The Grapes of Roth

Making Your Roth IRA Bear Fruit
By Cal Brown, CFP

Congress did a good deed by creating the Roth IRA, which was inaugurated January 1, 1998. Unlike a traditional IRA, the contribution is not tax-deductible, but you do get tax-deferred growth. The best part is this: when you start withdrawing the money in retirement, IT ALL COMES OUT TAX-FREE!

Many people who have not been eligible for a deductible IRA have been contributing each year to a non-deductible IRA. Unfortunately, these people will have to pay taxes on the growth (not on their contributions) when they withdraw the money. The Roth IRA is different – you will never have to pay taxes on any of money that is in a Roth IRA!

The only problem with the Roth IRA is that you can only contribute $3,000 per year. Although, more recently the lawmakers added a “catch-up” amount of $500 as an allowable contribution for those age 50 and up.

In the first few years of existence, there was a large wave of conversions from traditional IRAs to Roths. Although they are not as prevalent now, it is still permissible to convert.

If you have an existing IRA, whether it is a traditional IRA or a non-deductible IRA (or both), you can convert it to a Roth IRA. If the conversion occurred in 1998, investors could spread the income over four years to avoid a big tax hit all in one year. Now if you convert the whole thing, you will have to pay all the taxes in that year. Nevertheless, it is still a good idea.

You may be asking yourself, “Why would I want to take all my money out of my IRA and pay taxes on it now?” Here’s a one-word answer: Compounding.

Would you rather pay taxes on the “seed” or the “harvest?” Ask any farmer and he will tell you that this is a “no-brainer.”

Let’s assume you are 45 years old with an IRA valued at $100,000. You have 20 years until retirement during which time your Roth IRA could grow to $672,750 if it returned 10 percent per year. You would never need to contribute another penny…and you could get all of it out TAX-FREE!

If you convert the $100,000 and continue to add $3,000 per year to it, in 20 years it would be worth $844,600 – all tax-free. That’s why you’d rather pay tax on the seed and not the harvest.

Here’s another reason to convert: your children. If you are married, upon your death your traditional IRA can be rolled over to your spouse tax-free. However, most people are unaware that their adult children who inherit IRAs are unable to roll it over tax-free. The kids must pay taxes on your entire IRA amount or use the “stretch IRA” technique when the remaining parent dies. But with a Roth IRA, the kids will get it tax-free.

Another reason to convert is this: you are required to withdraw from a traditional IRA the “Required Minimum Distribution’ when you reach age 70 ½. If you do not withdraw the proper amount, the IRS hits you with a 50 percent penalty (that’s not a typographical error – yes, it is 50 percent). But with a Roth IRA, you do not have to begin withdrawals at 70 ½.

There is a little bad news about the Roth – first, not everyone is eligible to contribute. If you are married and your Adjusted Gross Income (AGI) is over $150,000, or if you are single and your AGI exceeds $95,000, you cannot contribute to a Roth IRA. Second, if you want to convert your traditional IRA to a Roth IRA, you cannot if your AGI is greater than $100,000.

However, if you are eligible, you should consult with your financial advisor and determine whether or not you should contribute and/or convert. Clients who converted their IRAs in 1998 endured four years of the

tax pain, but now have an incredible amount of assets with tax-free status. These are dollars that will never be subject to income taxes for as long as they live. And upon their death, these amounts will go to their heir's income tax-free, and without any complicated life expectancy distribution computations. Of course, if the estate is large enough, it would be subject to estate taxes.