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Roth IRAs take advantage of bargain tax bracket

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Everyone's always complaining (worrying) about paying taxes that are too high. If you're a retiree, this year's tax burden is not as bad as you think, especially for retirees who are smart investors.

For most retirees, the tax bracket remains 15% – a bargain bracket you can use to make provisions for your family.

This rate is historically very low and with the ongoing political fighting in Congress, this rate is likely to be the lowest tax bracket you'll see for many, many years. And with stock prices at all-time highs, 2014 will likely see stock volatility, providing another opportunity to save on taxes.

With interest rates so low, you probably will pay less tax on your earnings than you thought.

A retired couple on Social Security, with $2.5 million invested in certificates of deposit and stocks can earn an additional $50,000 in interest and dividend income and still remain in the 15% bracket.

How? $1 million in CDs getting 2% equals $20,000 of interest income. $1.5 million in stocks earning dividends of 2% equals $30,000 a year, for a total of $50,000 in investment earnings.

Because they are in the 15% tax bracket, the tax rules provide that they will pay no tax at all on their $30,000 of dividend income, a terrific bargain.

Converting to a Roth IRA

If you think your tax rate will increase, you may want to convert some of your retirement portfolio to a Roth IRA. You should also convert if you have a desire to cut down on the estate tax on your assets when you die.

Converting to a Roth IRA means paying tax today on your savings contributions and on the accumulated earnings from your traditional IRA, converting those funds into post-tax money. This also means all additional earnings accumulate tax-free.

Converting traditional IRA monies to a Roth isn't for everyone. Don't convert if your tax rate will decrease in the future, which includes many working taxpayers. If your tax rate is going to stay the same, keeping your portfolio in a traditional IRA or converting to an IRA is mathematically a push – there is no real advantage to converting to a Roth. And you should also not pull monies out of your IRA to pay for the tax bill you will have when converting.

Transferring tax-free money to heirs

If you are older than 70 1/2 and want to use your IRA to pass wealth on to heirs in a higher tax bracket, you can utilize your distributions in a Roth IRA to save on income taxes. Bill and Nancy, aged 76, are retired have one child, Joe. Bill and Nancy have $40,000 of social security income; they have $200,000 of CDs paying 1% annual interest – $2,000. They also have a stock portfolio of $200,000 paying 2% dividends – $4,000. They have $220,000 in a traditional IRA, where they are required to take a minimum distribution of $10,000 in 2014. Joe is working and making $75,000 per year and is in the 25% tax bracket.

Since they pay no income tax, they could convert approximately $10,000 into a Roth IRA and pay no tax. If the Roth grows to $20,000 before they die, they will have saved Joe at least $5,000 of income taxes on the IRA.

Take advantage of stock volatility

Since stocks are more fairly valued now than at the beginning of 2013, stock prices this year will likely be more volatile. If there is a correction, you can convert some of your retirement investments to a Roth IRA, taking advantage of the pricing to convert.

Take Dan. During a correction, the value of his IRA drops 10%, from $100,000 to $90,000. Dan does a Roth IRA conversion, reducing his tax cost on the conversion, paying $13,500 (instead of $15,000), since his IRA has lost value.

After the market rebounds, his Roth IRA is worth $100,000 again, and the $10,000 he gained back permanently escapes taxation since the money is now in the Roth IRA.

To ensure you convert near the bottom of the market, make four conversions, one in each quarter. Since you can reverse the conversion before filing a return, you can allow the best conversion to stick while unwinding the other three.

Roth IRA conversions and other tax-saving strategies can be helpful, but they can also create immediate tax consequences. That's why you should talk to your estate planning attorney or tax adviser before making any investment decisions.

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