaries earning big paychecks. One caveat: Roth beneficiaries do have to take distributions across their life expectancies, and Roth assets are still included in an estate’s value.

The fact that anyone who inherits a Roth could make withdrawals with no income tax has led some older adults to consider Roth conversions as an alternative to life insurance. Jonathan Mazur, a financial planner in Dallas, already has suggested that strategy to Shayne Keller, a 55-year-old semi-retired telecommunications consultant. Mr. Keller’s heart disease has made it tough for him to get life insurance. Instead, he’s now planning to convert a traditional IRA worth about \$300,000 to a Roth, and then name his two grandchildren as the Roth’s beneficiaries.

Another big advantage: A Roth IRA provides what many financial planners refer to as tax diversification.

“In the future, when you’re going to be taking assets out of your account, you don’t know what your personal situation is going to be, and you don’t know what tax rates are going to be,” says Sean

Cunniff, a research director in the brokerage and wealth-management service at TowerGroupin Needham, Mass. “So, if you already have a taxable account, like a brokerage account or mutual funds, and you have a tax-deferred account like a 401(k) or traditional IRA, adding a tax-free account gives you the most flexibility” to keep taxes low in retirement.

### ...And Why It's Not as Easy as It Looks

The trickiest part of paying the tax for a Roth conversion involves the IRS's pro-rata rule. In short, you can't cherry-pick which assets you wish to convert.

Let's say you have a rollover IRA (from an employer's 401(k) plan) with a balance of \$200,000, and an IRA with \$50,000. The latter contains \$40,000 in nondeductible contributions made over a number of years. As much as you might wish, you can't convert the \$40,000 alone—tax-free—to a Roth IRA.

Rather, you have to follow the pro-rata rule. The IRS says you must first add the balance in all your IRAs—in this case, \$250,000. Then you divide nondeductible contributions by that balance: \$40,000 divided by \$250,000. This gives you the percentage—16%, in our example—of any conversion that's tax-free. So, let's say you want to convert \$30,000 of your two IRAs to a Roth. The amount of the conversion that would be tax-free would be \$4,800 ( $\$30,000 \times 0.16$ ).

ENTER YOUR INFORMATION		Rate of Return:
		5%
PHASE ONE: How the contributions would		
\$300,000	\$15,000	\$315,000
\$321,000	\$16,050	\$337,050

See an example of how the “2010” strategy might work for a person who, in 2008, had a traditional IRA with \$300,000 and began making nondeductible contributions. Then see how the strategy might work for you.

“If you're thinking about doing a Roth conversion, leave your 401(k) alone” rather than rolling it into an IRA beforehand to keep your share of nondeductible contributions higher in the calculation above, says John Carl, president of the Retirement Learning Center LLC in

New York, which works with investment advisers. And if you've already rolled over your 401(k) into a traditional IRA, you may want to roll it back—a move that many employer plans allow, he adds.

Perhaps the toughest part of all this is “gathering the data”—showing which of your past IRA contributions were deductible and nondeductible, says Kevin Heyman, a certified financial planner in Newport News, Va. “You have to keep one heck of a record to know which IRAs were nondeductible over the years.”

It's involved, but possible, to reconstruct your after-tax basis in a traditional IRA, and it makes sense to do it now so you can weigh whether to convert to a Roth in 2010, says Mr. Slott, the IRA consultant.

First stop: tax returns you still have. You're supposed to keep a running record of nondeductible IRA contributions on IRS Form 8606 and file it with your tax return. If you haven't done so, you can either buy back your old tax returns from the IRS, using Form 4506, or you can order a free transcript of everything that's reported about you to the IRS, using Form 4506-T. Included in your transcript is

information from IRS Form 5498, which reports contributions you made to an IRA. Other resources are year-end statements from your IRA custodian.

As mentioned above, you should be able to pay any tax involved from a source other than the IRA itself to make the conversion worthwhile. Some retirees already are setting up piggy banks for that purpose. “I’m putting my savings plan together so we have money to pay for the tax,” says Marjorie Hagen, 60, a retired postmaster in Minneapolis. She and her husband plan to convert at least \$150,000 in IRA assets next year to give them “more control and flexibility,” she says.

An IRA withdrawal made simply to pay taxes on a Roth conversion could be a particularly bad move for battered investments because you’d be locking in losses. And if you’re under age 59½, you would get dinged with a 10% penalty for withdrawing IRA assets at the time of the conversion. The silver lining, of course, is that those battered investments probably would be taxed at relatively low value, meaning any tax you have to pay should be relatively low, as well.

Indeed, tax rates—what you’re paying now and what you might pay in the future—invariably complicate decisions about whether to convert. Linda Duessel, a market strategist at [Federated Investors Inc.](#), an investment-management firm in Pittsburgh, points out that the income tax you pay on a Roth conversion while you’re working would be at your top rate, since it’s added to your regular income. But in retirement, when IRA distributions presumably would help take the place of a paycheck, you’d be paying tax at your “effective” rate, or the total tax you pay divided by your taxable income.

If you expect your income to be lower in retirement—and tax rates to stay about where they are—then a Roth conversion might not make sense. The upshot: Whether you convert or not basically depends on what you expect to happen with your income in retirement, compared with your income while working, and whether you’re more comfortable paying taxes sooner at current rates or betting on lower taxes later.

