

# September 2009 Issue

## In This Issue...

- [The Benefits of Roths](#)
- [Undoing a Roth Conversion](#)
- [Is Your 401\(k\) Plan Enough?](#)
- [Segregating Your Goals](#)
- [Back to the Drawing Board](#)



## The Benefits of Roths

The Roth individual retirement account (IRA) has been an attractive retirement savings option since its inception in 1998. However, income eligibility restrictions have prevented many higher-income individuals from using this savings vehicle. Two recent developments are changing that - the removal of income limitations for Roth IRA conversions and tax laws making the Roth 401(k) permanent.

### 2010 Roth Conversions

Starting in 2010, all taxpayers, regardless of the amount of their adjusted gross income (AGI), can convert from a traditional IRA to a Roth IRA. Before 2010, your AGI cannot exceed \$100,000 to convert, not including any income resulting from the conversion. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs) but are exempt from the 10% early withdrawal penalty.

If you make a conversion in 2010, the tax can be paid in two installments in 2011 and 2012, with no tax due in 2010. However, if you prefer, you can elect to pay the tax in 2010, which may make sense if the current lower tax rates are not extended beyond 2010 or you expect much higher income in 2011 or 2012. Taxes on conversions made after 2010 must be paid in the year of conversion.

### Permanent Roth 401(k)s

Originally, Roth 401(k)s were scheduled to expire in 2010, so many companies were not willing to start a plan that would expire after a few years. However, the Pension Protection Act of 2006 made Roth 401(k)s permanent, which should help spread their use.

The Roth 401(k) is patterned after the Roth IRA - contributions are made from after-tax earnings that grow tax free, and qualified distributions are withdrawn tax free. Employees eligible for their employer's 401(k) plan are also eligible for the Roth 401(k). There are no income limitations for contributions to a Roth 401(k), with contribution limits of \$16,500 in 2009 plus a \$5,500 catch-up contribution for those age 50 and over, if permitted by the plan. Contributions can be split between a regular and Roth 401(k), as long as total contributions do not exceed the maximum. Funds contributed to each type must be held in separate accounts. Any matching contributions made by the employer must be held in the regular 401(k) account, so they will be taxable when withdrawn.

Unlike a Roth IRA, annual distributions must be taken after age 70 1/2. However, funds in the Roth 401(k) can be rolled over to a Roth IRA, which would not require distributions during the owner's lifetime. There is no provision to convert a regular 401(k) to a Roth 401(k).

If you expect your income tax bracket to be similar or higher during retirement, a Roth 401(k) will typically result in more retirement funds than a regular 401(k).

### **Don't Forget about the Roth IRA**

One advantage of the change in the Roth conversion rules is that it effectively removes the income limitations for contributions to a Roth IRA starting in 2010. In 2009, single taxpayers with modified AGI less than \$105,000 and married taxpayers filing jointly with modified AGI less than \$166,000 can make contributions, regardless of their participation in a qualified retirement plan. Contributions are phased out for single taxpayers with modified AGI between \$105,000 and \$120,000 and for married taxpayers filing jointly with modified AGI between \$166,000 and \$176,000 in 2009.

Starting in 2010, individuals with income over the limit can make contributions to a nondeductible traditional IRA and then immediately convert the balance to a Roth IRA. For 2009, you can contribute to a nondeductible IRA and convert the balance in 2010. In 2009, you can contribute a maximum of \$5,000 with an additional \$1,000 catch-up contribution if you are age 50 or older.

Since there are no required minimum distributions during your lifetime, the Roth IRA is a particularly effective way to transfer assets to family members. You can allow the Roth IRA to continue compounding on a tax-free basis during your life, with no withdrawals. If you leave the Roth IRA to your spouse after your death, he/she can roll the balance over to his/her own IRA, so no withdrawals would be required during his/her lifetime. When your spouse dies, his/her beneficiaries would then have to take distributions over their life expectancies, but qualified distributions would be taken free of federal income taxes. By using this strategy and only taking minimum distributions when required, the balance can continue to grow on a tax-free basis for years or even decades.

