



Easing The Tax Bite On Your IRA

Converting it now to a Roth IRA lets you take advantage of today's low rates.

Few people look for reasons to pay taxes early. But if you have a traditional individual retirement account and you're a retiree, young career person, or wage earner who meets certain income requirements, you might want to withdraw the money now, cough up the income tax, then place the funds in a Roth IRA. It's a bet that today's low federal tax rates will be higher in the next few years.

The tax cuts enacted by Congress at President Bush's behest have made the rates on most income brackets as low as they've ever been. At the same time, those cuts have caused revenue shortfalls, which combined with spending on the Iraq war and new Medicare drug benefits, have created a record deficit of \$477 billion. "The deficit reveals that we have been living beyond our means, and it has to be paid back somehow," says New York financial planner Lewis Alfest. "Economic growth alone will not cover it." All of that means tax rates are sure to rise, at which point it will cost you more to convert to a Roth.

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To recap, with a traditional IRA, you don't pay taxes on the money you invest or on its earnings. Taxes are due on withdrawals, which can start as early as 59 1/2 or as late as 70 1/2. With a Roth IRA, you contribute aftertax dollars, but future withdrawals come out tax-free. "I like to use the farmer analogy," says Ed Slott, editor of *Ed Slott's IRA Advisor* newsletter. "With the Roth, you pay a tax on the seed, but the crop grows for free. With a traditional IRA, it's the other way around."

The conventional wisdom says Roth conversions make sense only for young investors who have time for their accounts to recoup the taxes they have to pay on the traditional account. But if you are an older investor and have a young heir, perhaps a grandchild, who stands to inherit the IRA, you might consider converting as well. Here's why: If a 10-year-old were to inherit your Roth IRA, the child would be allowed to accumulate tax-free gains for life. In that light, the conversion costs are inconsequential. The only proviso is that the heir must start taking tax-free distributions from the account immediately. But since the government calculates the required distribution based on life expectancy, the amount for a child would be quite small -- 1.4% of assets for a 10-year old.

SAME TIME NEXT YEAR?

The one major obstacle to a Roth conversion is that the account holder, whether single or married filing jointly, may earn no more than \$100,000 in modified adjusted gross income -- a form of AGI created just for the purpose of calculating eligibility for a Roth conversion -- in the

year of the switch. That may mean you won't qualify for 2004, but keep it in mind when you're doing tax planning for 2005 and beyond. You may be able to lower your income enough in a future year to take advantage of the move: making maximum contributions to 401(k)s, delaying yearend bonuses, realizing capital losses, or bunching up deductions.

The Internal Revenue Service does not consider IRA conversion money as part of modified adjusted gross income. So even if you have \$1 million in your IRA, converting it to a Roth wouldn't put you past the \$100,000 limit. What if you're a retiree receiving minimum distributions that put you past that limit? Currently, that would prevent you from making the conversion. But the rules are changing next year so distributions no longer count toward modified adjusted gross income. So just wait until 2005 to convert.

Still, some people will not benefit from moving to the Roth. Among them are retirees with no younger heirs or people who can't afford to pay the up-front taxes out of non-IRA funds. If you use your IRA money to foot the tax bill, it will reduce the amount you can roll into the Roth. Finally, if you're near age 70 1/2 and need the IRA distributions to live on, you shouldn't worry about leaving it to your heirs. *Otherwise, as far as conversions go, there's no time like the present.*

By Lewis Braham



OFG: What do you believe future tax rates will likely be? Lower? The Same? Or Higher? When asked this question the majority feel that taxes will likely be higher in the future. Why? Tradition. Inflation. The War on Terror. Our National Debt. These are all valid reasons why the government will likely increase taxes. So does it make sense to postpone paying taxes into the future when we feel they are likely to be higher? No.

This article clearly validates this point. However, Roth IRAs and Roth 401(k)s still have limitations and restrictions when allowing you to grow your retirement nest egg. Therefore what vehicles are available that gives us limitless Tax-Advantaged Contributions, Tax-Free Accumulation, Tax-Free Withdrawal, and Tax-Free Transfer? The answer to this question is meticulously answered in Chapter 17 of *Missed Fortune* and Chapter 9 of *Missed Fortune 101* by Douglas Andrew.