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Managing Prosperity: Estate and Retirement Planning for All Ages

Roth Individual Retirement Accounts (IRAs)

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Roth IRAs are relatively new retirement investment plans for individuals. These plans have been available to U.S. taxpayers since 1998. With a few major exceptions, the rules for Roth IRAs are similar to the rules for traditional IRAs. Roth IRAs are different from traditional IRAs in four respects:

1. Contributions to Roth IRAs are not tax deductible
2. Earnings of a Roth IRA are tax free
3. You can continue to make contributions to a Roth IRA after age 70 1/2.
4. You do not have to begin withdrawing your money from a Roth IRA at age 70 1/2.

This bulletin answers some of the more frequently asked questions about Roth IRAs.

What is a Roth IRA?

A Roth IRA is an investment vehicle that provides federal tax payers with a tax-advantaged method of preparing for retirement. Like the traditional IRA, a Roth IRA is intended to allow individuals to provide a substantial portion of their retirement living needs.

Contributions to a Roth IRA come from after-tax income; thus, Roth IRA contributions are not tax deductible. However, all of the earnings of your Roth IRA are tax free as long as you established the account at least 5 years before you retire. Generally, you cannot withdraw funds from a Roth IRA before the age of 59 1/2 without facing an early withdrawal penalty.

Who can open a Roth IRA?

There is no minimum age limit for opening a Roth IRA. Anyone who earns "taxable compensation" during the year and has Adjusted Gross Income (AGI) of less than the established limit is eligible to open and make contributions to a Roth IRA. Taxable compensation simply refers to earned income, or income that is reported on Form W-2. Examples of taxable compensation include salaries, wages, commissions, self-employment income, and alimony received. Compensation does not include passive earnings such as rental income, interest income, dividend income, pension income or annuity income. AGI is simply your taxable income minus certain tax deductions, including items such as traditional IRA and SEP/Keogh contributions, medical savings account deductions, moving expenses, and one-half of your self-employment taxes. Your AGI is reported on Line 33 of Form 1040 (U.S. Individual Income Tax Return). The established limits (as of 2002) on AGI for opening a Roth IRA are as follows:

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Filing Status	Full Contribution	Partial Deduction
Married, filing jointly	< $150,000	$150,000-160,000
Married filing separately, and you lived with your spouse during the year	$0	$0-10,000
Single, head of household, or married filing separately and you did not live with your spouse during the year	< $95,000	$95,000-110,000

If your AGI is between the limits in the Partial Deduction column, you are not eligible to make a full contribution to your Roth IRA in that tax year; however, you are eligible to make a partial deduction (see IRS Publication 590 - worksheet 2.2 to determine your reduced Roth IRA contribution). If your AGI is greater than the above limits, you cannot make a contribution to a Roth IRA in that tax year.

What are the tax benefits of a Roth IRA?

Roth IRAs offer one significant tax benefit: **tax free earnings**

Tax Free Earnings: As long as you have held your Roth IRA account for at least 5 years by the time you retire, all of the earnings are tax free. That is, when you begin to withdraw funds from your Roth IRA, you will not have to pay income taxes on the amount you withdraw.

How much can you contribute to a Roth IRA in one year?

The maximum annual contribution to IRAs is the lesser of 100 percent of your compensation for the year or the amount shown below:

Tax year	IRA Limit	IRA Limit for tax payers age 50 and over
2001	$2,000	$2,000
2002	$3,000	$3,500
2003	$3,000	$3,500
2004	$3,000	$3,500
2005	$4,000	$4,500
2006	$4,000	$5,000
2007	$4,000	$5,000
2008	$5,000	$6,000

Thus, if you only earned $1,000 last year, the maximum Roth IRA contribution you can make is $1,000 for that tax year. Remember, you can still make contributions to a Roth IRA when you are over the age of 70 1/2.

In what assets can you invest Roth IRA contributions?

