An Unexpected IRA Nest Egg

Legislation that reduces tax rates is great but as financial planners we are even more excited when legislation gets passed that helps our clients achieve a secure retirement. Last year, Congress passed the Pension Protection Act (PPA), a bill that accomplished both goals. There were a number of topics tackled in this important legislation but this summary will focus on the IRA provisions.

A Can't-Miss Opportunity

The new rules make it possible for everyone -- regardless of income -- to convert their IRAs into a Roth IRA beginning in 2010. While the Roth IRA conversion ability was enacted with the Tax Increase Prevention and Reconciliation Act of 2005, it is the PPA which expands this idea to the high wage earners for this one-year window in 2010.

That's a huge investment opportunity because money you eventually withdraw from Traditional IRAs is taxed at your income tax rate, while all Roth IRA withdrawals are 100-percent tax-free (if you've had the account at least five years and wait until you are 59-1/2 to make withdrawals). Of course if you already have a Roth IRA open you can convert your traditional IRA or rollover IRA into the existing Roth, consolidate accounts, and get credit toward the 5 year requirement on tax free withdrawals.

It gets even better – for those high earners electing to convert to the Roth IRA, they get to spread out the taxes paid on the conversion. As you already know, traditional and rollover IRAs are tax deferred. Roth IRAs are tax free if you meet the conditions in the previous paragraph. When you convert to the Roth, taxes would normally be due on the money as it comes out of the tax deferred IRA (at a minimum you would owe on the earnings from a non-deductible traditional IRA). With the PPA, the conversion income will be spread equally and recognized in income over 2011 and 2012. You get to pay taxes in 2012 for money you recognized in 2010 – up to a two year deferral of taxes!!! For anyone that has the time period to recoup the taxes paid, this is a terrific opportunity. Even if you don't have a lot of time to recoup the taxes, in 2010 it might make sense from an estate planning perspective to convert significant IRAs to have the income tax liabilities paid removed from their estates.

If you've previously shunned IRAs, the best move you can make between now and 2010 is to invest as much as possible in a Traditional IRA. Then, in just over three years, you'll have a nice sum you can convert to a Roth IRA.

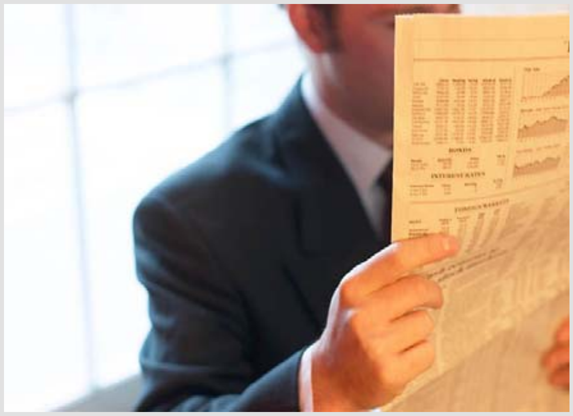
A Real-World Scenario

The best idea for high-income earners is to open a non-deductible IRA, because in 2010 you'll be able to convert the money into a Roth IRA. Yes, you'll owe taxes on any account gains that have accrued between now and your conversion, but once you get the money into a Roth you have a 100-percent tax-free account.

Let's say you're 35 years old and decide to open up your first Traditional IRA by investing $4,000 this year, and $5,000 from 2008 through 2010 (all the maximum limits). That's a total of $19,000. Let's assume that in 2010 the IRA's total value has risen to $25,000. That's $6,000 in gains over what you originally deposited. If you convert the Traditional non-deductible IRA into a Roth, at that point you'll only owe income tax on the $6,000 in gains your account accrued. And you get to pay half that tax bill in 2011 and 2012.

There are facts and circumstances for each individual (like other IRAs) that could complicate this scenario. You should speak with your financial advisor or tax professional if you have any questions about your own situation.

Here's what you need to know about IRAs:



- Everyone can contribute to a Traditional IRA, but not everyone can deduct their contribution.

    In 2007, the maximum annual IRA contribution will be $4,000 ($5,000 if you're at least 50 years old). If you aren't eligible for a retirement plan offered through your job, you're allowed to deduct your IRA contribution regardless of your income. Otherwise, the deduction is allowed only if you're single with income below $60,000 or married and file a joint tax return with an income below $85,000.

- The married limit rises to $100,000 in 2007. (If only one of you has a plan at work, the income limit for IRA deductibility is $160,000.) But here's what many higher-income folks overlook: If your income is above those cutoffs, you can still invest in a Traditional IRA and benefit from the tax-deferred growth of your account.

    The only catch is that you can't deduct the contributions that you make to your IRA. That's why this type of IRA is known as a non-deductible IRA. When you reach retirement age and make withdrawals from a non-deductible IRA, you'll owe income tax -- but only on the amount above the contributions that you originally put in.

    A non-deductible IRA is simply a Traditional IRA in which you don't get any upfront tax break on your contribution. Thus you don't have to pay taxes on those contributions when you withdraw them.

- Not everyone can contribute to a Roth IRA.

    The rules are different here: Only individuals with incomes below $110,000 and couples filing a joint tax return with an income below $160,000 can invest in a Roth IRA. If your income is above these thresholds, a Roth is out of bounds.

    Up to now, this has meant that high-income earners have been prohibited from investing in Roths.

- Currently, not everyone can convert a Traditional IRA to a Roth IRA.

    As of right now, you can convert a Traditional IRA to a Roth only if your adjusted gross income is below $100,000. That's the limit whether you're single or married. Of course as this article points out, this limit will be overlooked in 2010.

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Disclosure

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