[Back to topics.](#)



## Undoing a Roth Conversion

When converting a traditional individual retirement account (IRA) to a Roth IRA, transferred amounts must be included in income if taxable when withdrawn (i.e., contributions and earnings in traditional IRAs and earnings in nondeductible IRAs), but are exempt from the 10% federal income tax penalty. In 2009, your adjusted gross income (AGI) cannot exceed \$100,000 in the conversion year, excluding any converted amounts. Starting in 2010, you can have any amount of AGI and still convert to a Roth IRA.

To use this strategy effectively, you need to decide when to convert. Recent stock market declines have lowered the cost of converting, since taxes are paid based on your investments' value on the conversion date. However, if those values decline after you convert, you end up paying taxes on more than the current market value.

If you're in that situation, consider recharacterizing your conversion. For conversions made in 2009, you can recharacterize until October 15, 2010, meaning you can convert back to your original traditional IRA. Just make sure not to take possession of the funds. The transfer from the Roth IRA to the traditional IRA should be a trustee-to-trustee transfer. After the recharacterization, it is as if you did not convert, so you owe no taxes. If you already filed your 2009 tax return and paid the taxes, you can file an amended return to get a refund. You can then reconvert at a later date. The reconversion can be completed at the later of 30 days after the recharacterization or the beginning of the tax year following the first conversion.

You can recharacterize just a portion of the conversion. However, if you have several investments in the IRA, you can't simply choose the ones with the largest losses. In that situation, a pro-rata portion of all the investments in the account will be considered in the recharacterization. You can bypass this rule by setting up separate Roth IRAs for each investment. Then, if one declines substantially, you can recharacterize that one Roth IRA account, leaving the other accounts intact.

There are other situations where you might want to recharacterize. You might have converted to a Roth IRA, thinking your income in 2009 would be less than \$100,000. If you later find out your income is over that threshold, you can recharacterize the conversion to avoid taxes and penalties. You can also recharacterize annual IRA contributions. Perhaps you contributed to a traditional

IRA, but find your income is over the threshold. You could recharacterize to a Roth or nondeductible IRA contribution.

[Back to topics.](#)



## Is Your 401(k) Plan Enough?

If you work at a company that offers a 401(k) plan, especially if the plan offers matching contributions, that 401(k) plan may be the most important part of your retirement investment plan. But should it be the only part?

In 2009, the maximum annual 401(k) contribution is \$16,500, not including employer matching contributions. If you are at least 50 years old, you can contribute an additional \$5,500 in 2009, if permitted by the plan. Your plan may impose lower limits to ensure that it complies with nondiscrimination rules.

Yet, if you're over 40 and haven't started saving for retirement, even these large annual contributions may not be enough to reach your retirement goals. Or, if you have been saving regularly, recent stock market declines may have drastically reduced your savings. Here are five questions to help you decide whether your 401(k) plan is the only plan you'll need for retirement:

- **What kind of lifestyle do you want to fund in retirement?** You'll find general rules of thumb indicating you need anywhere from 70% to over 100% of your preretirement income during retirement. How much you'll need depends on your individual circumstances. If, for example, your mortgage will be paid off and you plan to stay home and watch your grandchildren during retirement, 70% of your preretirement income may be sufficient. If, on the other hand, you plan to travel extensively, 100% may be a better number.
- **How much can you count on from Social Security?** Social Security benefits were never designed as the sole source of retirement income, but they still are a valuable source of income. Those with lower incomes will find that Social Security replaces a higher percentage of their preretirement income than those with higher incomes. For 2009, the maximum Social Security retirement benefit for a worker retiring at full retirement age is \$2,323 per month, with the average benefit totaling \$1,153.
- **How much does your employer contribute to your 401(k) plan?** The \$16,500 maximum contribution to your 401(k) plan does not include

employer contributions. Employer-matching contributions vary by plan, but a typical match is 50 cents for every dollar contributed, up to a maximum of 6% of your pay. However, due to these tough economic times, many employers are reducing or eliminating matching contributions. If your employer offers a match, make sure you take full advantage of it. A generous matching contribution can contribute substantially toward your retirement.

