

Q & A: Roth IRAs

If you are thinking about opening a Roth IRA (or already have one), it's not surprising if there are some gaps in your knowledge about them. Roth IRAs come with a host of requirements and limitations. The following are some of the questions that people often ask us, along with our answers:

Can anyone contribute to a Roth IRA?

No. It depends upon your "modified adjusted gross income" (MAGI). MAGI is your adjusted gross income (AGI) plus certain items that have been excluded or deducted from your income (and any foreign income that you may have). If you are married and filing a joint return, you can make the maximum contribution when your MAGI is no more than \$159,000. With a MAGI between \$159,000 and \$169,000, you can make a partial contribution. If you are single, you can contribute the maximum if your MAGI is no more than \$101,000; a partial contribution if it's between \$101,000 and \$116,000.

How much can I contribute?

This year you can contribute up to \$5,000. Next year, maximums are adjusted annually, indexed for inflation in \$500 increments. Plus, if you are age 50 or older, you are entitled to add an additional \$1,000 "bonus" contribution every year. (These same contribution limits apply to traditional IRAs, too.) At one time the higher allowable contribution limits of recent years were set to expire in 2010, but recent legislation has made them permanent.

Can I contribute to a Roth IRA even if I don't have enough income from employment, though my spouse does?

The general rule is that if you're married and file a joint return, you can contribute to a Roth IRA even if you have little or no income that qualifies you to make the contribution. Solely for the purpose of determining how much you can contribute, you'll be treated as if you had taxable compensation equal to your own qualifying income plus your spouse's qualifying income minus your spouse's contributions to a traditional or Roth IRA. Stated more simply, when either spouse works for a living and earns at least double the Roth IRA contribution limit, both spouses can contribute the maximum amount. The source of the money doesn't matter. Either spouse can make the contribution.

What is the deadline for making a Roth IRA contribution?

You can make contributions up to the deadline for filing your federal income tax return, but not including extensions. (Again, the rule is the same for traditional IRAs.)

How, then, do a traditional IRA and a Roth IRA differ?

Mainly, it's the tax treatment of contributions and distributions. With a traditional IRA, contributions may be deductible, but never with a Roth IRA. But as long as you meet certain conditions, distributions from a Roth IRA aren't taxed. In most instances, distributions from a traditional IRA are.

How do I know if a distribution from a Roth IRA is tax-free?

You can receive distributions of amounts that represent your original contribution at any time. Earnings and any amount converted from a traditional IRA to a Roth IRA (more on conversions later) may be withdrawn tax free and without penalty if: (1) you have owned your Roth IRA for at least five years and (2) you are at least age 59-1/2. These requirements are waived if you: become disabled; use the distribution to pay up to \$10,000 of certain first-time home-buying expenses; or are a beneficiary receiving distributions following the death of a Roth IRA owner. (Your Roth IRA assets must be distributed to your beneficiary at your death.)

Are there other advantages to a Roth IRA?

Definitely. With a traditional IRA, you must begin receiving distributions at age 70-1/2. With a Roth IRA there's no requirement that you must ever begin receiving them. Funds remaining at your death pass to the person whom you have named as the beneficiary of your Roth IRA free of income taxes. And your beneficiary can choose to spread out tax-free distributions over his or her own life expectancy.

What happens if I make a contribution to a Roth IRA during the year and later discover that I am over the income limit for making the contribution?

You will be facing a 6% "excess contribution" penalty. But you can avoid the penalty if you catch your error before your tax return is due. What you have to do is withdraw your contribution plus the earnings on that money by the due date of your return plus extensions. For 2007 returns that deadline is October 15, 2008. You must report the earnings as a distribution from your Roth IRA on your Form 1040 and pay tax on that amount (plus a 10% penalty if you are under age 59-1/2). You may, however, be able to avoid the tax and penalty if you can switch your 2007 Roth contribution plus the earnings to a traditional IRA before the deadline.

Can I move assets from my traditional IRA to a Roth IRA?

Possibly. Under current rules you can convert your traditional IRA to a Roth IRA, but only when your AGI does not exceed \$100,000. Strangely, the same cap applies for everyone. The amount that you convert to a Roth IRA is taxed as ordinary income in the year that you make the conversion.

For purposes of determining whether you exceed the \$100,000 limit, the amount that you convert is not counted. Nor does the conversion amount count in figuring your eligibility to make a contribution. But the conversion amount *does* have an impact on other tax issues relating to your AGI (for instance, medical and casualty loss deductions and the taxation of Social Security benefits).

Some good news: Beginning in 2010, there will no longer be an income cap on conversions. And just for 2010 conversions, you can spread your tax bill over two years.

Making IRA contributions is just one way to build sufficient resources for your retirement. If you would like to find out about other strategies for saving and investing for retirement, please feel free to contact us at any time.

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