Roth IRAs Are for Rich People, Too

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New Tax Law Opens Participation to Upper-Income Households

Throughout history rulers and governments have taken a share of their constituents’ earnings through taxation, and those who didn’t pay up have suffered penalties as serious as banishment and death. Even before there was money, Egyptian peasants were expected to give the pharaoh a portion of their crops or some of their time.

In fact, our own country the United Sates of America owes its existence in part to a tax revolt. The colonies were already fed up with England’s Stamp Act when the crown tried to tax tea. They responded by forming a revolutionary army and going to war for independence. These days, tax-free opportunities tend to be fairly rare. Yet such an opportunity exists in the U.S tax code, and it is nothing if not underused. A mere 4% of the $4.3 trillion held in IRAs is in Roth IRAs. One reason why the Roth IRA is not more popular might be because participation is subject to certain income and contribution restrictions that make it off-limits to more high-income households. However, one of the most restrictive Roth IRA limits is scheduled to be repealed soon.

Decision 2010

The Pension Protection Act 2006 repealed a rule preventing files with adjusted gross incomes exceeding $100,000 from converting tax-deferred retirement assets to a Roth IRA. Although the repeal doesn’t take effect until 2010, you may want to begin investigate now whether a conversion would be appropriate for you. Any earnings in Roth IRA are typically free of federal income taxes and penalties as long as they are withdrawn after age 59½ and the account has been in place for at least five years (except in cases of death, disability, or a first-time home purchase up to a $10,000 lifetime maximum). Because a Roth IRA can be funded only with after-tax dollars, a Roth conversion requires that you pay income taxes on the amount you are converting. The amount you convert in a given year is included in your gross income when you calculate your taxes. You can convert the assets all at once or over multiple years. One drawback is that if you use tax-deferred assets to pay taxes on the conversion before you reach age 59½, it would be considered an early distribution and would be subject to a 10% federal income tax penalty. Believe it or not, today’s top federal marginal income tax rate is low by historical standards. If you expect that tax rates will be higher when you are retired, you may want to consider converting to Roth IRA. Before you take any specific action, be sure to consult with your tax professional.

Check Your Progress

The table below shows the median amounts that workers of different ages and income levels have in their 401 (k) plans. As you compare these amounts with your own retirement savings progress, remember that qualified withdrawals from tax-deferred retirement plans are taxed as ordinary income. How much would you have left after income taxes?

Median 401(k) Account Balances

Salary Range	Age 40-49	Age 50-59	Age 60-69
\$20,000-\$40,000	\$58,957	\$76,788	\$64,147
\$40,001-\$60,000	\$78,834	\$99,932	\$97,588
\$60,001-\$80,000	\$132,531	\$163,935	\$160,051
\$80,001-\$100,000	\$196,592	\$243,382	\$237,303
More than \$100,000	\$290,349	\$367,413	\$350,576

Source U.S News & World Report, August 2007

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