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New Ways to Shelter Your Retirement

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by Janet Morrissey
Thursday, August 20, 2009

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With a Roth IRA, you won't have to worry about changes in rates and brackets, and neither will your heirs.

For years a cardinal rule of retirement investing has been to put every penny you can into IRAs, 401(k)s, and other tax-deferred accounts. That advice rested on a commonsense assumption: that after you stopped working you'd move into a lower tax bracket. That was important because the money you take out of a tax-deferred account is subject to ordinary income taxes.

But with the Bush tax cuts expiring and new taxes on the horizon, that assumption about tax brackets no longer seems like such a sure thing. So it's time for retirement savers to adjust their strategies to reflect the new reality and to protect themselves against tax changes that could take a significant bite out of their retirement accounts.

Taxes have always been the wild card in retirement planning, but the outlook is wilder than ever. Consider: Income tax and capital gains rates are slated to rise in 2011 when the Bush tax cuts expire. In 2011 the maximum capital gains rate will rise to 20% from 15%; the special tax break for dividends will end, meaning they will once again be taxed as ordinary income; and income tax rates will revert to pre-2001 levels of 15%, 28%, 31%, 36%, and 39.6% — up from current rates of 10%, 15%, 25%, 28%, 33%, and 35%.

Those rates are the floor, not the ceiling, though. Taxes could surge even higher, especially for the wealthier segment of the population, as certain exemptions and itemized deductions will be phased out for those with incomes exceeding \$200,000.

At the same time, Congress is considering a surtax on couples earning at least \$350,000 to pay for health-care reform. If it goes through, the top rate of 39.6% would climb to about 45% — the highest income tax rate the nation has seen since 1986, when the top levy was 50%.

And that would probably not be the end. There's still the question of how the federal government will begin to cover the trillions in debt it is running up as it spends money to combat the worst economic downturn since the Great Depression.

The uncertain tax outlook can be paralyzing. "The whole idea of not knowing how much money you really have saved because you don't know how much you're going to have to pay in taxes makes it impossible to plan," says Keith Maliniak, a 60-year-old physician in Harrisburg, Pa.

But even if you don't know how high your rates will be, there are steps you can take to insulate your retirement stake from the vagaries of the tax code. Luckily, you have a weapon in the war on taxes: the Roth IRA.

With a Roth, you don't get a tax deduction when you put money in, but the money in your account grows tax-free and — this is the key advantage — your withdrawals are tax-free, so you don't need to worry about what the tax rates will be or what bracket you'll be in when you retire.

Until now Roths have had a big catch: income limits of \$105,000 for individuals and \$160,000 for joint filers. But starting in 2010 anyone will be allowed to convert existing retirement accounts to Roth accounts, making this key retirement tool available to everyone. (Of course you'll have a big tax bill when you make the switch — more on that later.)

In addition to allowing tax-free withdrawals in retirement, Roth IRAs offer several other advantages over tax-deferred accounts: You don't have to make mandatory withdrawals from the account when you reach 70½ years of age as traditional IRAs require; second, you can pass the account on to your children and grandchildren, where the assets will continue to grow tax-free; third, you can withdraw contributions anytime without penalty following the initial five-year "seasoning" period; and fourth, you can withdraw up to \$10,000 tax-free to purchase a principal residence.

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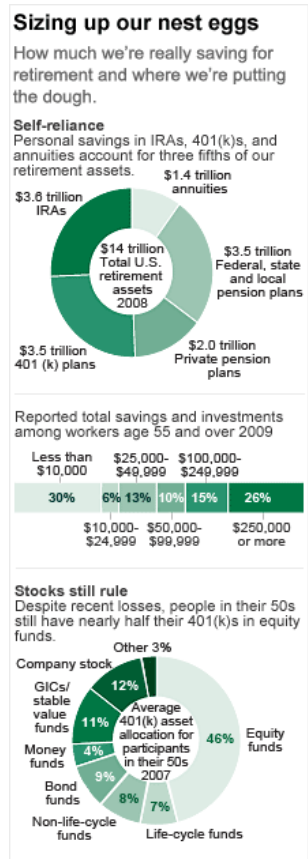
"I think in almost any circumstance, tax-free is better than tax-deferred," says Gregg Fisher, president and chief investment officer at Gerstein Fisher, a financial advisory firm. If you left a Roth to a grandchild, for example, the account could continue to appreciate tax-free for 60 or more years.

Many financial advisers are now recommending that clients put at least 30% — and possibly as much as 80%, depending on age and income — of their retirement assets into Roth IRAs so that a bigger chunk of their assets escape taxation. This strategy is significantly different from five years ago when advisers favored tax-deferred IRA accounts and recommended only 10% to 15% be channeled into Roths, says Joseph Leonard, a financial planner and author of *The Retirement Vault*.

If your income is below the IRS limits, you can contribute up to \$5,000 a year to a Roth (\$6,000 if you are over 50). Some companies have begun to offer Roth 401(k)s, which have no income limits. But for the most part, high earners have to settle for converting existing IRAs and paying the tax bill. As part of the deal, if you convert in 2010 you can stretch the tax payments out over three years, easing the pain.

The questions of whether — and how much — to convert are complicated and there's no one-size-fits-all answer. When you convert, the money in the IRA is added to your taxable income. This could bump you up into a higher tax bracket: "If you earn \$120,000 a year and want to convert \$200,000 of IRA money, that will throw you from the 28% tax bracket to the 36% bracket for that particular year," says Leonard.

That said, advisers suggest that the combination of the stock market slump and the likelihood of future tax increases makes today an ideal moment to convert traditional IRAs to Roths. "First, we're at historic low income tax rates," says James Lange, a CPA and lawyer and the author of *Retire Secure*. "Second, if you believe stocks go up over time, and that we're at a low point, this is probably one of the best times in history to convert."



In general, conversion may make most sense for younger people who are in lower tax brackets and have smaller IRA balances. That's because their tax hit will be lighter and they'll have a long time for the assets to grow tax-free before they need to make withdrawals.

If you're in the top two tax brackets and within 10 years of retirement, it might be wise to convert only a small portion of your IRA to Roths, if any. "If you're five or six years from retirement, you may want to wait to convert because you may be in a lower tax bracket five years from now," says Leonard.

But there are situations in which even high earners and older people may want to convert. Lange offers this example. "Let's say you used to have income of \$150,000, and you got laid off and you're only going to have income of \$60,000 this year," he says. "You're hoping to get a job and be back where you were next year. Then you should make the conversion this year because you'll be in a much lower tax bracket."

For some folks, the appeal of leaving tax-free accounts to heirs may be reason enough to move to a Roth. That's what persuaded Carroll Harris, a 68-year-old Southport, N.C., resident, to begin converting his traditional IRAs in 2008; he plans to do more conversions in 2009, 2010, and 2011 to spread out his tax payments. "I'd rather bite the bullet and pay the tax now," says Harris, who worked for 30 years in the international transportation business. "It's going to be a tremendous asset for my children and their children down the road because it will sit there and build for 30 or 40 years for them tax-free!"

One thing the experts agree on: Don't convert unless you can pay your taxes out of other cash — using assets from your IRA to pay the taxes is a losing proposition. "If you're paying the tax from

the account itself, you're lengthening the break-even period because you have a lesser amount of money in the account growing tax-free," says Fisher.

And if all the complications lead you to make a decision you later regret, you can cancel a Roth conversion up until April of the following year. "If your financial circumstances change — you lose your job — and you no longer feel comfortable paying a large tax bill because of the conversion," says Fisher, "there's an opportunity to go back and undo the deal." You can't beat a tax break that comes with an escape clause.

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