## FINANCIAL EDUCATION SERIES 2010

# The Roth IRA: Is It Time to Make the Switch?

Should you stick with a traditional Individual Retirement Account – or should you go for the Roth IRA? You will be hearing a lot more about this choice, thanks to a tax law change that takes effect in 2010.

That change allows even high-income earners to convert their regular IRA to a Roth IRA. Should you consider making the switch? Here's a look at the case for converting.

#### **TALKING TRADEOFFS**

Today, there is far more money in regular IRAs than Roth IRAs. Partly, that's because traditional IRAs have been around for longer, so they have received more years of regular annual contributions. In addition, many folks fund 401(k) or similar employer-sponsored retirement plans and then later roll this money into an IRA.

But having a big chunk of your wealth in a regular IRA can have its drawbacks — and you might want to shift some of this money into a Roth IRA. What drawbacks? For starters, you could face big tax bills in retirement.

When you funded your traditional IRA or 401(k), Uncle Sam might have given you a tax deduction. But when you take money out of these accounts, you have to return the favor, paying income taxes on all taxable withdrawals.

That's where the Roth IRA gets its appeal. If you make a regular annual contribution to a Roth IRA, you don't get an initial tax deduction, but all withdrawals in retirement will likely be tax-free.

Don't qualify to fund a Roth IRA with regular annual contributions? You can also get money into a Roth IRA by converting your traditional IRA. This involves paying taxes today on the taxable sum converted. But in return,

your withdrawals in retirement should be tax-free. Starting in 2010, the old rule that limits conversions to those who have an adjusted gross income of less than \$100,000 disappears. That means you can convert to a Roth IRA, no matter how much you earn.

#### **PICKING YOUR PAIN**

So should you convert? In large part, this is a question of whether you want your financial pain now or later. Sticking with the regular IRA may make sense if you are in a high tax bracket today and expect to be in a much lower bracket once retired.

But if you don't expect your tax bracket to drop much once you quit the workforce, and there is a risk your tax bracket could rise, you might convert to the Roth IRA. That way, you pay your IRA's tax bill today, while the tax cost is relatively cheap.

The right decision will depend on your individual circumstances. For instance, if it will be a long time until you or your heirs start drawing down your Roth IRA, you will likely find that converting is more attractive.

Converting could also be compelling if your taxable income during a particular year is fairly modest. That might occur if you have been laid off or, alternatively, you recently retired and

"You probably shouldn't pull money out of a retirement account to pay the tax bill on a Roth IRA conversion, because that withdrawal will trigger income taxes and possibly tax penalties."

haven't yet claimed Social Security or started receiving your pension.

#### **FIVE QUESTIONS**

While the expected change in your tax bracket and your time horizon are key considerations, they aren't the only issues. You might also want to weigh five other questions.

Are you planning to bequeath part of your IRA? Unlike with a regular IRA, you don't have to take required minimum distributions from a Roth IRA once you turn age 70 ½. Result: You could keep your Roth IRA intact and leave it to, say, your children.

Indeed, a Roth IRA can make a great inheritance. Your children will have to draw down the account over their lifetime. Nonetheless, if they are careful with their withdrawals, they could squeeze years of tax-free growth out of the account.

Do you fear tax rates will rise? By converting part of your IRA to a Roth IRA, you can hedge your tax bets. If income tax rates fall in the years

continued

### THE ROTH IRA: IS IT TIME TO MAKE THE SWITCH? continued

ahead, the withdrawals from your regular IRA may trigger a smaller-than-expected tax bill. If rates rise, however, your regular IRA withdrawals could get punished – but your Roth IRA would ease some of the pain, because withdrawals from that account should remain tax-free.

Are you anticipating strong market returns? Forecasting the performance of the financial markets is mighty tough. Still, for those who believe the recent bear market has set us up for strong returns in the years ahead, converting could be attractive, because the Roth IRA's future investment growth will be tax-free.

Do you have the money to pay the conversion tax? You probably shouldn't pull money out of a retirement account to pay the tax bill on a Roth IRA conversion, because that withdrawal will trigger income taxes and possibly tax penalties.

Instead, converting makes most sense if you can pay the resulting tax bill with money that's in a regular taxable account. For those who convert in 2010, there is an added incentive: You can opt to spread the extra taxable income over the next two tax years.

Of course, paying that bill will leave your taxable account somewhat depleted. If that's a worry, consider one of the Roth IRA's unique features. If you are under age 59 ½ and five years have passed since you converted to a Roth IRA, you can withdraw the sum you converted (but not the subsequent investment gains) and there shouldn't be any taxes or penalties owed. After age 59 ½, you can withdraw the sum converted at any time without penalty.

Have you ever made nondeductible IRA contributions? If you weren't eligible to make annual contributions to a Roth IRA or tax-deductible IRA, perhaps you ended up making nondeductible IRA contributions instead.

If you convert your IRA to a Roth IRA, you don't have to pay taxes on these nondeductible contributions. For instance, if you have made \$20,000 of nondeductible contributions over the years and your IRA is now worth \$45,000, you would only have to pay taxes on \$25,000.

One caveat: The sum converted is assumed to come pro rata from all your IRAs combined. That won't be an issue if your nondeductible IRA is your only IRA. But if you have, say, \$100,000 sitting in a rollover IRA, you will have to assume that a big portion of your conversion is coming from that account – and thus your tax bill could be higher than you hoped.

Citi Personal Wealth Management is committed to your long-term financial success. You can expect professional advice tailored to your needs, convenient access to Citi's global resources, and a broad range of diverse investment products.

For more information, please contact your Citi Personal Wealth Management advisor.

IRA is an abbreviation for Individual Retirement Account.

Source: The new rules affecting Roth IRA conversions are part of the Tax Increase Prevention and Reconciliation Act, which was passed in 2006.

Citigroup Inc. and its affiliates do not provide tax or legal advice. To the extent that this material or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

These strategies do not necessarily represent the experience of other clients, nor do they indicate future performance or success. Investment results may vary. The investment strategies presented are not appropriate for every investor.

© 2010 Citigroup Global Markets Inc. Citi Personal Wealth Management is a business of Citigroup Inc., which offers securities through Citigroup Global Markets Inc. ("CGMI"), member SIPC. Insurance is offered through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number OG56746). CGMI, CLA and Citibank, N.A. are affiliated companies under the common control of Citigroup Inc. Citi and Citi with Arc Design are registered service marks of Citigroup Inc. or its affiliates.