

# TO ROTH OR NOT TO ROTH? THAT IS THE QUESTION

A version of this article was posted on  
InvestmentNews.com on April 14, 2014

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Although Roth IRAs have been available since 1997, changes in recent years to the U.S. tax code have made these retirement savings accounts more popular than ever.

In 2010, higher income limits allowed larger numbers of investors, particularly high-net-worth investors, to qualify for Roth IRAs. Then, in 2013, the Internal Revenue Service confirmed that those 401(k) plans that offer a Roth option may allow their participants to roll over funds in their plan to an “in-plan” Roth account.

These changes not only broaden the appeal of Roth IRAs to high-net-worth investors, they also enable advisors to reach out to their clients and prospects with a potentially appealing wealth transfer strategy. Or, as the playwright William Shakespeare might have said (assuming, of course, he also moonlighted as an advisor): “A Roth by any other name would smell as sweet.”

## **Shakespeare’s investment tip #1: What’s in a name?**

A Roth IRA is an individual retirement plan, established by the Taxpayer Relief Act of 1997 and named for its chief sponsor Senator William Roth, in which an individual makes retirement contributions with after-tax dollars.

Many believe that Congress will continue to favor Roth-like options because tax revenues are immediate and not delayed on contributions. Federal tax revenue projections are based on 10-year periods that cause Roth contributions to be looked on with greater favor than deferred tax savings incentives. The Obama administration’s recent MyRA is basically a Roth IRA in a different wrapper with restricted investment options. On the flip side, future tax proposals are likely to lead to scrutiny of current Roth benefits, such as allowing money to remain in a Roth IRA indefinitely without the required minimum distributions (RMDs) of traditional IRAs.

## **Shakespeare’s investment tip #2: See first that the design is wise and just**

Before suggesting clients convert some or all of their retirement savings from a traditional IRA to a Roth IRA,

advisors need to carefully consider the potential impact of a variety of financial strategies on their clients’ present and future savings.

First, determine which tax-planning strategy makes the most sense for your client—pay taxes now or later? This is important because a Roth IRA may be more appealing to those who believe their tax bracket will increase by the time they make withdrawals, either because of increases in federal tax rates or because the individual’s income will grow. Still, funds must be available now to pay any taxes associated with the conversion to a Roth IRA.

Second, agree on a “retirement income” strategy taking into account how your client will use the funds upon retirement. Since qualified Roth distributions are not counted as earned income they avoid the potential of triggering higher taxes due by reaching Social Security tax thresholds and higher Modified Adjusted Gross Income (MAGI) for Medicare Part B premiums.

Finally, consider the impact a Roth IRA conversion may have on your clients’ estate plans and the transfer of wealth from one generation to another. For example, with

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Roth IRAs, clients may plan for gift and estate planning by leaving money to heirs in an income tax-free account.<sup>1</sup> And, because Roth IRAs don't require RMDs at age 70½ like traditional IRAs, these accounts can potentially grow larger, leaving more money for heirs.

**Shakespeare's investment tip #3: Men (and women) at some time are masters of their fates**

Thanks to recent changes in the tax code, the advantages of Roth IRAs now extend to even larger numbers of individuals.

To make a Roth IRA contribution, the investor must have earned income in a particular year from salary, hourly wages or profits from a small business. Income and contribution limits are set by the federal government and may not be higher than those illustrated in the accompanying chart. In addition, if an individual's earned income is less than his or her eligible contribution amount, the maximum contribution amount is the individual's income.

At the same time, investors are allowed to convert (or change the designation of) a traditional IRA to a Roth IRA regardless of their income. This does not trigger any penalty typically imposed on early withdrawals and does not affect eligibility to open other Roth IRAs.

Keep in mind that partial conversions are available—it's not an all or none situation. Roth conversions are treated as taxable income and could move your client into a higher income tax bracket. If that is a concern, consider recommending a partial conversion—converting just enough of the traditional IRA to remain in the current income tax bracket. Then, accomplish additional conversions in subsequent years.

Advisors should also remember that those individuals who earn too much money to contribute to a Roth IRA might instead consider making a non-deductible contribution to a traditional IRA that may be converted later to a Roth IRA. However, keep in mind that other IRA assets may impact the effectiveness of this strategy. Make sure your clients speak with their tax professional.

