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The Roth Retirement Account

IRA and 401(k)…No Time Like the Present

The first quarter represents an excellent time to review your financial plans, enact any needed changes, and make sure you are participating in the appropriate employee benefits provided at work. Many human resources managers are conducting educational sessions to help employees learn about their benefits and any modifications that transpired from last year's plans. Additionally, the emergence of another tax season brings one last chance to set aside dollars (either pre- or after-tax) into a individual retirement account for 2007 and take advantage of whatever "generous" opportunities Uncle Sam allows.

This Year Brings a Few New Considerations…

Oil prices have surged over the past year and many professionals in the energy field have reaped financial windfalls that can help in retirement (though plenty of others are moaning about rising gasoline prices). This particular presidential election year has prompted renewed fears that the IRS code will be modified and tax rates may be higher in the future than they are today. More than in prior years, financial planning discussions at work and at home are including considerations of a Roth account, both IRA and 401(k).

Here Comes the Roth…

When the Roth IRA was introduced in 1998, many individuals (and their financial advisors) envisioned participating in this new type of retirement account. They were attracted to the tax-free distributions to be received during retirement (among other benefits). However, a closer look inside the fine print gave many a second thought. After all, the contributions were not tax-deductible like in the traditional IRA and many higher wage earners were unable to participate due to the income limitations.

The introduction of the Roth 401(k) a few years later helped overcome the income limit as employees were able to contribute after-tax dollars regardless of their levels of compensation. Additionally, the degree of allowable participation was far greater than under the IRA ($15,500 vs. $4,000 in 2007) and more and more employers added the Roth 401(k) to their benefits packages. However, many employees still opted for the traditional work benefit, preferring to receive the advantaged tax treatment today (tax deduction vs. tax-free distribution) since their brackets would most likely decline in retirement.

So What's Different Now?

These days, however, many individuals actually believe they may be earning more in retirement than during their current working years:

- Young people just starting out in the working world are confident that their earnings power will increase 30, 40, 50 years from now and their tax brackets may be higher in retirement.
- Older (rather, mature) folks who still enjoy working expect to receive a healthy pension in retirement, and then take on a consulting gig or two to earn additional income that jumps them into higher tax brackets.
- Some baby-boomers will be reaping the benefits of nice inheritances as they reach retirement and anticipate more substantial income streams for the future.

- Finally, a new Administration and Congress could revoke prior tax cuts, the result of which may mean higher tax rates in the years to come.

For these reasons and others, the Roth is generating additional interest and appeal.

A Crucial (but Limited) Conversion Feature…

Under the Tax Increase Prevention and Reconciliation Act of 2005, taxpayers will be allowed to convert from traditional to Roth IRAs in 2010 regardless of their levels of income. Further, any taxes owed at conversion will not be due immediately, but instead can be paid in two equal installments in 2011 and 2012.

Currently, anyone earning more than $100,000 is unable to make such a conversion so most high net worth investors have been left out of the Roth IRA equation altogether. This provision allows those individuals who already possess traditional IRAs (or choose to contribute to one today) to reap the unique benefits of the Roth in a few years. Additionally, some employees have old 401(k)s that have been (or will be) rolled over into IRAs to give them greater investment and administrative flexibility. In particular, those individuals who expect to be in a higher tax bracket in retirement should be taking advantage of this Roth conversion opportunity.

But That's Not All…

Roth IRAs enjoy several benefits over their traditional counterparts for certain taxpayers. The earnings on the after-tax contributions grow (and are distributed) income tax-free. Some consider them a very sophisticated estate planning tool as Roth accounts are creditor-proof and pass outside of the probate process. While traditional IRAs are subject to required minimum distributions (RMD) at age 70.5, Roth owners are not forced to take any distributions during their lifetimes and, therefore, can pass along a more substantial sum to their heirs.

Over the next few years (including tax year 2007), certain individuals should consider making contributions to a traditional IRA and converting those dollars to a Roth in 2010. Even if they are above the income limits and/or participate in an employee sponsored retirement account, these individuals can contribute to the traditional IRA on an after-tax basis and then reap the benefits of the Roth at conversion. Similarly, those who plan to rollover an old 401(k) into a traditional IRA may find this to be an opportune time as they will then be able to convert to a Roth in 2010 if so desired. Bear in mind, the higher wage earners cannot contribute to the Roth IRA at all today so this limited opportunity allows them a brief window to initiate such an account in 2010 and enjoy the benefits in retirement.

So is the Roth right for you? Would a conversion from traditional to Roth IRA make sense during that brief allowable window? Financial planning and tax issues can be quite complex so consult your advisor for the proper guidance. After all, there is no time like the present.