WHICH TYPE OF IRA MAKES THE MOST SENSE FOR YOU?

In 1974, when IRAs were first created, they were rather simple and straightforward. Now, 35 years later, it's challenging to know the best way to save more for retirement – given the array of rules for Traditional IRAs and the relatively new Roth IRA.

To help you navigate the complexities, John O'Shea, a Wealth Planning Specialist with TIAA-CREF's Wealth Management Planning group, answers frequently asked questions on IRAs.

1. **The Traditional IRA and Roth IRA are getting a lot of media attention lately. Can you give some insight as to why?**

   Answer: With declines in financial markets, people have a renewed interest in understanding their retirement plans and the options available to them. Given today's financial environment, the Traditional IRA and Roth IRA are viewed as a necessary component of almost everyone's total retirement plan. So it's terrific to hear that they're getting attention.

2. **Have the Traditional IRA and Roth IRA rules changed recently?**

   Answer: Yes. Congress frequently tweaks the rules for IRAs. The Traditional IRA was created 35 years ago.[1] Initially, it permitted eligible employees under age 70½ to contribute the lesser of $1,500 or 15% of compensation to an IRA. It also allowed employees in employer-sponsored retirement plans to transfer (or roll over) plan assets to an IRA when retiring or changing jobs. Over the past 35 years, Congress has periodically expanded the eligibility requirements, the annual contribution limit, and the rollover rules – enabling more people to participate and contribute greater amounts.

   The Roth IRA was added to the mix in 1997. It's effectively a mirror image of the Traditional IRA. The contribution amount is not deductible. Instead, the contribution amount is considered income in the year you make the contribution, but withdrawals are generally tax-free. This means that the Roth IRA earnings (e.g., interest, dividends, and capital gains) compound tax-free – not simply tax-deferred.

   Since inception, Congress has also taken action to allow more people to participate and contribute greater amounts to Roth IRAs. For example, in 2006 Congress introduced the Roth 401(k) and 403(b).[2] And in 2010, Congress intends to allow virtually anyone to convert a Traditional retirement plan (e.g., a 403(b), 401(k), 457(b) or Traditional IRA) to a Roth IRA, whereas now there are limitations based on the individual's adjusted gross income.

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3. **You mentioned that a Traditional IRA and Roth IRA should be viewed as a necessary component of almost everyone's total retirement plan. What do you mean?**

   Answer: People are living much longer in retirement. Each of us needs to be prepared to supplement our Social Security income with retirement savings to maintain our desired lifestyles in retirement – this could be for decades, maybe as much as 30 years.

   As we save for retirement, a primary rule is to contribute to your employer-sponsored plan especially if your employer matches your contributions. In addition, you should try to save more, when possible. One tax-efficient way to save more is by establishing a Traditional and/or Roth IRA and contributing to it regularly.

   You can always contribute the lesser of $5,000 or total earned income to an IRA, as long as you or your spouse (if filing a joint income tax return) has earned income during the year, and you're under age 70½ by the end of the tax year for which you made the contribution. So, a married couple could save an additional $10,000 annually for retirement by using this option. Note: If your income reaches a certain level, you can't deduct the contribution on your income tax return.[3]

   The rule is slightly different for a Roth IRA. You can contribute the lesser of $5,000 or total earned income to a Roth IRA as long as you or your spouse (if filing a joint income tax return) has earned income during the year that doesn't exceed certain thresholds.[4] So, a married couple could save an additional $10,000 annually for retirement by using a Roth IRA. In contrast to Traditional IRA contributions, Roth contributions are made with after-tax money, so you essentially set aside more money for your retirement because you pay the tax with your other assets. Once the Roth IRA is funded, the entire amount, including any earnings, is working for you. In addition, you can continue contributing to the Roth plan even if you are over age 70½.

   To compare a Traditional IRA with a Roth IRA go to **www.tiaa-cref.org/iras**, where you get a snapshot of important features you need to consider. An IRA calculator is also available to help you compare IRA options. By inputting specific data into the calculator, you should be able to determine your eligibility and contribution limits, and compare the possible results of investing in either the Traditional or Roth IRA.

