Taking Advantage of the Roth IRA

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For many years the cardinal rule of retirement investing was to put every penny you can into IRAs, 401(k)s and other tax-deferred accounts. This advice rested on a commonsense assumption that after you stopped working you would move to a lower tax bracket. This was important because all the money withdrawn from these tax-deferred accounts is subject to ordinary income taxes. But with the Bush tax cuts expiring and new taxes on the horizon, that assumption about lower tax brackets no longer seems like such a sure thing. The spending binge of our current administration and the resulting 9 Trillion dollar deficit over the next ten years will certainly result in higher taxes… so it's time for retirement savers to adjust their strategies and protect themselves from tax changes that could take a significant bite our of their retirement accounts.

When the Bush tax-cuts expire in 2011, the maximum capital gains rates will increase from 15% to 20%; the special tax break for dividends will end (*they will once again be taxed as ordinary income*) and income tax rates will revert back to the higher pre-2001 levels. These changes are automatic and represent the minimum increases we'll see. Considering our current situation, tax rates could certainly go even higher, especially for those with incomes exceeding $200,000. Not knowing how bad it might get has a paralyzing effect on retirement-minded savers – it makes it difficult, if not impossible to plan.

All this uncertainty makes the Roth IRA even more attractive than before. As you probably know, the Roth IRA allows you to make deposits just like traditional IRAs. Unlike traditional IRAs however, you don't get a tax deduction when you put the money into Roth IRA… but the money grows *forever* on a tax-free basis. One analogy I've used for years is the seedtime and harvest story. Traditional IRAs are like getting a tax break when you buy the seed… but *paying full taxes on the entire crop* at harvest time. When you choose a Roth IRA instead, you effectively 'waive' the upfront tax break on the seed… and enjoy the *entire harvest on a tax-free basis*. With tax-free withdrawals, it doesn't matter what the tax rates might be at that point down the road.

Another benefit the government provided was the ability to convert a portion or all of your traditional IRAs into a tax-free Roth and many Americans have been doing this… converting their retirement accounts from 'taxable upon withdrawal' to tax-free. In almost every situation, tax-free is better than tax-deferred, and for some, the benefits provided by making the conversion are clearly obvious. But there are pitfalls to be aware of and converting doesn't always make sense in each and every situation.

One of the hang-ups of a Roth was that they were not available to higher income earners… those with incomes exceeding $105,000 for individuals and $160,000 for joint taxpayers were not allowed to participate… and for the time-being these limits will remain for ongoing annual deposits to Roth accounts. But starting in 2010, <u>*anyone*</u> will be able to convert existing retirement accounts to Roth accounts making this key retirement strategy available to everyone for the first time.

Other than tax-free withdrawals in retirement, the Roth offers several other benefits:

Withdrawals   A major plus to a Roth IRA is that you are not forced by the IRS to start taking mandatory withdrawals at age 70½, which can provide years of tax-free growth far beyond your traditional IRA.

Estate Benefits   You can also pass your Roth IRA to your children and grandchildren, where the account will continue to grow on a tax-free basis. Leaving a Roth to a 10-year-old grandchild would grow a $50,000 IRA into 5 Million over the next 60 years. *Now, that's a legacy!*

Flexibility You have a lot of flexibility when it comes to withdrawing from a Roth. Qualified Distributions are those that occur after a five-year "seasoning" period and meet one of the following conditions: **1)** you are 59½ or older **2)** there is a death or disability **3)** or for a first-time home purchase (*subject to a lifetime limit of $10,000*).

If your distributions don't meet these guidelines, you can still pull money out, but it is considered a "non-qualified" distribution. With a Roth IRA, non-qualified distributions come from principal first and then from earnings. This means you'll receive your after-tax contributions back first (*which are non-taxable*) followed by your earnings… and the earnings would only be taxable if they too are withdrawn during the 'non-qualified' period.

As I said earlier, despite all the benefits, converting to a Roth will make incredible sense for some people… and be a wrong move for others.   If the tax-free benefits of a Roth IRA interest you and you'd like to learn more, please call or drop me a quick email and we'll schedule some time to get together to talk about it. I'll have the coffee on.

Make it a great month,

Lee

Through his workshops, publications, and consultations, Lee Tibstra teaches how to maximize what you do with your money while minimizing mistakes… resulting in more safety, more growth, more income, and best of all… more peace of mind and happiness. With over 30 years experience, Lee is a REGISTERED FINANCIAL CONSULTANT (RFC®) and an approved member in good standing of the NATIONAL ETHICS BUREAU. Lee can be reached directly by calling 708-254-0300 or by email at TheSmartMoney@me.com and you can always visit us online at www.Smart Money Planners.com.