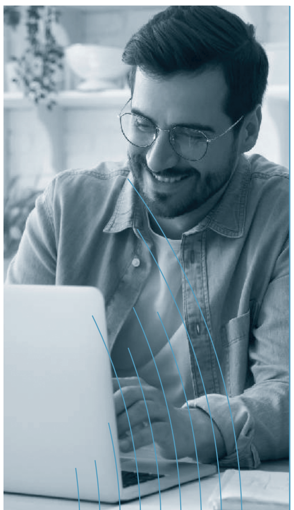
HBKS® Wealth Advisors

Making Sense of Roth IRAs



The Yes, No, Maybe Retirement Account

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ONE OF THE MOST COMMON QUESTIONS I've been asked throughout my career in financial planning and investment management is, "Should I contribute to a Roth Individual Retirement Account (IRA) this year?" The question is straightforward enough; you might expect an answer as simple as "yes" or "no"— that is, if considerations about taxes, IRS rules, estate planning, and investment management did not matter.

Roth IRAs are not complicated. Their most widely publicized rules, such as the annual contribution and catch-up limits, are relatively easy to understand and familiar to investors and savers at all levels. However, determining if a contribution makes sense, or more importantly, if it is permissible in a given year, is a little more complex. Certain questions and considerations must be addressed to prevent mistakes and potentially costly penalties related to Roth IRAs.

A few of the many factors to consider prior to making your next retirement account contribution:

MARGINAL AND EFFECTIVE TAX RATES

No one likes paying taxes. While Traditional IRAs give you an immediate tax benefit by reducing your current taxable wages, Roth IRAs provide a substantial opportunity to accumulate tax-free savings for the future. Determining which is best for you partially depends on the earned income reported on your tax return. It also is important to consider future tax rates. Our goal is to plan well enough to pay the least amount of taxes legally allowed.

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MARITAL STATUS

Maximum contributions to IRAs are the same for everyone, but there are several rules and limitations that apply. The way you file will determine how much you can contribute, or if you are eligible for a spousal Roth IRA, even if your spouse does not work outside of the home and does not have earned income. Can you make a full contribution? Or are you subject to a phase-out? Adhering to these rules and filing the proper forms annually with your tax return are critical to ensuring your Roth account remains compliant and up to date.

EXISTING IRAS

With a little creative planning almost anyone can contribute to a Roth IRA. Even those with adjusted gross incomes (AGIs) greater than the phase-out amount can participate, though they might need to do some technical maneuvering to get funds into a Roth. Advanced planning is absolutely necessary for people in the highest marginal tax brackets. It is also critical for those with existing pre-tax IRAs, or IRAs with after-tax basis.

WORKPLACE PLANS

Workforce plans are an option for retirement savers otherwise blocked from making Roth contributions. Many employers' defined contribution plans offer a Roth 401(k) option. It's a relatively new option, legislated into existence in 2006, so not available in all plans, but it is growing in popularity and being included more in employer-sponsored plans. A Roth 401(k) is not subject to the same set of rules that govern Roth IRAs, and anyone with a workplace plan that provides the Roth option can contribute their portion of the payroll deferral to the Roth account within their plan. Many employers offer something called "after tax" contributions and some provide for in-plan Roth conversions that allow employees to save more on an after-tax basis. This strategy has been effectively nicknamed the "mega backdoor Roth IRA."

Funding a Roth IRA is never a bad move from a financial planning perspective — unless you do it the wrong way.

If you expect tax rates to increase in the future and are considering using some of your accumulated savings to fund a retirement account this year, it is worth spending time reviewing your personal circumstances. Funding a Roth IRA is never a bad move from a financial planning perspective — unless you do it the wrong way. If you do, it can become an expensive error and create headaches for you down the road. When done correctly, the Roth IRA is one of the most flexible retirement accounts both for you as owner and retiree, and later, your beneficiaries.

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