4. **Which contributory plan do you recommend – the Traditional IRA or the Roth IRA?**

   Answer: It depends on a variety of factors, including your age, your financial goals, your current and future tax rates, your need for additional income in retirement, and your future legacy plans. That said, Traditional IRAs are generally viewed as the best choice, if (a) your income level permits you to deduct the contribution from your taxable income, (b) your income tax bracket will be lower after retirement or (c) you don't have an employer-sponsored retirement plan.

A Roth IRA might be considered an appropriate choice if (a) your tax bracket will be the same or higher in retirement, (b) you want to reduce the risk of your Social Security income becoming taxable, (c) you want to continue contributing after age 70½, (d) you would like tax diversity among your retirement plans,[5] and/or (e) you don't intend to use the funds for retirement income and want to increase the opportunity for your beneficiaries to receive this amount tax-free.

It's often beneficial to discuss this choice with a financial and/or tax advisor.

5. **Are there alternatives for those who earn too much and aren't eligible to contribute to a Roth IRA?**

Answer: They can always contribute to a Traditional IRA, or wait until 2010 when limitations on Roth plans go away. In addition, they might be eligible to move funds from an existing Traditional IRA or tax-qualified plan (e.g., 403(b), 401(k), or 457(b)) into a Roth IRA. This is commonly referred to as a Roth conversion. If you opt to pay the income tax upon conversion from your other assets, the act of converting actually allows you to keep more assets inside the Roth IRA which can have a positive net impact on your total retirement portfolio.

In addition, if you currently make gifts or have considered making a gift to your child, grandchild, and/or to other loved ones, consider contributing to a Roth IRA for that person's benefit. Generally, a person is eligible to have a Roth IRA if he or she has earned income. A teenager with summer employment, a college student working part-time, a young adult just entering the full-time workforce and/or a more established adult who is employed but who has not been able to adequately save for his or her retirement are all likely eligible to contribute the lesser of $5,000 or total earned income on an annual basis to a Roth IRA.

Younger loved ones aren't always as devoted to saving for retirement. Instead, they're interested in buying necessities and/or in paying down student loans and other debts. What better way to get that person excited about saving than contributing to a Roth IRA on his or her behalf? It also gives you the opportunity to teach him or her about investing and discuss risk tolerance and the merits of diversifying assets as he or she considers various fund types.

As an added bonus, the Roth IRA has broad creditor protection under federal and most state laws which can be beneficial to a younger loved one who has professional liability concerns, a bad marriage or other creditor issues.

It's an especially attractive investment vehicle for a younger person who is in a low income tax bracket and who will likely be in a higher bracket as his or her career develops. The Roth IRA also provides early withdrawal exceptions for some medical needs, for disability reasons, for higher education, and for first-time home buyers so there is flexibility to accommodate certain life events.

6. **Is a Roth conversion essentially moving funds from an existing Traditional IRA or tax qualified retirement plan [e.g., 403(b), 401(k), or 457(b)] into a Roth IRA?**

   Answer: Yes. It's important to point out that when you convert to a Roth IRA, the conversion amount (less any non-deductible contributions) is subject to federal and, where applicable, state income tax for the year in which the contribution is made to the Roth IRA. This means that you could potentially pay a hefty income tax bill upon conversion to a Roth IRA.

   The tax code has prevented people with taxable income in excess of $100,000 from converting to a Roth plan. But, beginning in 2010, Congress has expanded eligibility by removing the income limitations and filing status restrictions so that this type of retirement plan is available to more people. It's part of the natural evolution of IRAs, as we discussed earlier.

   The most significant influence on a person's decision to convert to a Roth IRA is the tax rates at conversion and at withdrawal. If your tax rate is the same at conversion and withdrawal, then a Traditional IRA and Roth IRA will likely produce similar results. If your tax rate is higher at conversion than at withdrawal, you're likely better off staying in your Traditional IRA. If your tax rate is lower at conversion than at withdrawal, you may benefit from converting into the Roth plan.

