Roth IRA 101

The Roth IRA in a Nutshell

The Roth IRA was born on January 1, 1998 as a result of the Taxpayer Relief Act of 1997. It's named after former Senator William V. Roth, Jr.

The Roth IRA provides no deduction for contributions, but instead provides a benefit that isn't available for any other form of retirement savings: if you meet certain requirements, all earnings are tax free when you or your beneficiary withdraw them. Other benefits include avoiding the early distribution penalty on certain withdrawals, and avoiding the need to take minimum distributions after age 70fi.

Plus and Minus

The chief advantage of the Roth IRA is obvious: the ability to have investment earnings completely escape taxation. The advantage comes at a price, though. You don't get a deduction when you contribute to the Roth IRA.

So which is more important? It depends on your personal situation, and also on what assumptions you want to make about the future. How long before you withdraw money from your IRA? What will your tax bracket be then? What earnings can you anticipate in the interim?

You can do lots of fancy analysis, but the bottom line is that most people are better off in the Roth IRA. The chief reason is that the Roth IRA is effectively bigger than a regular IRA because it holds after-tax dollars. If you can take advantage of this feature of the Roth IRA by maximizing your contributions you'll add greater tax leverage to your retirement savings.

There are two other significant advantages to the Roth IRA. One is that the minimum distribution rules don't apply. If you're able to live on other resources after retirement, you don't have to draw on your Roth IRA at age 70fi. That means your earnings continue to grow tax-free. The other advantage is the ability to take certain early distributions without paying the early distribution penalty. In short, the Roth IRA makes it easier to keep your money in, and also easier to take your money out.

Eligibility

You can establish a Roth IRA if you're eligible for a regular contribution to a Roth IRA or a rollover (or conversion) to a Roth IRA.

You're eligible to make a regular contribution to a Roth IRA even if you participate in a retirement plan maintained by your employer. These contributions can be as much as $3,000 for 2004 or $4,000 for 2005 through 2006. (If you're 50 or older by the end of the year, add another $500 for 2004 and 2005, and $1,000 beginning in 2006.) There are just two requirements. First, you or your spouse must have compensation or alimony income equal to the amount contributed. And second, your modified adjusted gross income can't exceed certain limits. For the maximum contribution, the limits are $95,000 for single individuals and $150,000 for married individuals filing joint returns. The amount you can contribute is reduced gradually and then completely eliminated when your modified adjusted gross income exceeds $110,000 (single) or $160,000 (married filing jointly).

You can convert your regular IRA to a Roth IRA (in other words, make a rollover to a Roth IRA) if (a) your modified adjusted gross income is $100,000 or less, and (b) you're single or file jointly with your spouse. You'll have to pay tax in the year of the conversion, but for many people the long-term savings outweigh the conversion tax.

Distributions

Distributions from Roth IRAs are tax-free until you've withdrawn all your regular contributions. After that you'll withdraw your rollover (conversion) contributions, if any. Special rules apply when you withdraw your rollover contributions. When you've withdrawn all your contributions (regular and rollover), any subsequent withdrawals come from earnings. The withdrawals are tax-free if you're over age 59fi and at least five years have expired since you established your Roth IRA. Otherwise (with limited exceptions) they're taxable and potentially subject to the early withdrawal penalty.

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