Roth IRAs

Dear Reader:

I'm writing to fill you in on the rules for Roth IRAs, in case you are interested in setting one up.

While no deduction is available for contributions made to a Roth IRA, you may be entitled to a credit (saver's credit) against tax for your contribution. And earnings on the contributed amounts build up tax-free and it's fairly easy to qualify for tax-free distributions for retirement. Here's how the Roth IRA works:

Contributions. For 2009, you can contribute up to $5,000 to a Roth IRA (as long as you have compensation for the year at least equal to the contributed amount). The $5,000 limit will be increased when the cost-of-living index warrants it. Individuals age 50 or older can make additional contributions of $1,000. Thus, the limit is $6,000 a year for people who will be age 50 (or older) during 2009.

However, the maximum contribution allowance must be reduced by any contributions (deductible or nondeductible) you make to “regular” IRAs.

Unfortunately, there are some limits on Roth IRA contributions. For single taxpayers, if adjusted gross income (AGI) is $120,000 or more, no contribution can be made to a Roth IRA. If AGI is between $105,000 and $120,000, the $5,000 maximum contribution is phased out (reduced) according to a formula. For married taxpayers filing jointly, no contribution can be made if AGI is $176,000 or more, and the $5,000 maximum (per spouse) is phased out for AGIs between $166,000 and $176,000. For married taxpayers filing separately, the allowable contribution is phased out for AGIs between $0 and $10,000.

You may be allowed a credit against your income tax equal to a percentage of your Roth IRA contribution if your AGI doesn't exceed certain levels (which are much lower than the phase-out AGI levels above).

Contributions can be made to Roth IRAs even if you are a participant in a qualified plan and even if you reach age $70^1/_2$.

Distributions. “Qualified” distributions from a Roth IRA are tax-free. Thus, you can avoid tax on Roth IRA earnings forever (i.e., even at distribution). A distribution is qualified if made: once you reach age $59^1/_2$, upon death or disability, or (up to $10,000 per lifetime) for first-time homebuyer expenses. However, a distribution is not qualified if made within the five-year period beginning with the first tax year you made a contribution to a Roth IRA.

A nonqualified distribution is treated first as a nontaxable return of contributions. To the extent a nonqualified distribution exceeds contributions it is taxable and is also subject to a 10% penalty under the regular early withdrawal rules (i.e., the penalty will not apply if the distribution is made once you reach age $59^1/_2$, or upon death or disability, or in other limited circumstances).

Qualified rollover contributions. You may be able to roll funds over from a regular IRA into a Roth IRA so the post-rollover income can grow tax-free in the Roth IRA. (Converting a regular IRA into a Roth IRA is treated as such a rollover.) You can roll funds over from a regular IRA to a Roth IRA only if your AGI, calculated with specified modifications, does not exceed $100,000 in the rollover year. Any funds rolled over will be taxed under the regular IRA distribution rules as if there were no rollover. The 10% early withdrawal penalty will not apply to the rollover. However, if rolled over funds are withdrawn within the five year period that renders them taxable, the 10% penalty will apply to the withdrawal. (Beginning in 2010, the $100,000 AGI ceiling on conversions from a traditional IRA to a Roth IRA will be removed.)

Ordering rules apply if a Roth IRA contains conversion amounts (possibly from different years) as well as other contributions. The regular Roth IRA contributions are treated as withdrawn first and then converted amounts, starting with amounts first converted. Withdrawals of converted amounts will be treated as coming first from amounts already included in income. Earnings are treated as withdrawn after contributions. For these purposes, all Roth IRAs will be treated as a single Roth IRA.

Certain elements of the Roth IRA can be complicated. Nonetheless, many taxpayers can benefit significantly from Roth IRAs. Please give us a call if you would like to discuss these matters further.