   For conversions made in 2010 only, you can opt to pay the conversion tax on your 2010 income tax return which is due April 15, 2011; or you can defer the tax and pay one-half of the tax with your 2011 income tax return and the other half with your 2012 income tax return. If you prefer to put off paying the taxes until later, be sure to consider your marginal income tax rate, because President Obama has expressed interest in raising the 33% bracket to 36% and raising the 35% bracket to 39.6% effective for 2011 and beyond. So, if you're in one of these two tax brackets, deferring the conversion tax could wind up costing you more than paying it right away.

7. **Do you agree that the timing of the conversion will have a significant impact on the amount of tax that's paid?**

   Answer: Yes. We just endured nine months of market declines. Probably none of us thought we'd see declines of this magnitude during our lifetimes. If you converted amounts to a Roth IRA in September 2008 and the market dropped by 40%, you'd likely have paid income tax (due April 15, 2009) on assets that you no longer have. But for those who converted in September 2008 and for others who face a similar dilemma – they have the ability to "re-characterize" or reverse the conversion.

   You can re-characterize a conversion any time before your tax return for the year of the conversion is due, including extensions. And, you can use the extension date for the re-characterization even if you filed your return by April 15. For example, if a Traditional IRA is converted to a Roth IRA in 2008, you can re-characterize or reverse the conversion any time up to October 15, 2009, regardless of when you actually filed the 2008 return, (as long as you filed it on time). By way of example,

if you convert in January 2008, then you have 21 months to monitor your account to determine whether the conversion was appropriate which argues in favor of converting early in 2010 if you plan to convert.

The most common reasons to reverse a conversion seem to be: (a) the Roth IRA's value has declined, (b) the conversion pushed you into a higher income tax bracket, and (c) you don't have enough other assets available to pay the conversion tax.

8. **What factors, other than tax rates, should be considered when evaluating whether the Roth conversion is a suitable strategy?**

Answer: In addition to tax rates, two other important factors are the availability of funds to pay the income tax on the conversion, and the timing for accessing the converted funds.

In general, there are two sources for paying the income tax after a conversion: (a) you can use assets from the Traditional plan (e.g., a 403(b), 401(k), 457(b) or Traditional IRA) that you are converting, or you can use assets from your other non-qualified assets. Using funds from the account that you are converting will reduce the amount you actually convert, and you'll have less money in the Roth IRA growing tax-free.[6] So rather than paying the tax from the Traditional plan, you may be better off using non-qualified assets, even when you factor capital gains tax on any appreciated assets that you may need to sell to pay the conversion tax.

In terms of accessing the converted funds, the sooner you need the funds the less sense the conversion makes – because when you convert, you lose the money that you use to pay the tax liability. You also lose the future after-tax earnings on that money. In addition, you must generally wait to withdraw funds until five years from the first day of the tax year in which you converted, if you want to avoid a penalty and tax on the earnings.[7]

9. **If you were counseling someone on the merits of a Roth conversion, what other strategies might you suggest?**

Answer: My thought is that beginning in 2010, when the Roth conversion strategy becomes available to essentially everyone, a primary strategy should be to minimize income tax upon conversion. This means that deciding whether to convert requires an in-depth understanding of your Traditional retirement plan (e.g., a 403(b), 401(k), 457(b) or Traditional IRA). You especially need to gather information about the taxable and non-taxable plan contribution totals. The following two examples illustrate this point.

