Myths abound when it comes to investing in an IRA

by Lynn O'Shaughnessy

In so many ways, the Individual Retirement Account is exquisitely simple. If you can recite your ABC's without hesitating, or even if you can unfold a napkin, you have enough intellectual firepower to open an IRA.

Despite their simplicity, however, IRAs intimidate many Americans. And that's one reason why IRA opportunities have been passed by more times than a dirty truck stop. To be sure, there is $3.7 trillion sitting in IRA accounts today, but nearly half of that money came through rollovers from 401(k) plans.

In hopes of drumming up more interest for this retirement wallflower, I'm going to address some of the most stubborn IRA myths. Here goes:

Myth No. 1: The traditional deductible IRA is best, because I can pocket a tax deduction.

Snagging a tax break can be tantalizing, especially at this time of year, but the Roth IRA is a better bet for just about anybody who qualifies. Once you understand how each IRA works, you'll probably come to the same conclusion.

With a traditional deductible IRA, you can happily capture a tax deduction. If you put $4,000 into one of these IRAs and you're in the 15 percent tax bracket, for example, you'd earn a $600 tax deduction. But when you withdraw this money during retirement, you'll pay income taxes on all this loot. And the federal government, impatient with all the years you've hoarded the money, will require that you begin siphoning the account shortly after reaching the age of 70 1/2.

With a Roth, you won't be handed an upfront tax break, but you will be amply rewarded for your delayed gratification. The money grows tax-free, and the government will not force you ever to disturb your Roth stockpile. What's more, if you do eventually tap into the account, you will owe no federal taxes at all. For either of these IRAs, income limitations exist, but the most inclusive IRA is the Roth, which the vast majority of taxpayers will qualify for.

Myth No. 2: If I make too much to contribute to a Roth, it's definitely not worth bothering with an IRA.

Not so fast. It's true that the wealthiest among us have been excluded from the Roth party. But Congress opened the door a crack last year when it passed legislation that will allow rich investors an indirect way to move cash into a Roth.

Beginning in 2010, anybody, regardless of their financial girth, will be able to convert a traditional IRA into a Roth. Wealthy investors, who are giddy at the prospects of shielding their money from future tax hits, are now shoveling money into traditional nondeductible IRAs. Among IRAs, the nondeductible traditional IRA is the ugly duckling, which is why you rarely hear anything about it. Investors receive no tax deduction for their contribution, but as long as the money remains in its IRA cocoon, no taxes are owed.

So far the nondeductible IRA sounds like a Roth, but here's the crucial difference: Unlike the Roth, when money is taken out of a nondeductible IRA, the cash is hit with income taxes. Sophisticated investors don't care about this blemish because in three years, they plan to escort all this money into a Roth. They will have to pay tax on the assets after making the switch, but frankly it should be well worth the expense. The Roth is an excellent way to diversify a family's tax burden and protect assets from future tax increases.

Myth No. 3: I can't contribute to my 401(k) and an IRA.

I was surprised to learn how many people believe this fallacy. In a recent survey, Fidelity Investments concluded that 48 percent of Americans who don't possess an IRA think they can't contribute to both types of plans in the same year.

Ideally, people should invest in a 401(k) plan and a Roth. But for many workers it's going to be tough financially to pull this off. So what should they do? Consider tossing enough money into a 401(k) to capture any employer match and then divert the rest of your cash to a Roth IRA.

This same misconception also extends to the self-employed workers, who assume that they can't contribute to a Roth or a traditional IRA if they put money into a SEP-IRA, which is a retirement account for the self-employed and small businesses.

Actually, self-employed people, like myself, can often stash away even more acorns for their retirement than the working stiffs tied to a 401(k). Using a federal formula, an investor might be able to contribute up to $45,000 this year. Your tax preparer should be able to tell you how much you can kick in - that's whom I rely upon - or many financial institutions provide SEP-IRA calculators on their Web sites.

Myth No. 4: You need thousands of dollars to open an IRA.

It's true that you can stuff a lot of money into an IRA. This year, the contribution limit for someone who is at least 50 is $5,000, while the ceiling drops to $4,000 for everybody younger. You certainly won't need this much cash, however, to open an account. Fidelity Investments, for instance, waives its $2,500 minimum to open an IRA account if you agree to automatically deposit $200 a month into your IRA. You should be able to find plenty of mutual funds that will ignore their stated minimums if you sign up for automatic monthly deposits of as little as $50.

If you're just getting started with an IRA, you might want to consider investing in a low-cost umbrella mutual fund so that you can get instant exposure to many different investments. For instance, Vanguard STAR - which has a $1,000 opening minimum - invests in 11 underlying Vanguard funds. Another option is T. Rowe Price Spectrum Growth, which provides the same kind of access to nine of the fund family's mutual funds. Meanwhile, Charles Schwab has just announced its online "15-Minute IRA," which can hook you up with a Schwab target mutual fund that is appropriate for your age.

Only 15 minutes? See, I told you it was easy.

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