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The Misunderstood Roth IRA
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The misunderstood Roth IRA

Every year, millions of taxpayers decide to fund an Individual Retirement Account. Unfortunately, many of them pick the wrong one.

Ed Slott, an IRA expert and CPA in Rockville Centre, N.Y., sees this mistake all the time. "People have it ingrained that 'Deductible is good,'" he says. "So they choose a deductible IRA."

In the vast majority of cases, a Roth IRA would be a far better choice. "You really can't lose" with a Roth, says Slott, who steers clients of all ages toward this choice whenever possible.

The big difference: tax-free income in retirement

With a Traditional IRA, qualifying taxpayers can deduct contributions of up to $2,000 a year from their taxable income.

But the tax you didn't pay isn't forgiven — it's just postponed, along with tax on whatever your contributions earn. When you start making withdrawals in retirement, you'll have to cough up those deferred taxes.

By contrast, $2,000 annual Roth IRA contributions aren't deductible. But everything these contributions earn over the years is tax-free — so there's no tax bill at all in retirement.

With no tax on its earnings, a Roth IRA can grow exponentially bigger than a Traditional IRA, Slott points out. "People are shortsighted," he laments. "They can't get it through their heads that they're better off paying the tax now and leaving the back end to grow tax-free."

The pitfalls of IRA comparisons

In comparison charts and calculators, tax-deductible IRAs sometimes seem to beat Roths because of two assumptions:

- **Your tax bracket in retirement.** If your tax rate drops, it could pay to postpone taxes with a Traditional IRA. But Slott says, "In my experience, almost all retirees have more income, not less, than they did before."
- **Traditional IRA owners will invest their tax savings.** When they do, this gives deductible IRAs an extra edge. But these savings add up to only $300 a year if you're in the 15% tax bracket, or $560 in the 28% bracket. "That's just $5 to $10 a week — maybe enough for a movie ticket," observes Slott. "It's unlikely that you're going to save it."

Roth IRAs will spare you hassle later, too

When Traditional IRA owners reach age 70½, a shock awaits: the IRS will compel you to take required minimum distributions (RMDs) designed to empty the IRA during your lifetime.

There are several ways to calculate an RMD, which must also be refigured every year. It adds up to a headache at a time of life when you hoped for less hassle, not more.

"With a Roth IRA, you don't have to take distributions at all," Slott says. Your money can continue compounding tax-free — an advantage that makes converting a Traditional IRA to a Roth IRA worthwhile even for retirees, who can potentially benefit from another 10 to 30 years of growth.

In consultations and in his monthly IRA newsletter*, Slott also advises conversion for "anyone who cares about their beneficiaries." (You must have individual or joint income of $100,000 or less.) This could allow you to leave your IRA to your children income-tax-free, in contrast to the tax bill they'd otherwise inherit.

Still of two minds whether or not to take the deduction? Slott says it comes down to a simple question: When you retire, would you prefer to pay tax, or not to pay tax?

"The Traditional IRA doesn't hold a candle to the Roth," he sums up. "I can't see any situation where it's better."

* *Ed Slott's IRA Advisor*, 1-800-663-1340 or www.irahelp.com ($79.95 a year)

You can open a Roth IRA at any age if you have:

- Earned income from employment or self-employment
- Total income* under $95,000 (single filers) or $150,000 (joint filers). (Partial contributions are allowed with income up to $110,000 for single filers, and $160,000 for joint filers.)

The maximum contribution is $2,000 a year (in a Roth IRA or any combination of Roth and Traditional IRAs).

* See your Form 1040 Instructions for details on how this is calculated.

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5 things most people don't know about Roth IRAs

1.You can usually save much more in taxes with a Roth than by deducting a Traditional IRA

2.Subject to income limitations (see box), you can open a Roth IRA even if you're covered by an

3.You don't have to file any annual paperwork with the IRS. (Your IRA custodian does it all.)

4.You won't have to take required minimum distributions from a Roth IRA. Ever.

5.Even retirees can benefit from the tax advantages of converting a Traditional IRA to a Roth.