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Choosing a Roth IRA

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One of the most-discussed ways of saving for retirement is through an Individual Retirement Arrangement or "IRA." An IRA is a tax-advantaged retirement plan set up and managed by an individual (unless a financial advisor is hired to manage the investment). If and when you decide that an IRA is right for you, an important question looms- should you choose a Traditional IRA or a Roth IRA? One thing that is certain though is that regardless of whether you choose a Roth or Traditional IRA, the assets you contribute to the IRA will grow tax free. Therefore, the ultimate consideration in deciding whether to choose a Traditional or Roth IRA generally becomes whether you would rather pay tax now or later.

You may decide that you would rather pay tax now and receive tax-free distributions later. For these people, the Roth IRA is clearly the way to go. But in order to make this determination, you should consider whether you expect to be in a higher tax bracket later in life, if you think taxes will generally increase with time, and whether you can actually afford to pay the taxes now. If you answer "yes" to all of these questions, then funding a Roth IRA may make more sense.

Nevertheless, even if a Roth IRA is principally a good idea for you, unexpected events may make it a less profitable means of protecting your retirement savings. For example, if you had funded a Roth IRA in 2008, not only would you have had to pay tax on the assets contributed to the Roth IRA but it is likely you would have also lost significant wealth on top of the tax paid due to the financial crisis. A double whammy! This example just goes to show that even the best vehicle for investments does not exist in a vacuum.

So You've Decided That a Roth IRA Is Right for You

There are several requirements that have to be met before you can fund an IRA with after-tax assets. These assets include the following:

1. Income Limitations: In 2009, a single individual must have a modified adjusted gross income ("MAGI") under $105K to be able to contribute the full amount to a Roth IRA. If the individual has a MAGI between $105K and $120K, then the amount that he or she may contribute is phased out. If the individual has a MAGI above $120K, then the individual cannot contribute to a Roth IRA at all. These numbers are $166K and $176K respectively for joint filers.
2. Compensation: In order to be able to contribute to an IRA, an individual must have "earned compensation," unless the IRA is being funded by an individual with taxable compensation on behalf of a spouse that does not have taxable compensation.
3. Form of Contribution: Contributions must be in cash or a cash equivalent.
4. Contribution Limits: In 2009, no more than $5,000 can be contributed to an IRA. Additionally, for individuals aged 50 years and over there is an additional $1,000 catch-up provision.

Age Limitations

Unlike Traditional IRAs that do not permit contributions to be made after the age of seventy and a half, a Roth IRA does not have an age limitation on who can contribute.

Distributions

Roth IRAs do not have required distributions, allowing the assets in the Roth IRA to continue to grow indefinitely. But in order to make a distribution from a Roth IRA without penalty—a "qualified" distribution—the owner of the Roth IRA must be at least 59½. If the owner is not at least 59½, there will be a 10 percent penalty on the distribution to the extent the distribution consists of earnings. Additionally, if the Roth IRA has not been held for five years, any earnings distributed are taxed.

Distributions are made from a Roth IRA in the following order: (1) regular contributions, (2) conversion contributions, and (3) earnings.

Roth IRA Conversion

You can roll-over 401(k) Roth accounts, 403(b) plans, 457 plans, and other IRAs into a Roth IRA. When rolled-over, the deductible contributions and earnings are taxed (non-deductible contributions are not taxed as they have already been taxed prior). There is also an additional 10 percent penalty on any assets rolled-over from a Traditional IRA if you make more than $100K for the year.

If you make more than $100K, you may want to wait until 2010 to make your Roth IRA conversion. Starting in 2010, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") removes the $100,000 income limitation and therefore makes it possible for any type of IRA to be converted into a Roth IRA without a penalty. A Roth IRA rollover in 2010 will still be subject to tax; but this tax will be payable over two years: 2011 and 2012.

Individuals who are disqualified from contributing to a Roth IRA because of the applicable income limitations may alternatively fund a Traditional IRA now and then simply rollover the Traditional IRA into a Roth IRA in 2010.

Roth IRAs for Kids

Consider creating a Roth IRA for a child if the child only makes a limited amount of income. If the income the child makes is below the personal exemption amount, then the child can contribute all of his earnings to a Roth IRA and these earnings will escape tax. By escaping tax on the contribution, this ensures that the amounts contributed to the Roth IRA are never taxed. ■