Karen Telleen-Lawton: Invest Now for a Sustainable Retirement

This may be the year to consider switching traditional IRAs to Roth IRAs

By Karen Telleen-Lawton, Noozhawk Columnist | Published on 01.25.2010

You know that the only sure things in life are death and taxes. So why are we so unsure about IRAs, which ultimately concern both? Perhaps it's because we can't keep up with the changes.

Nevertheless, 2010 might be a great year to check them out. This year, there's a one-year opportunity to spread over the next two tax years the back income tax that results from switching traditional IRA accounts to Roth IRAs. The decision begins by asking first how to invest this year's retirement funds, and then whether to switch existing accounts.

You can determine your eligibility for a Roth or traditional IRA by checking government sites or investment sites for age, income and other limits. Assuming you qualify, you can then examine the choice between a traditional or Roth IRA.

The traditional IRA is deductible: You invest before-tax dollars and are taxed when you withdraw funds. The Roth IRA is nondeductible: You invest after-tax dollars that accumulate tax-free and are withdrawn tax-free during your retirement years.

Because you pay tax upfront on Roth IRAs, they are appropriate for people who believe their relative tax rate now is low. This may include temporarily unemployed, young or lower-income people, or anyone who believes that their tax rate will be greater in retirement because of high retirement income or higher tax rates. Another group for whom the Roth is advantageous are those who intend to bequeath funds rather than spend them. A traditional IRA requires withdrawing the funds beginning at age 70½. The Roth can be willed income tax-free.

If none of these apply to you, the traditional IRA might be your best bet.

Should you switch your existing traditional IRA funds to Roth ones? Usually, if you make such a switch, you need to pay back taxes this year on those funds that were contributed tax-free but now will accumulate in a post-tax vehicle. The tax hit is often enough to discourage a saver from converting. Again, income limits affect this decision, but if you're eligible, 2010 presents a unique opportunity to defer the tax consequence until 2011 and 2012.

There are two scenarios where it would be better to keep your existing traditional IRAs. One is, if you would have to liquidate some of your IRA money to pay the back taxes, you should leave them alone. In some instances — such as you're not yet 59½ — you may have to pay a 10 percent penalty on that withdrawal.

Secondly, if you plan to bequeath your IRA funds to charity, it's better to leave the traditional IRA funds where they are. From a traditional IRA, they will pass to your charity recipients never having been taxed. Your Roth IRA funds, by contrast, were charged income tax on the way in.

One last caveat: Tax laws always change, so the better decision now may not be the better decision later. But given that change can't be predicted, it's better to make the best decision you can for the current situation.

Above all, invest now for a sustainable retirement.

— Karen Telleen-Lawton's column is a mélange of observations supporting sustainability. Graze her writing and excerpts from Canyon Voices: The Nature of Rattlesnake Canyon *at www.CanyonVoices.com.*