- **What are your average returns on your 401(k) investments?** You can only invest in investments offered by your 401(k) plan. But within those parameters, select investments that match the long-term nature of your investments and that will help grow your retirement funds over time. This is especially important now that stock market declines have substantially reduced most 401(k) balances.
- **What other sources of income can you count on in retirement?** If you already have other retirement assets, you might not need to count as heavily on your 401(k) plan. Other potential sources of retirement income might include a defined-benefit pension plan, individual retirement accounts (IRAs), an inheritance, or other investments.

[Back to topics.](#)



## Segregating Your Goals

Your willingness to assume risk with your investments is not necessarily a static concept. You may be less willing to take risk with investments designated for an essential financial goal, while you may be more willing to take risk for nonessential goals. However, those varying risk levels may be difficult to assess if all of your investments are commingled in one account.

For instance, assume you have three goals - to ensure you have enough funds to support yourself through retirement, to send your children to an Ivy-league college, and to purchase a vacation home. The most crucial goal is to ensure you don't run out of money during retirement. Thus, you want a high level of assurance that you'll reach that goal, devoting a substantial portion of your resources to the pursuit of it. Your investments for that goal are likely to be somewhat conservative, especially as you approach retirement age.

The next important goal is sending your children to Ivy-league colleges. You have more limited resources to devote to that goal, plus your children can still attend a less-expensive college or pay part of the costs themselves. For that goal, you may be willing to assume more risk with your investments to increase the likelihood of reaching that goal.

Your goal for a vacation home is clearly last, so you may have few resources to devote to it. For that goal, you may be willing to use very aggressive investments, since that may be the only way you can achieve that goal.

The point is that your willingness to assume risk is not static. It will vary depending on how important each goal is to you and how much you can designate to that goal. Commingling all of your investments for all goals in one account may make it difficult to analyze your investments in this manner. Thus, you might want to set up separate accounts for each goal, so you can more closely match the investments to your willingness to assume risk for that goal.

[Back to topics.](#)



## Back to the Drawing Board

When's the last time you looked at your retirement plans? Don't let the recent market declines cause you to just give up and ignore your plans. Sure, you'll probably need to make some changes. So go back to the basics and reconstruct those plans, following these key steps:

**1. Determine how much income you'll need for retirement.** First, decide how you'll spend your retirement years. Do you want to travel extensively or are you content to stay at home pursuing inexpensive hobbies? Will you remain in your current home or move to a different city? Do you want to retire totally or will you work part-time? Depending on your plans, you may need anywhere from 70% to over 100% of your current income. If retirement is so far away that you're not sure what you want to do, use a range of retirement income assumptions, such as 70% at the low end, 90% in the middle range, and 110% at the high end.

**2. Decide when you want to retire.** Although many people want to retire early, supporting yourself for those additional years can make that difficult to achieve. You may want to work longer to save the amounts needed or consider part-time employment after retirement.

**3. Estimate your current retirement benefits.** Assess how much you're likely to receive from Social Security and company pension plans. Over the years, these benefits have been providing a smaller percentage of retirement income, so use conservative estimates.

**4. Total your current retirement savings.** Prepare a net worth statement to help you determine how much you currently have saved for retirement. Also consider other financial needs that must be met, such as paying for a child's

college education or providing nursing home care for an elderly parent. These needs can seriously reduce assets left for retirement.

**5. Develop your retirement savings plan.** Based on the above factors and your estimate of long-term inflation, you can make a reasonable estimate of your total capital needs at retirement. You can then calculate how much you need to save on a monthly, quarterly, or annual basis.

Don't give up if you can't afford to save the amount needed. You can start out saving what you can and increase your savings in subsequent years. You can also revise your retirement plans. Reducing your financial needs, delaying your retirement date, or working part-time after retirement can substantially change the amount needed for retirement.

**6. Review your retirement plan annually.** This allows you to assess your progress and make any needed changes.