216-481-7748
ken@klzservices.com

To Roth or Not to Roth? That is the IRA Question!

For many taxpayers, the Roth IRA is one of the best tax-advantaged retirement plans around. Are you eligible to harvest the grapes of Roth? Is a Roth IRA or a traditional IRA right for you?

Choosing between the Roth IRA and a traditional IRA can be difficult, and it's a big decision. First available in 1998, the Roth IRA is a relatively new retirement vehicle. Not all taxpayers can fully benefit from a Roth IRA because of rules called "income phaseout limitations." For single taxpayers, the 2009 Roth benefit is limited if adjusted gross income exceeds $105,000. For joint filers, limitation begins at $166,000 ($167,000 in 2010) . Married persons filing separately lose any benefit with the first dollar of income. In each case, a phaseout range allows a reduced benefit until income reaches a maximum amount. By contrast, regular IRA contributions are not subject to gross income limitations unless the taxpayer or the taxpayer's spouse is a participant in an employer-sponsored plan.

If you're single and your adjusted gross income exceeds $120,000, you cannot contribute to a Roth IRA, though you could of course contribute to a traditional IRA. On the other hand, if you're a single filer and your income falls below the $105,000 adjusted gross income limit, you can make the full maximum annual $5,000 contribution to a Roth IRA. A special "catch-up" contribution of $1,000 can be added to that limit if you've passed your 50th birthday during 2009. If your income falls between this $105,000-$120,000 range, as a single taxpayer you are eligible to make a partial Roth IRA contribution. The same logic applies to joint filers, subject to the $166,000-$176,000 phaseout limitations ($167,000 - $177,000 in 2010).

Contributions to a Roth IRA are never deductible. However, all the money in a Roth IRA account may be withdrawn completely tax-free if you comply with "qualifying distribution" rules. By contrast, contributions to a traditional IRA may or may not be deductible and therefore may or may not be withdrawn tax-free in accordance with the "qualifying distribution" rules.

Whether or not you can deduct contributions to a traditional IRA may depend on your income level when you are covered by an employer's retirement plan. For tax years 2009 and 2010, single taxpayers who are covered by an employer's retirement plan can make deductible IRA contributions subject to an adjusted gross income phaseout range of $55,000 and $65,000. For married taxpayers filing jointly, an adjusted gross income phaseout range of $89,000 and $109,000 applies in 2009 and 2010 to an IRA participant who is covered by an employer plan. The phaseout range for an IRA participant who is not covered by a plan but whose spouse is covered is $159,000 - $169,000 of income in a joint return.

What do these rules mean? If you're single, under age 50, covered by an employer plan, and your adjusted gross income exceeds $65,000 in 2009 and 2010, you cannot deduct any portion of your maximum $5,000 traditional IRA contribution. You can still contribute the $5,000 annual maximum to an IRA, but your entire contribution will be nondeductible. The same logic applies to joint filers, subject to the limitations described above.

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So is the Roth better than the traditional IRA? That depends. For taxpayers that are only allowed to make nondeductible IRA contributions, the Roth IRA is clearly preferable. That's because contributions to a Roth IRA may be withdrawn tax-free as "qualifying distributions." Qualifying distributions will also not be subject to the 10% early withdrawal penalty tax.

To satisfy the qualifying distribution rules you must not draw from the Roth IRA for the first five years and meet one of six other requirements:

1) The distribution is made after you reach age 59 ½.
2) The distribution is paid because of your death or disability.
3) The distribution consists of substantial equal periodic payments.
4) The distribution is used for qualifying medical or health insurance expenses.
5) The distribution is used for higher education expenses.
6) The distribution is used for a first home purchase and is limited to $10,000

Taxpayers with existing traditional IRA accounts can choose to rollover their IRAs into Roth IRAs. That means paying taxes now so you don't have to pay them later. Whether you should do that depends on many factors unique to your own situation. It also requires highly complex "what-if" computations that can only be handled by a computer and a skilled tax professional. In fact, different software programs sometimes give different answers, so you really have to be both a tax and computer expert to do this important analysis correctly!

We are prepared to help you, and will be happy to do so. Please don't hesitate to call if you have any questions.