Example #1: Arthur's retirement plans consist of a 403(b) and two IRAs. Arthur's 403(b) has $150,000 in pre-tax contributions and earnings, and zero non-deductible contributions. One IRA has $50,000 in pre-tax contributions and earnings and zero non-deductible contributions. The other IRA has $50,000, with $30,000 in pre-tax contributions and earnings and $20,000 in non-deductible contributions. If you want to convert a total of $50,000, you can, but you can convert part of the amount.[8]

However, when you calculate the taxable and non-taxable amounts, all of your Traditional IRAs are treated as a single IRA. You can't just choose to convert the IRA with the most non-deductible contributions. The IRAs are aggregated so that, in this example, 80% is taxable income and 20% is not taxable (your return of investment). A possible strategy would be for Arthur to roll over all or part of the taxable portion of each IRA into the employer retirement plan, assuming that the plan allows it. There's a unique feature in the tax law that prohibits Arthur from rolling over non-taxable IRA contributions to the 403(b) plan.[9] This feature could be advantageous to Arthur, because it gives him the option to consolidate pre-tax assets in the 403(b) plan and leave the non-deductible contributions in the IRA. This enables Arthur to convert the IRA without owing taxes. Alternatively, Arthur could consolidate $50,000 in the 403(b) plan and leave the $20,000 non-deductible contributions and $30,000 pre-tax contributions in the IRA. This lets Arthur convert $50,000 and pay tax on only $30,000.

Example #2: Arthur has two 403(b) plans. One has $50,000 in pre-tax contributions and earnings and zero non-deductible contributions; the other has $50,000 with $30,000 in pre-tax contributions and earnings and $20,000 in non-deductible contributions. The rules for 403(b) and 401(k) plans differ, so the account balances aren't aggregated when converting to a Roth plan. This means that Arthur can pick and choose which account to convert. It's also likely that, if he prefers, Arthur can convert only non-deductible 403(b) contributions. However, this specific strategy has only been allowed by an IRS Private Letter Ruling, so Arthur would need to consult with his tax advisor before implementing this strategy.[10]

The Roth conversion requires planning and can be a solution to your financial needs. However, you should consider it along with other available solutions. I would suggest working with your TIAA-CREF advisor to conduct a comprehensive review of your financial plan and then determine whether converting is an appropriate solution for you.

10. Does it matter who is named as beneficiary of the Roth IRA?

Answer: It matters in that it's important that you understand the beneficiary's financial circumstances.

First, if you think that you won't need the Roth IRA during your lifetime and believe that the proceeds will likely be withdrawn after your death, you need to consider the beneficiary's tax rate when you decide whether to convert to a Roth plan.

If your beneficiary (or a trust established for the beneficiary's benefit) will be in a higher income tax bracket than you are when you convert to a Roth Plan, converting may make sense. If, however, the beneficiary will likely be in a lower income tax bracket, converting may not be the best choice.

Second, upon your death, the minimum distribution rules apply to both Traditional retirement plans (e.g., a 403(b), 401(k), 457(b) or Traditional IRA) and to Roth retirement plans (e.g., Roth IRAs, Roth 403(b)s, and Roth 401(k)s). The amount that a beneficiary is required to take from the plan will vary depending upon the beneficiary.

Spousal beneficiaries have more flexibility than other beneficiaries. For example, spouses can generally roll over an inherited Traditional retirement plan or inherited Roth IRA retirement plan to their own retirement plan. In addition, a spouse may roll the inherited plan into a new IRA, allowing them to postpone distributions until age of 70½ (or until the spouse separates from service, with a 401(k)/403(b) retirement plan). And the life expectancy table for calculating required distributions is more favorable for spouses, allowing them to stretch out distributions from the plan over a longer period.

Non-spouse beneficiaries and qualified trusts can also withdraw the inherited plan assets gradually through annual distributions beginning the year after the original IRA owner's death. Distributions are generally calculated based on the individual's life expectancy or in the case of a trust, based upon the life expectancy of the oldest trust beneficiary using an IRS table. For most younger-generation beneficiaries, this allows them to stretch out payments in annual installments through about age 84.

Care must be taken when naming an "estate" as a beneficiary of your plan because this usually accelerates the distributions from the plan. This means that the IRA account balance is, subject to income tax earlier than it would have been had you named an individual beneficiary or qualifying trust. The main difference between a Traditional retirement plan and a Roth retirement plan is that a distribution from a Traditional retirement plan is generally subject to income tax whereas a distribution from the Roth plan is generally tax-free to the beneficiary.

