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Tax-Free Investment Earnings for Life!?

Recently passed tax legislation allows wealthy individuals with Individual Retirement Accounts (IRAs) to convert their balances to Roth-IRAs starting in the 2010 tax year. It isn't often that a long-term tax savings technique, such as a Roth-IRA conversion, is available to taxpayers without some sort of income cap. Even though the legislation is not effective until 2010, there are some actions that you may be able to take now to maximize your tax benefits when Roth-IRA conversions are available.

First, some background on Roth-IRAs. Roth-IRAs are one of the best vehicles around to accumulate long-term wealth for you and your family. If you meet some fairly simple guidelines, ***the earnings from a Roth-IRA are not subject to income tax…*****ever!!** You read that correctly--under current tax law, earnings from a Roth-IRA may never be taxed during your lifetime. In fact, ***a Roth-IRA can be passed along to your spouse, who can continue to enjoy the same tax-free benefits; and, in many cases, a Roth-IRA can be passed along to your children, providing them with the same tax-free benefits.*** The tax-free accumulation feature of a Roth-IRA can make a big difference in the financial well-being of you and your family. For example, a $100,000 Roth-IRA investment earning 7.2% per year for 30 years would grow to more than $800,000. Under current tax law, this $800,000 could be withdrawn from the Roth-IRA income-tax free.

So why doesn't everyone have a Roth-IRA account?

Unfortunately, the laws regarding contributions to a Roth-IRA severely limit who is eligible. Additionally, the original law restricted the ability to convert traditional IRAs to Roth-IRAs to lower and middle income taxpayers. Fortunately, recent legislation will allow a greater number of taxpayers to utilize the power of a Roth-IRA. The *Tax Increase Prevention and Reconciliation Act of 2005* now allows individuals to execute Roth-IRA conversions regardless of their income level.

Who *can* contribute annually to a Roth-IRA?

Taxpayers with earned income and whose modified Adjusted Gross Income (AGI) does not exceed the following thresholds are eligible to make a full annual Roth-IRA contribution:

Single - $95,000
Married Filing Jointly - $150,000

Annual Roth-IRA contribution limits are as follows:

Tax Year(s)	Age 49 or younger	Age 50 and older
2006 and 2007	$4,000	$5,000
2008 and beyond	$5,000	$6,000

Allowable contributions are reduced by any regular IRA contributions that are made during the tax year. The contribution amount is also reduced as a taxpayer's Adjusted Gross Income (essentially the income on the bottom of page one of your Form 1040) exceeds the above thresholds.

Who can convert an existing IRA to a Roth-IRA?

Through tax year 2009, taxpayers with modified Adjusted Gross Income (AGI) less than $100,000 can convert some or all of their IRA balances to a Roth-IRA. On May 17, 2006, President Bush signed the *Tax Increase Prevention and Reconciliation Act of 2005* into law. Under the Act, **starting in 2010, the existing $100,000 income test for converting a traditional IRA to a Roth IRA will no longer apply.** Another benefit included in the new legislation allows taxpayers who convert an IRA to a Roth-IRA in 2010 to defer the related income inclusion and recognize the income ratably over the next two years, 2011 and 2012.

How does a Roth-IRA conversion work?

The following is a step-by-step approach to a Roth-IRA conversion:

1. Taxpayer establishes a Roth-IRA at a financial institution.

2. Taxpayer transfers some or all of their traditional IRA assets to the Roth-IRA. For purposes of this example, let’s assume $100,000 is transferred.

3. If the taxpayer’s combined federal and state tax rate is 40%, the taxpayer will owe $40,000 of income tax on the transaction ($100,000 of converted IRA times 40%). If the conversion is made in 2010, the income can be included in the taxpayer’s 2010 taxable income, or half of the income could be recognized in 2011 and half of the income could be recognized in 2012.

4. Over the next 30 years, a $100,000 Roth-IRA invested at a 7.2% annual rate of return would grow to a value of more than $800,000. Future distributions would not be subject to income tax. With proper planning, the Roth-IRA can be passed on to the owner’s spouse and eventually to the owner’s children, thereby extending the tax-exempt benefits.

What are some of the risks of converting an IRA to a Roth-IRA?

- Even though current tax law provides that Roth-IRA balances are not subject to income tax, there is a chance that tax laws could change and some or all of the Roth-IRA balance could be subject to income tax in the future.

- A taxpayer may be in a high income tax bracket in the year of conversion and in a much lower tax bracket when drawing down the Roth-IRA. In this case, it may not make sense to accelerate income in a high tax rate year when future regular IRA distributions are expected to be taxed at low rates.

- Converting an IRA to a Roth-IRA will require an upfront tax payment. Some taxpayers, especially those with tight budgets in retirement, may not be able to afford paying taxes now with the hope of saving taxes over the long-term.

- Taxpayers who have a short life expectancy may not benefit from the tax-free earnings within a Roth-IRA (too few years of deferral to make up for the large upfront tax payment).

- Congress may elect to reduce income tax rates in the future. This would make a Roth-IRA conversion less attractive; however, even if tax rates decrease, a Roth-IRA conversion may still make economic sense.

I am not eligible to make an annual Roth-IRA contribution and I won't be eligible to convert my IRA to a Roth-IRA until the $100,000 or less income requirement is lifted in 2010! What can I do now?

- If you have a qualified retirement account with a former employer, you might consider rolling this plan into an IRA so that you can convert the IRA into a Roth-IRA in 2010. If you rollover your qualified plan balance from your former employer's plan into your current employer's qualified retirement plan, you won't be able to convert this money to a Roth-IRA. Current law only allows you to convert an IRA to a Roth-IRA. A qualified plan (such as a 401(k)) account cannot be converted to a Roth-IRA.

- If you are self-employed, consider setting up and contributing to a SEP-IRA. In 2010, you can consider transferring the balance in your SEP-IRA to a Roth-IRA.

- If you have earned income, you may want to consider making annual deductible (if eligible) or non-deductible IRA contributions in years 2006-2010 and converting your IRA balance to a Roth-IRA in 2010. Upon conversion in 2010, you would owe income tax on the earnings inside the non-deductible IRA, and on the total conversion amount for the deductible IRA. If you make non-deductible contributions to an IRA, for tax and record-keeping purposes, we recommend that you set up a separate IRA to hold current and future non-deductible IRA money. For some taxpayers, it may not be worth the hassle of setting up and contributing relatively small amounts ($4,000-$6,000 per taxpayer per year) to an IRA with the hopes of converting the balance to a Roth-IRA in 2010.

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2006 and 2007	$4,000	$5,000
2008 and beyond	$5,000	$6,000

  We recommend consulting a tax advisor before making IRA contributions, as the eligibility rules are complex and you will want to have a full understanding of any changes that you make to your investment plan.

How can I determine if a Roth-IRA conversion may be appropriate for me?

Again, we recommend that you consult your tax advisor before moving forward with a Roth-IRA contribution or conversion. Your tax advisor can assist you with the multi-year tax and cash flow considerations relating to a Roth-IRA conversion.

What is a Roth 401(k) Plan?

A Roth 401(k) Plan is similar to a Roth-IRA and might be offered by your employer. We recommend that you consult with your employee benefits department to determine whether your employer has added a Roth 401(k) feature to your company's retirement plan.