A Roth IRA is not an investment asset, it is a retirement investment plan. You must decide where your annual contributions are going to be invested. The most common investment assets for Roth IRAs are corporate stocks, bonds, mutual funds, and certificates of deposit (CDs). Realize that each of these assets has different potential returns and different levels of risk. In general, corporate stocks have higher historical earnings than other investments, but they are also more risky than the other investments. It is your responsibility to choose your investment assets. Don't hesitate to obtain professional advice if you are uncomfortable with financial decisions.

Are the funds in a Roth IRA guaranteed against loss?

The answer to this question depends on how you have your funds invested. Always remember the risk-return tradeoff – the higher the earnings potential of the asset, the higher the risk that you face. If all of your funds are invested in U.S. Treasury securities or CDs, then the funds are essentially guaranteed against loss. The downside to this strategy is that you will not receive a high rate of return, and inflation may actually reduce the purchasing power of your principal. To receive a higher rate of return, you will usually have to invest in higher risk assets, such as corporate stocks, bonds, or mutual funds. Realize that funds are "at risk" with these assets – you may lose all or part of your investment.

Can a non-working spouse make Roth IRA contributions?

Yes, as long as the working spouse received compensation (earned income) during the year. The maximum annual contribution for a non-working spouse is the lesser of $3,000 ($2,000 for tax year 2001) or the total compensation reported as gross income (minus any IRA contributions). This means that the maximum annual contribution for a married couple (under age 50) is $6,000 – that is, no more than $3,000 per person per year.

Can you make annual contributions that are less than the maximum allowed?

Yes. You do not have to make the maximum annual contribution. However, if you make less than the maximum contribution in one tax year, you cannot make more than the maximum contribution in a following year in an attempt to "catch up."

Once you start a Roth IRA, do you have to make contributions every year?

No. You do not have to make Roth IRA contributions every year, even if you are eligible.

Do you have to make a "lump sum" contribution one time per year, or can you make monthly contributions?

You may make Roth IRA contributions whenever you like throughout the year. You can make monthly contributions if you like. Regardless of how often you make your contributions, you must stay under the maximum contribution limit.

What is the deadline for making Roth IRA contributions for a certain tax year?

Contributions for a certain tax year must be made by the deadline for filing your federal income taxes. This deadline is usually April 15 of the following year. For example, if you would like to make an IRA contribution for tax year 2002, the last possible date that you can make your contribution is April 15, 2003.

When can you withdraw funds from a Roth IRA?

You may withdraw funds from a Roth IRA without penalty at age 59 1/2. You will not have to pay income taxes on the amount you withdraw from your account. For example, assume you are 60 years old and you withdraw $10,000 from your Roth IRA. You will owe no federal income taxes on the $10,000.

Unlike a traditional IRA, you do not have to begin withdrawing funds from a Roth IRA at age 70 1/2.

What are the penalties if you withdraw money from a Roth IRA before the minimum age?

Generally speaking, if you withdraw funds from a Roth IRA before the age of 59 1/2, you will incur an early withdrawal penalty plus ordinary income taxes on the earnings withdrawn (market value - annual contributions). The early withdrawal penalty is 10 percent of the amount withdrawn. For example, assume you are 50 years old, in the 15 percent tax bracket, and you withdraw $10,000 from your Roth IRA this year. You will owe $1,000 in early withdrawal penalties and you may owe income tax on the earnings portion of the $10,000 withdrawal. Use IRS Form 5329 to report the additional taxes you might owe on early withdrawal from a Roth IRA.

There are exceptions to the age 59 1/2 rule. You may be able to withdraw funds from an IRA before age 59 1/2 in the following situations:

- you have un-reimbursed medical expenses that are more than 7.5 percent of your adjusted gross income
- the withdrawals are less than the cost of your medical insurance
- you are disabled
- you are the beneficiary of a deceased IRA owner
- you receive your withdrawals in the form of an annuity (constant payments over a specified period of time)
- the withdrawals are less than your qualified higher education expenses
- you use the distributions to buy, build or rebuild a first home (up to $10,000)

Can children have a Roth IRA?

There is no minimum age limit for opening a Roth IRA, so children may open an IRA if they earned income during the year. The income they earn must be consistent with the job/duties they perform.

Can you convert funds from another retirement plan into a Roth IRA?