This is also an important distinction if one or more of your beneficiaries is a qualified charity. You would likely want to provide for the charity through the Traditional retirement plan (which will be taxable to individuals), since the charity is exempt from income tax.

This tax difference may be especially relevant if the annual distributions to your beneficiary would put that beneficiary into a higher income tax bracket or if the beneficiary's circumstances require special planning where deferred income adds complexity, such as with a non-citizen spouse or a beneficiary with a disability for which he or she is receiving or may receive government aid

11. **If a beneficiary inherits a Traditional retirement plan (e.g., a 403(b), 401(k), 457(b) or Traditional IRA), can he or she convert the inherited plan into a Roth retirement plan?**

Answer: If a beneficiary inherits an IRA, my answer is "no" because there doesn't appear to be any IRS guidance on this point. That said, there is an IRS Notice that states that the beneficiary of a 403(b) or 401(k) can convert the inherited plan into an inherited Roth plan.[11] As such, one strategy to consider if you don't need the funds during your lifetime is to consolidate them into your 403(b) or 401(k) plan so that after your death the beneficiary of the inherited 403(b) or 401(k) plan has the additional option to convert the plan to an inherited Roth plan after considering his or her own tax position.

12. **Is the beneficiary of an inherited Roth retirement plan (e.g., Roth IRA, Roth 403(b), or Roth 401(k)) entitled to any protection in the event of a bad marriage, a disability, a malpractice claim, or other creditor action?**

Answer: An inherited Roth plan, like an inherited Traditional retirement plan, is generally not protected from a beneficiary's creditors under federal and/or state law. So if your beneficiary has professional liability concerns, a bad marriage, a disability, or other credit issues, consider establishing a qualified trust for this person's benefit and transferring the retirement plan into the trust at your death. Consider TIAA-CREF Trust Company, FSB, as a Trustee to assist with the income tax, investment, and trust administrative decisions.

[1] In 1974, the Employee Retirement Income Security Act (ERISA) created the Traditional IRA.

[2] Congress has not yet authorized a Roth 457(b) plan although it is anticipated that they will soon.

[3] You cannot deduct the contribution if you are single and your adjusted gross income exceeds $65,000 or if you are married (filing jointly) and your adjusted gross income exceeds $109,000.

[4] If **single** in 2009, you can make a full Roth contribution if income is less than $105,000. You can make a partial contribution if your income is between $105,000 and $120,000. You cannot make a contribution if your income exceeds $120,000. If **married** in 2009, you can make a full Roth contribution if your income is less than $165,000. You can make a partial contribution if your income is between $166,000 and $176,000. You cannot make a contribution of your income exceeds $176,000.

[5] Tax diversity means that you have both a Traditional plan and a Roth plan so that you can control how much cash flow comes from pre-tax and after-tax sources during your retirement. This flexibility can help you if you are on the border between two tax brackets.

[6] If you are younger than age 59½, you will likely incur a 10% penalty on any portion of the converted plan that you use to pay the income tax liability. This is in addition to the conversion tax.

[7] There is an important difference regarding this five-year rule when talking about multiple Roth IRAs and Roth 403(b) or 401(k) accounts. For multiple conversions to Roth IRAs, each IRA is governed by the five-year rule applicable to the oldest converted Roth IRA. For example, if you convert to your first Roth IRA on December 12, 2010, and then have a series of additional conversions to other Roth IRAs after that date, the five-year period begins on January 1, 2010, for all of your Roth IRAs. On the other hand, if you have multiple conversions to Roth 403(b) or 401(k) accounts, each account has its own separate five-year rule.

[8] There is no limit on the amount that can be converted. There is also generally no limit on the number of times that you may convert in any given year or the number of times you can convert assets from a single plan in the same year.

[9] See Section 408 of the Internal Revenue Code.

[10] See IRS Private Letter Ruling 9840041.

[11] See IRS Notice 2008-30, Q-7.

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