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Stern Advice: It's time to rock your Roth

By Linda Stern

(Reuters) - Tax year 2010 lives, at least for another month, and that means people who made Roth IRA decisions last year can revisit them until Oct. 17. Savers who converted retirement money to a Roth IRA last year may find a little time travel -- and reversal of those decisions -- worthwhile.

That's just one of several significant savings opportunities presented by Roth IRAs. Because of tax law changes and stock market gyrations. it's worth diving into the sometimes-tedious rules and regulations that govern that whole area.

As a refresher, Roth individual retirement accounts allow your savings to accumulate tax-free for decades. You don't get a tax deduction for the money you contribute to a Roth, but if you wait until you are 59 1/2 to withdraw money, you never have to pay taxes on the income that compounds within the account. That can be really significant.

For example, if you put the maximum allowable $5,000 a year into a Roth IRA every year for 30 years, you'll have contributed a total of $150,000 in after-tax money. But, even at a conservative (by historical standards) long-term rate of return of 7 percent, you'll have accumulated $505,365 in money to withdraw tax-free.

You can convert money from an existing tax-deferred individual retirement account into a Roth by paying income taxes on the amount you convert. And though there are income limitations on who can contribute to a Roth, there are currently no limitations on who can convert. That's what creates many of the current opportunities. Here's a review of strategies that make sense.

-- Convert now. The optimal time to convert from a traditional to a Roth IRA is when your investments are undervalued and you're in a low tax bracket. And with the S&P 500 stock index down nearly 5 percent this year, your investments may be beaten down. "This is a very good time to convert," says Jean Dorrell, a financial adviser with Senior Financial Security in Summerfield, Florida. "The market is dropping; you're probably under water in some of your investments, and you can take advantage of that by converting."

To keep their tax rate low, Dorrell tells clients to convert just a portion of their IRA money every year, instead of converting large amounts all at once. That should keep the conversion tax burden manageable.

-- Create a 2010 do-over. If you converted last year, you may find that the amount now in your Roth is less than what you put there. So you're paying taxes on "income" that has disappeared. You have until Oct. 17 (the final due date for extended 2010 income tax returns) to "recharacterize" that conversion, effectively canceling it and the resulting tax bill.

If you've already filed your 2010 tax return, you'll have to file an amended return. Definitely worth doing, says Ed Slott, an IRA expert and publisher of Ed Slott's IRA Advisor newsletter.

He even suggests that people who converted last year and saw their Roth account remain relatively stable may want to recharacterize, to defer the tax day of reckoning.

You're not allowed to convert the same money twice in the same year, but if you're reversing a conversion from last year, you only have to wait 30 days to reconvert it. So if your Roth is beaten down, you can reverse it now, and then convert back to a Roth later this year. That could buy you time to pay the taxes and, more importantly, a lower tax bill. Put another way, if you converted $50,000 last year, and it's only worth $40,000 now, you can unconvert, wait 30 days, and then reconvert $40,000 now. It will save you from having to pay income taxes on the $10,000 that was lost.

-- Give one away. Roths really shine when they are owned by young people in low tax brackets. The income taxes on the amount they are contributing isn't very high. They can later tap some of that money for buying their first home, paying for college or more, without having to pay penalties. (They may even be able to avoid taxes on some of those early withdrawals.) And if they save it all for retirement, they have decades of compounding to enjoy.

But a lot of young people don't have the $5,000 a year to put into a Roth. Parents can match their child's earnings or savings and direct that money to a Roth.

-- Stretch one out. If you inherit a Roth IRA from a parent, or even better, a grandparent, that truly is the gift that keeps giving. Instead of liquidating it quickly, you can stretch the distributions over your entire lifetime. How much is that worth? A 6 year old who inherits a $100,000 Roth and earns 6 percent a year can pull more than $2 million dollars out of it over her lifetime, estimates the Entrust Group, a company that offers self-directed IRAs. That's huge.

(The Personal Finance column appears weekly. Linda Stern can be reached at linda.stern@thomsonreuters.com)