**ROTH CONTRIBUTION LIMITS FOR 2014**

This table shows how the Adjusted Gross Income (AGI) affects the contribution limits to a Roth IRA by filing status. See Publication 590, Individual Retirement Accounts (IRAs), for a worksheet to calculate the reduced contribution.

Filing Status	Modified AGI	Contribution Allowed
Married filing jointly or qualifying widow or widower	< \$181,000	up to the limit <sup>2</sup>
	≥ \$181,000 but < \$191,000	a reduced amount
	≥ \$191,000	zero
Married filing separately and living with spouse at any time during the year	< \$10,000	a reduced amount
	≥ \$10,000	zero
Single, head of household or married filing separately not living with spouse at any time during the year	< \$114,000	up to the limit <sup>2</sup>
	≥ \$114,000 but < \$129,000	a reduced amount
	≥ \$129,000	zero

**Shakespeare's investment tip #4: To thine own self be true**

Among the many reasons why your clients should consider opening a Roth IRA instead of a traditional IRA are:

- › Contributing at any age—Roth IRA contributions may be made at any age, providing the individual has earned income, while traditional IRA contributions can only be made up to age 70½.
- › Not requiring distributions—Currently, individuals are not required to take distributions from a Roth IRA, whereas traditional IRA account holders must start withdrawing money at 70½. However, this feature is under scrutiny by Congress.

<sup>1</sup> Please note that both the President's 2015 Budget Proposal and Chairman Camp's Tax Reform plan may put significant restrictions on the "stretch" IRA.

<sup>2</sup> For 2014, the maximum contribution to both a Traditional and Roth IRA is the lessor of \$5,500 (\$6,500 if age 50 or older) or the amount of taxable compensation for the year.

- › Availability to non-working spouses—A non-working spouse can open a Roth IRA based on the working spouse's earnings or the couple's joint tax filing status.
- › Complementing other savings programs—Individuals may contribute to a Roth IRA even if they participate in an employer-sponsored retirement plan.
- › Avoiding Medicare surtax—Roth distributions don't count toward the MAGI threshold that determines the surtax for Part B premiums.
- › Reducing estate value—Because taxes are paid in advance, a Roth IRA may also reduce the value of a person's estate by lowering the estate value below the estate tax threshold and may even eliminate certain estate taxes.
- › Allowing clients to change their minds—Subject to certain restrictions, individuals can switch their IRA contributions from one type of IRA to another, or undo a conversion (which is known as a re-characterization). This can be done to recover ground from an earlier decision that performed poorly or because an investor simply changes his or her mind.

**Shakespeare's investment tip #5: There is nothing either good or bad, but thinking makes it so**

Your clients should also consider a number of potential disadvantages to Roth IRAs. For instance, because all contributions are taxed immediately, individuals need to be able to pay the cost of converting a traditional IRA to a Roth IRA. Ideally, this should be done by using funds outside of an IRA, such as cash reserves.

Tax laws are, of course, always subject to change, especially when it comes to things like new tax rates, new or increased taxes on certain benefits and potential VAT implications. So keep in mind that a wise strategy today may not be a wise strategy tomorrow.

Before opting to open a Roth IRA or make a conversion, your clients should consult a professional tax advisor. And they should not wait until late December to place the call. By then, the tax advisor may be overwhelmed with requests for assistance and it may be too late to do whatever is required to facilitate the most beneficial—and least expensive—conversion during that calendar year.

**Shakespeare's investment tip #6: The golden age is before us, not behind us**

According to the Internal Revenue Service, 10% of all IRA holders with annual incomes of more than \$1 million converted their IRAs to a Roth account in 2010, which was the first year with revised income limits.

Changes in recent years to the U.S. tax code have clearly prompted new interest in Roth IRAs. Advisors are recognizing the opportunity to better serve the retirement needs of their clients and prospects. So make sure you are prepared to answer client questions and consider reaching out to your high-net-worth clients to help them understand the potential benefits of Roth IRAs and the advantage of diversifying the tax status of their retirement savings. Many advisors and their clients agree that with regard to the Roth IRA, "Though it be but little, it is fierce."

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Pershing LLC does not provide tax or legal advice. This article is intended to provide general information. Clients should be advised to consult with a legal or tax advisor about their individual situation before implementing any strategies described, including establishing, maintaining or changing a retirement account.

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