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What is a Roth IRA?

NewsCore

A Roth IRA is an individual retirement account that offers many tax benefits to the future retiree. If you qualify, consider taking advantage of this savings vehicle.

How it operates

Unlike a traditional IRA where contributions are taxed upon withdrawal, contributions to a Roth IRA are made with "after-tax" dollars. Account holders do not pay taxes on withdrawals made in retirement.

The two options within a Roth IRA include a contributory Roth and a conversionary Roth. To use a contributory Roth, an investor must have an earned income. Retirees who no longer have an earned income can convert a traditional IRA or a 401(k) into a conversionary Roth. "By doing so, the retiree will pay taxes at their bracket level and then the money will grow tax-free in the account as long as they have it," explains Jean Dorrell, Certified Estate Planner and founder of Senior Financial Security in Ocala, Fla.

According to Jason Kolinsky, of New Jersey-based Kolinsky Wealth Management, contributions to a Roth IRA may be withdrawn tax free at any time.

Rules and requirements

To contribute to a Roth IRA, your modified adjusted gross income (AGI) must be less than the annual limit.

In 2012, a person may contribute a maximum of $5,000 if his or her filing status is single and AGI is less than $110,000 a year, says Ryan Louie, Certified Financial Planner and Wealth Manager at Ford Financial Group in Fresno, Ca.

Your modified AGI must be less than $173,000 if married and filing jointly.

Those over 50 can contribute an additional $1,000 as a "catch-up" contribution for a total of $6,000.

Benefits and drawbacks

Louie points out a traditional IRA simply defers income taxes until later in hopes that a lower tax rate will apply, whereas a Roth IRA investor will never pay taxes on gains.

A Roth IRA further allows those aged 70 ½ or over to continue making contributions and offers no minimum distribution requirements.

Even if an individual already participates in a qualified retirement plan such as a 401k, he or she is still capable of making contributions to a Roth IRA, says Kolinsky.

He adds, "you won't miss the upfront tax deduction and you will benefit from tax-deferred, compounded growth and tax-free withdrawals."

If for some reason you need the money prior to retirement, you can always withdraw the principal you invested without paying any income tax.

However, while original contributions may be withdrawn tax free, be aware that withdrawing investment earnings early makes them taxable and elicits a 10% early withdrawal penalty. Earnings may only be withdrawn tax free in cases of death, disability, a first time home purchase or if the individual is age 59 ½ or over.

If you are in a high tax bracket now, but you expect to be in a lower one at retirement, you could end up paying more in taxes overall with a Roth IRA. In this scenario, a traditional IRA might make more sense for you, Louie advises.

What to consider when deciding where to open a Roth IRA

"Fees can impact the growth of any investment dramatically so reviewing the fees before opening your Roth IRA account is important," Kolinsky counsels. He adds that many banks, brokerage houses and online trading firms charge sizable annual fees and commissions to open and maintain an account.

Dorrell recommends working with a brokerage firm if investors are interested in having advisory and investment advice on Roth IRAs, but she reminds potential account holders that many firms require around $10,000 to start the Roth account.

"For investors who may not want this advisory, they can open an account at a bank and have no minimum premium requirement," she suggests.

Jean Dorrell, CEP and founder of Senior Financial Security, (The Villages, Fla.) has more than 20 years of experience working directly with seniors on a variety of financial issues. Her expertise lies within tax services, retirement and estate planning, annuity selection and wealth management.

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