Clothier & Head Tax Insight

Roth IRA's - Now and Later

Roth IRA's can be an important part of your retirement savings plan. Though no tax deduction is available for contributions to a Roth IRA, the investment growth is tax free. Unlike traditional IRA's, qualified distributions made after age 59-1/2 are completely tax-free, including all investment earnings. This could result in a significant tax savings in future years.

There are several different ways in which you can contribute to a Roth IRA. Each has its own limitations. Beginning in year 2010, one of those limitations expires, providing a new opportunity for certain "high income" individuals. The three ways to contribute into a Roth IRA are:

- Rollover contributions
- Annual contributions
- Roth 401(k) contributions

Rollover contributions

A rollover contribution represents a transfer of funds out of your traditional IRA into a Roth IRA. Prior to 2010, your adjusted gross income (AGI) reported on your income tax return for the year, must be less than $100,000 in order to qualify for such a rollover. If your AGI exceeds $100,000, you are precluded from making such a rollover. By undertaking a rollover, the future appreciation in your Roth IRA will be completely tax-free when distributed to you during retirement.

Beginning in 2010, the $100,000 AGI limit is removed, and regardless of your AGI level, you will be able to rollover a traditional IRA into a Roth IRA. This change allows high income individuals to fund a Roth IRA when they would normally be precluded from doing so.

There is a tax consequence for making such a rollover. In the year of the rollover, the dollar amount involved is subject to ordinary income tax. This tax must be considered during the process of deciding whether such a rollover should be made, and could be a large unexpected tax liability if not planned for properly.

Finally, for rollovers made during the year 2010 only, the amount included in income is spread evenly to tax years 2011 and 2012. As an example, if you rolled over $50,000 from a traditional IRA to a Roth IRA in 2010, you would report no additional income on your 2010 tax return. You would, however, report an additional $25,000 of income on both your 2011 and 2012 tax returns. This 2-year spread is automatic, but you can elect out of this treatment. By electing out of the 2-year spread, the entire $50,000 rollover would be includible as income on your 2010 tax return.

Annual contributions

For 2008, the Roth IRA contribution limit is $5,000 ($6,000 if you are age 50 or older). For 2009 and beyond, the annual contribution limits will be increased when the cost-of-living index warrants it. There are various limitations which could reduce or eliminate your ability to make such a Roth IRA contribution.

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To be eligible to make such a contribution, you must meet several requirements:

- You (and/or your spouse, if married) must have "earned income" (compensation or self-employment net income) for the year at least equal to the amount contributed.
- If single, and your adjusted gross income (AGI) reported on your income tax return for the year is more than $99,000, your contribution limit is reduced (phased-out) such that once your AGI reaches $114,000, you cannot make a Roth IRA contribution.
- If married and filing a joint return, once your combined AGI reaches $156,000, each spouses' contribution limit is phased-out such that no contributions are allowed once combined AGI reaches $166,000.
- If married and filing separate tax returns, allowable contributions are phased-out for AGI's between $0 and $10,000.
- Finally, you can make contributions to both a traditional IRA and a Roth IRA in the same year. However, the combination of contributions into both accounts cannot exceed the $5,000 ($6,000 if age 50 or older) limit for the year. Your contribution limit can be split between traditional and Roth IRA accounts in any combination of amounts, as long as you don't exceed the contribution limits in total.

Roth 401(k) contributions
If your employer maintains a 401(k) retirement plan, or is considering implementing one, they can add a Roth component to the plan itself. If this option is made available by your employer, you can choose between making normal tax-deferred 401(k) payroll deferrals, or Roth 401(k) payroll contributions, or a combination of both. As with Roth IRA contributions, Roth 401(k) contributions are not tax deductible. In addition, the total amount of your contributions split between normal 401(k)deferrals and Roth 401(k)contributions cannot exceed the annual dollar limits for contributions into a 401(k) plan. The single dollar limit on total contributions into a 401(k) / Roth 401(k) is $15,500 for 2008. For individuals age 50 or over, you have a total limit of $20,500.

The AGI limits which apply for making an annual Roth IRA contribution (as previously discussed), do not apply to Roth 401(k) contributions. As a result, high income individuals can make contributions into a Roth 401(k) account when they otherwise would be precluded from doing so.

Qualified Roth 401(k) distributions and related earnings are exempt from tax, while regular 401(k) distributions are not. Due to the differing tax treatment of the distributions, plan administrators will incur an additional burden (and cost) associated with separately tracking contributions into, and earnings on, Roth 401(k) accounts. As a result, many employers have been reluctant to add a Roth component to their 401(k) plans due to this additional administrative cost.

Roth IRA's, though not currently available to everyone, can have a significant impact on your retirement savings plan. With the law change scheduled for 2010 allowing rollovers of traditional IRA's to Roth IRA's, a change in your retirement savings plan may be in order. Please contact our office if you would like to discuss your unique situation.

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