Improving Your Roth IRA Strategy

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As investors, we not only are trying to capture returns, but we're also trying to maximize what we keep after paying taxes. After all, taxes are one of the largest drags on an investor's true return. That is why financial advisors often prefer working on client retirement plans that involve Roth IRAs.

Roth IRAs allow you to pay taxes on money going into your account, making all future withdrawals and investment returns completely tax-free, as long as a few requirements are met. This is a way to hedge against the possibility of higher tax rates in the future.

They can also help you benefit from asset location – where you strategically invest different types of assets in various vehicles to adapt to the nuances of the tax code.

At the time of writing this, Roth IRAs are also not subject to required minimum distributions at age 70 ½ unlike traditional, pre-tax IRAs.

These are just a few of the reasons to select a Roth IRA, but as you can see, they all center around improved financial flexibility and greater lifetime tax savings.

So how do you contribute to a Roth IRA? There are two common ways.

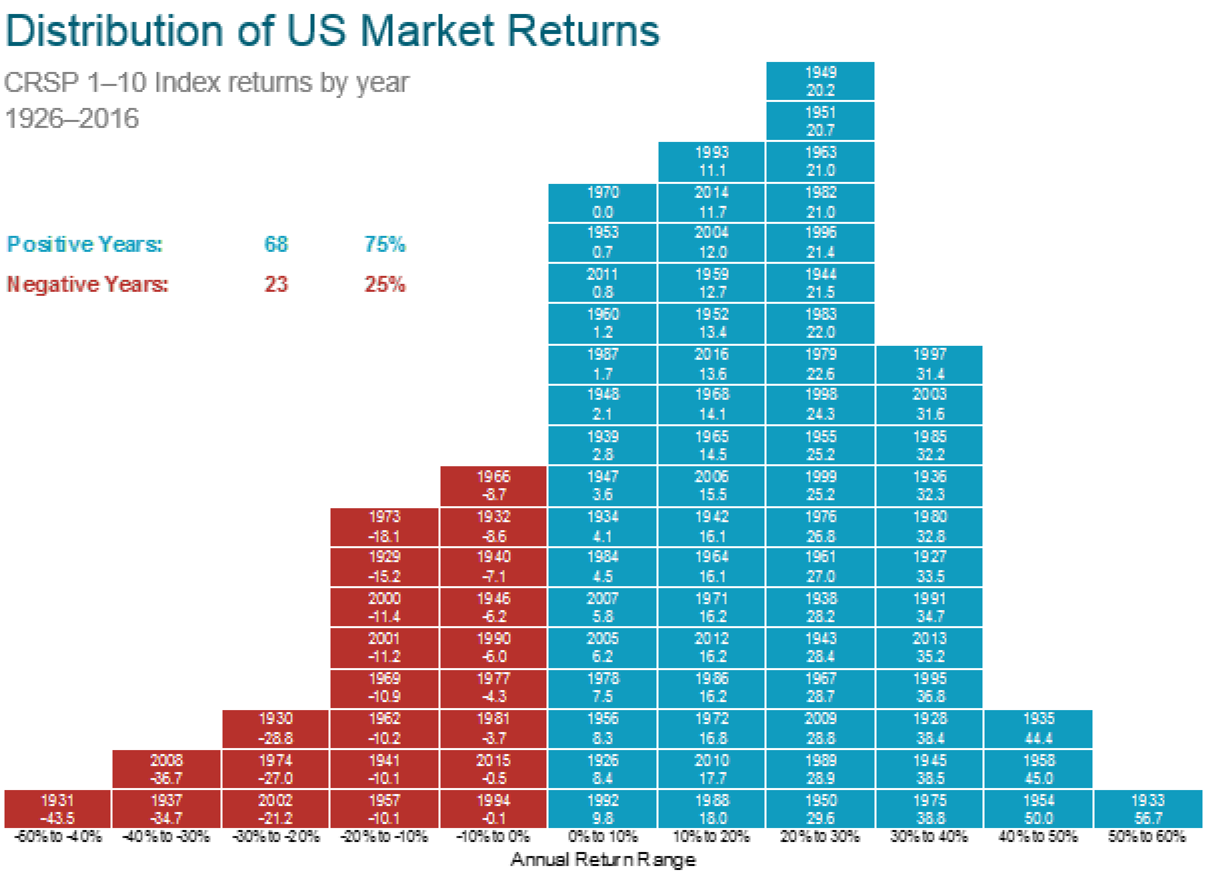
First, you can make annual contributions. For 2017, you're generally allowed to contribute up to $5,500 per year, plus an additional $1,000 if you're age 50 or older. However, there are income limits that prevent higher earners from making these contributions.

The other common way is to convert pre-tax dollars from an existing IRA or employer retirement plan into a Roth IRA. Fortunately, there are no longer income limits that prevent conversions.

However, it's important to note that any Roth IRA conversion will likely create a higher tax bill for you in the year of the conversion. For this reason, it often makes sense to convert as part of a holistic tax planning strategy to ensure that, although you are paying more taxes upfront, it will result in a more efficient retirement income strategy in the future.

Many folks, even many of our clients, prefer to wait until the end of the year to convert. However, there are several reasons to consider converting to a Roth IRA earlier in the year.

First, if we look at broad market returns over the years, there have been far more years in which markets have risen in value than years where they have declined. Take a look at the chart below showing the distribution of U.S. market returns. If you're doing conversions regularly over a number of years, the odds would seem to be in your favor to get money into a Roth IRA as soon as possible to capture more tax-free growth.



Source: DFA Returns

Second, it's very difficult to determine exactly how much to convert to a Roth IRA in any given year. Our lives (and the tax code) have many moving parts. We often won't know our exact tax situation until after the year has ended. This would seem to conflict with the rule that requires a Roth IRA conversion be completed by Dec. 31 to be factored into that tax year's situation!

Fortunately, there are rules that allow you to essentially undo all or a portion of what you've converted through what is called a recharacterization. So if you're worried you converted too much into your Roth IRA, pushing you into a higher tax bracket, you can recharacterize a precise amount in the following tax year (typically this needs to be done by Oct. 15).

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Finally, you might worry about what happens if you make a Roth IRA conversion early in the year and your investment value declines over the next year or so. In that case, you could still consider doing the recharacterization mentioned above. There are some rules and nuances to consider in this scenario, but the ability to recharacterize mitigates both the market and tax risk.

Now for those of you who don't already have a Roth IRA, you might consider opening one as soon as possible. To avoid being taxed on Roth IRA distributions, one of the requirements is that five years have passed from the first year a contribution was made to the account before taking the distribution. So even if you can't meaningfully fund a Roth IRA now, it is still beneficial to open one and fund it with a small contribution or conversion from an existing IRA. That will at least get the five-year clock started.

If you're married, opening new Roth IRA accounts for both spouses often makes sense.

The bottom line is if, after consulting your financial advisor, it's determined that utilizing a Roth IRA is a good strategy, you should consider executing on that soon. The current rules offer ways to minimize your downside risk. We also like the potential upside and flexibility that come with having Roth IRAs as a part of your portfolio.

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