INVESTOPEDIA

Top 10 Mistakes To Avoid On Your Roth IRA

By Lita Epstein | April 10, 2015

You may think the only thing you have to know about a Roth IRA is that your contributions are limited to $5,500, if you are under the age of 50, and $6,500 if you are 50 or over. It's a lot more complicated than that.

But, first let's take a quick look at the key difference between a Roth IRA and a traditional IRA. Contributions to a Roth IRA are not tax deductible, but when you withdraw the money, withdrawals on both contributions and the gains are tax-free. The traditional IRA is tax deductible, but when you withdraw the funds they are taxed at your current tax rate (see *Roth Vs. Traditional IRA: Which Is Right For You?* for more details).

If you decide on a Roth, here are the 10 most common mistakes people with Roths are likely to make.

1. NOT EARNING ENOUGH

You cannot contribute more to a Roth IRA than you actually earned in income. This income can come from wages, salaries, tips, professional fees, bonuses and other amounts received for providing personal services. You can also consider earnings from commissions, self-employment income, nontaxable combat pay, military differential pay, and taxable alimony and separate maintenance payments. If your earnings come from other types of income – such as dividends, interest or capital gains – they cannot be used to determine your allowable Roth contribution. You can contribute to a Roth up to allowable limits for both you and your spouse as long as you file jointly and one of you makes enough eligible income to fund the contribution.

The IRS uses Modified Adjusted Gross Income (MAGI) to calculate what you can contribute. When calculating MAGI, income is reduced by certain deductions such as contributions to a traditional IRA, student loan interest deduction, tuition and fees deduction, or foreign earnings deduction. If your income level is close to your planned Roth contribution be sure to review IRS rules for MAGI to make sure you stay under the limit.

2. EARNING TOO MUCH

You can earn too much to contribute to a Roth IRA. People who are married must make less than $183,000 if married filing jointly or a qualifying widow(er) in 2015. If you earn between $183,000 and $193,000, you may be able to contribute some money but the amount will be reduced. IRS Publication 590-A includes a worksheet to figure out your reduction. Above $193,000 no contribution is allowed. Income limits are adjusted each year by the IRS.

Taxpayers filing as single; head of household; or married, filing separately (who did not live with their spouse at any time during the year) can contribute to a Roth IRA as long as they earn less than $116,000. If they earn between $116,000 and $131,000, their allowable Roth contribution is reduced. Above $131,000 no Roth contribution is allowed.

3. CONTRIBUTING TOO MUCH

If you have more than one IRA, you can make the mistake of contributing more than the allowable maximum. This can cost you a penalty of 6% on the excess each year after that mistake. You can avoid the penalty as long as you discover the mistake before filing taxes and take it out of the account. You can also avoid the long-term penalty by carrying over that contribution to another tax year, but be sure to document that with the IRS.

4. FILING TAXES SEPARATELY

Filing taxes separately from your spouse can be costly in many ways. You lose all types of deductions and others are reduced. As long as you earned more than $10,000 and lived with your spouse at any time during the year that you file separately, you lose all rights to take advantage of a Roth IRA. If you made less than $10,000, you may be able to make a reduced contribution to the Roth IRA.

5. BREAKING THE 365-DAY IRA ROLLOVER RULE

Beginning in 2015, you will only be able to roll money from one IRA into another IRA once over a 365-day period. This affects all IRAs you hold, so be very careful when you are planning to make a change. Previously, the rule was once a year, but now the year it occurs does not matter. It is based solely on a 365-day period. “Some people can lose their entire IRA because they did two rollovers in a year and didn't realize it," says Ed Slott, author of “The Retirement Savings Tax Bomb...and How to Defuse It.”

6. CHOOSING THE WRONG TYPE OF ROLLOVER

You may not realize it, but there are many different ways to roll over an IRA and small technical mistakes can result in penalties or an unnecessary tax hit. Various mistakes can be made with each type of rollover, especially if you choose the wrong type for your individual financial situation. The details are too complicated for this brief overview, but you can learn more about the potential problems at STA Wealth Management.

7. ROLLING OVER THE MONEY YOURSELF

Given the potential mistakes of choosing the wrong rollover, it’s always best to seek financial advice either from a fee-based financial advisor or from your IRA trustee. Always avoid rolling over the money yourself (taking out the money by check and then depositing it somewhere else). So many things can go wrong.

The most common mistake is missing the 60-day deadline because you used the cash for something else and then didn’t have enough to make the full contribution on time. If you do choose to do it yourself, be sure to be meticulous about documenting the transfer in case the IRS questions it. If you can’t prove you made the transfer, you will pay taxes and penalties on the money transferred. Your best bet is to do a custodian-to-custodian (also called trustee-to-trustee) transfer, then make sure the funds have been transferred into the type of IRA you chose. For more, see *Guide To 401(k) And IRA Rollovers*.

8. MISSING OUT ON A ROTH IF YOU EARN TOO MUCH

As indicated above you can make too much money to contribute to a Roth, but all is not lost. You may be able to contribute to a non-deductible IRA, which is available to anyone no matter how much they make. This money is contributed using money that has already been taxed and there are no limits on the amount that can be contributed or the income you are permitted to have.

You must immediately convert this non-deductible IRA into a Roth IRA before there are any earnings on the money. Advisors recommend that you deposit the money into a low interest earning IRA account initially to minimize the chance it will earn any income before you transfer it (so you don’t raise any questions about transferring earnings). You could be stuck with a tax bill if you have another traditional IRA or a 401(k) with your employer, so get financial advice before trying this strategy. For more, see *How can I fund a Roth IRA if my income is too high to make direct contributions?*

You do have the option of converting a 401(k) or traditional IRA to a Roth IRA. The advantage of this move is that any earnings after the conversion will no longer be taxable. The disadvantage is that you must pay tax based on your current earnings for any money converted. If you do plan to use this strategy work with a financial advisor to be sure you don’t make a mistake. See *Converting Traditional IRA Savings To A Roth IRA*

9. NOT REBALANCING YOUR ACCOUNT

The market will rise and fall over the many years that you'll hold your IRA. Start by settling on an allocation that fits your tolerance level for the ups and downs. Generally today advisors recommend that the growth portion of your portfolio should be 110 or 120 minus your age. So if you are 30, the percentage of your portfolio in growth stocks should be 80% or 90%. It's wisest to have a mixture of stocks from companies of different sizes and of investments in different industries. Mutual funds can help you get the proper mix if you have a small portfolio or you don’t have the time to research and pick stocks. (For more, see our tutorial *Mutual Fund Basics*.)

As the market shifts, you may find that you've made too much money in one area and that your portfolio is no longer balanced. It’s a good idea to review your asset allocation once or twice a year (not more frequently because you don’t want to react to short-term market swings). For help with this, see *The Best Portfolio Balance*. Remember that account holders and their spouses don't pay taxes on the income from their Roth investments.

10. NOT TAKING RMDS IF YOU INHERIT A ROTH

Money withdrawn from Roth IRAs is generally not taxable, but that’s only true for the original owner of the IRA or his or her spouse. If you inherit an IRA from someone who is not your spouse, you will have to take required minimum distributions (RMDs), similar to those of a traditional IRA or 401(k).

The IRS penalty for not following the RMD rules can be as high as 50% of the money not withdrawn that was supposed to have been taken out. So if you are lucky enough to inherit a Roth IRA, but sure to review the withdrawal rules with your financial or tax adviser.

THE BOTTOM LINE

Having a Roth can provide a bonanza of retirement benefits for yourself and your heirs. Don't undermine those perks by tripping up on the many rules that determine who can have a Roth and how account holders have to manage the funds.