## Strategies to Consider

What’s the best way to take advantage of the rule change? First, keep in mind that you don’t have to convert your entire IRA next year. You can do it piecemeal, as you can afford it, over a number of years. A Roth conversion “isn’t an all-or-nothing option,” says TowerGroup’s Mr. Cunniff. If you hold traditional IRAs made up largely of pretax contributions, such as a 401(k) rollover, your tax bill could be steep. One way to mitigate the tax-bill pain is to get your accountant to help you figure out how much you could convert within your current tax bracket each year without bumping yourself into a higher one.

It’s also a good idea to put converted holdings in a new account, rather than an existing Roth. Here’s why: If the value of your converted assets falls further—after you have paid taxes on their value—you can change your mind, “recharacterize” the account as a traditional IRA, and, in turn, no longer owe the tax. Later on, you could reconvert the assets to a Roth again. (See IRS Publication 590 for the timing details.) This dilutes the tax benefit if you’ve combined those converted assets with other Roth holdings that have appreciated in value.

In fact, you might consider opening a separate Roth for each type of investment you make with the converted money. That way, you could “cherry-pick the losers,” recharacterizing investments that perform poorly, suggests Mr. Slott. Let’s say you made two types of investments—one that doubled in value and another that lost everything. If those investments were in the same Roth, the account value would appear unchanged. But if they were in separate accounts, you could recharacterize the one that suffered—and allow the one doing well to continue appreciating in value as a Roth.

Some owners of IRAs that hold variable annuities with depressed account values are planning to convert those investments to Roth IRAs as well. The current value of the underlying investments in their variable annuities has fallen below their income benefit or death benefit. In that situation, if you convert to a Roth, you’d pay tax on the lower account value—and potentially get a higher benefit in the future tax-free.

Still, if you have a variable annuity and you’re considering a Roth conversion, make sure you value the account according to the latest IRS rules, Mr. Slott cautions. The IRS cracked down on annuity holders using “artificially deflated” variable-annuity values in Roth conversions a few years ago to lower their taxes, he says. “The IRS ruled that you have to get the actual fair-market value of the account from the insurance company and use that number.”

## What You Should Do Now

There are a few ways to get ready for next year. Again, as noted above, if you have money to invest, consider funding an IRA before Dec. 31. That way, you can convert those assets to a Roth as soon as Jan. 2.

Also locate and organize your paperwork for any nondeductible IRA contributions you’ve made in the past. By taking that step, you should be able to come up with an estimate of how much of your potential conversion would be taxable. If you expect your 2010 income to be similar to this year’s, you can look up the tax brackets at [www.irs.gov](http://www.irs.gov) to get a ballpark idea of the taxes involved.

## Next comes the tough part: Identifying ways to pay those taxes with money outside of your IRA.

To think through all the moving parts, it may help to consult a financial planner or accountant who has extensive experience working with retirees relying on IRAs. The tax rules governing IRAs are intricate, nonintuitive, and arcane. One misstep can unwind a tax-deferred nest egg in a way you might not have intended.

For example, if you’re already taking regular, so-called 72(t) retirement payments, which allow IRA holders to make “substantially equal” withdrawals penalty-free before age 59½, converting that IRA to a Roth is even trickier, Mr. Slott says. The new Roth can contain no other Roth IRA assets, and the 72(t) payments must be continued from the Roth—but no 72(t) payments from the traditional IRA can be converted to the Roth. And if you have company stock in your 401(k), you might wind up with a lower tax bill if you withdraw the stock from the account before doing an IRA rollover and Roth conversion, he adds.

Seek out online tools to help you devise your conversion strategy as well. One resource is Mr. Slott's Web site, [www.ira-help.com](http://www.ira-help.com), which has a discussion forum where consumers can post questions about Roth IRA conversions and get answers from investment advisers who specialize in IRA distribution work.

At least one free, interactive calculator has been developed to help people think through the decision. Convergent Retirement Plan Solutions LLC, a retirement-services consulting firm in Brainerd, Minn., released a Roth Conversion Optimizer calculator in May for investment advisers with Archimedes Systems Inc., a Waltham, Mass., maker of financial-planning software. A consumer version of the calculator is available at [www.RothRetirement.com](http://www.RothRetirement.com).

"For the vast majority of middle America, the question is, 'What's the best portion of my IRA to put into a Roth?'" says Ben Norquist, president of Convergent.

The calculator takes several factors into account, including your income needs from retirement assets, future tax rates and the portion of your assets you convert to a Roth. Then, it crunches those variables to show you, using a simple bar graph, the impact of a Roth conversion on your future assets.

One caveat: With any calculator that lets you adjust the future tax rate, as this one does, it's easy to manipulate the answer if you're predisposed to doing a conversion now—or avoiding it because you don't want to pay the resulting tax bill, Mr. Slott says.

Still, the calculator does help you pin down the answer to the big question you should answer for yourself this year, Mr. Norquist says: "If I can take a portion of my assets and shift them over to a Roth, am I going to sleep better knowing they can't be touched by future tax increases?" If your answer is "yes," it's time to start digging out records and number-crunching.

By Kelly Greene