You can convert funds from a traditional IRA, a SEP-IRA, and/or a SIMPLE-IRA into a Roth IRA. By "rolling" funds from another IRA into a Roth IRA you will not be subject to the 10% early withdrawal penalty. However, you must report the taxable portion of the rollover funds as income during the year the conversion is made. You will owe federal and state income taxes on the taxable portion of the rollover. You do not have to convert all of the funds from a traditional IRA into a Roth IRA in the same year – you may extend the conversion process over several years.

The process of converting funds from a SIMPLE-IRA to a Roth IRA is similar to the process of converting a traditional IRA to a Roth IRA. However, you cannot convert any funds from a SIMPLE-IRA within the first two years of participation in the SIMPLE-IRA plan maintained by your employer.

Where can you open a Roth IRA?

You can open a Roth IRA at commercial banks, federally-insured credit unions, savings and loan associations, or any entity approved by the IRA to act as a trustee or custodian. This includes certain investment brokers and insurance agents. Make sure that you specify the tax year for which you are making the contributions. For example, if you make an IRA contribution on March 1, 2003 for tax year 2002, be sure the contribution form clearly indicates that your contribution is for tax year 2002.

Can you have a traditional IRA and a Roth IRA at the same time?

Yes. You may have a traditional IRA and a Roth IRA at the same time. Further, you can make contributions to a traditional and a Roth IRA in the same year. However, your total annual contribution to IRAs (traditional and/or Roth) cannot exceed the maximum allowable contribution ($3,000 for tax year 2002). For example, in tax year 2002, you may contribute $500 to your traditional IRA and $2,500 to your Roth IRA in the same year.

Can you have more than one Roth IRA?

Yes, you may have as many Roth IRAs as you like. However, total annual contributions to all IRAs (traditional and/or Roth) cannot exceed the maximum contribution limit per year. For example, assume you have a Roth IRA with a bank and another Roth IRA with a savings and loan. If the maximum annual contribution you can make is $3,000, you can contribute $1,500 to each Roth IRA, or $2,000 to one and $1,000 to the other, or any combination that does not exceed $3,000 in one year.

Can you have other retirement investments and Roth IRAs at the same time?

Yes. As long as you are eligible to open or make contributions to a Roth IRA, you can have a Roth IRA at the same time you participate in other retirement plans, such as traditional IRAs, 401(k)s or SIMPLE-IRAs.

Are Roth IRA contributions eligible for the Saver's Tax Credit?

Yes, as long as you are eligible for the saver's credit for tax years beginning after December 31, 2001. The saver's tax credit is a nonrefundable income tax credit for eligible taxpayers who make voluntary contributions to qualified retirement plans. An income tax credit directly reduces your annual income tax liability. This means that you may be able to reduce your annual income taxes by making a contribution to a Roth IRA. See IRS Publication 553 "Highlights of Tax Changes" for more information.

Watching your IRA grow

Time is your best friend in investing. The earlier you start, the larger your IRA will be when you retire. The following table illustrates the potential growth of $2,000 annual contributions to investment assets with various average annual rates of return. Please note that investments that earn higher rates of return tend to be more risky.

Further Information

For further information about Roth Individual Retirement Accounts (IRAs), see the following sources:

Individual Retirement Arrangements (IRAs). Publication 590. Department of the Treasury, Internal Revenue Service. 2001.

IRS – The Digital Daily website:
http://www.irs.gov/cover.html

Virginia Department of Taxation website:
http://www.tax.state.va.us/index.htm

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Years to Retirement	Average Annual Rate of Return 3%	6%	9%	12%	15%
5	$18,496	$20,110	$21,848	$23,720	$25,734
10	$47,625	$55,449	$64,694	$75,616	$88,517
15	$86,332	$108,160	$136,557	$173,582	$221,921
20	$136,673	$184,674	$253,651	$353,348	$497,998
25	$201,561	$294,167	$441,530	$678,533	$1,062,377
30	$283,346	$447,863	$738,428	$1,260,149	$2,206,834
35	$386,312	$662,404	$1,204,868	$2,295,602	$4,520,077
40	$514,989	$959,698	$1,933,680	$4,132,586	$9,186,100