Basics of Roth IRAs (2nd of 3 articles)

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Last month's newsletter article covered traditional Individual Retirement Accounts (IRAs). This month, we will explore a variation of these retirement accounts known as Roth IRAs. Roth IRAs are similar in many ways, but the tax benefits work in reverse, i.e., contributions to the plan are not deductible, but qualifying withdrawals at retirement are completely tax-free.

Contribution Limits

Generally, you must have earned income (i.e., income subject to social security taxation) or receive alimony to be eligible to fund any IRA. Non-working spouses filing jointly may "piggy-back" on income earned by the working spouse. The maximum contribution to both types of IRA combined is $5,500/year ($6,500 if at least 50 years of age) OR earned income, whichever is less.

Contribution Eligibility

Eligibility to make Roth contributions phases out completely for married taxpayers filing jointly with adjusted gross income above $196,000 ($133,000 for single). Whereas taxpayers may still be able to make non-deductible contributions to a regular IRA, even if their income is too high, Roth contributions are simply not allowed if income exceeds these limits. Unlike traditional IRAs, Roth IRAs can be made even after you reach 70-1/2, assuming you receive earned income.

Tax-Free Buildup

Like a regular IRA, income and gains are not subject to tax inside the account. At retirement, qualified Roth IRA distributions are exempt from tax. By comparison, traditional IRA distributions are reported as ordinary income, which is subject to tax at the same rates as wage income.

Distributions Tax-Free

Qualified distributions from a Roth – typically those that are made from a Roth account that has existed for at least five years, and distributed after you reach age 59-1/2, or due to disability, or to a beneficiary after the owner's death -- are fully excluded from the recipient's gross income. Early distributions from either type of IRA may be subject to a 10% penalty tax, calculated on the taxable portion of the distribution. For a traditional IRA, that would generally mean the entire amount distributed, but for a Roth IRA, it's only the part of the distribution that represents earnings and appreciation on your contributions.

No Lifetime "Required Minimum Distributions" (RMDs)

Unlike traditional IRAs and employer retirement plans, Roth IRAs are not required to make minimum distributions once the participant reaches age 70-1/2. This may be an appealing feature for taxpayers who prefer to use these accounts to accumulate wealth to pass on to their heirs. On the death of the original owner, the beneficiary (other than the surviving spouse) will be required to begin taking RMDs, based on life expectancy.

Roth Conversions

The income limits on contributions significantly limit the ability of many taxpayers to fund Roth IRAs. Luckily, there are other ways to direct assets into a Roth IRA. Funds held in a regular IRA, or even those in an employer-sponsored retirement plan, may be rolled-over to a Roth IRA. The amount converted from a traditional plan to a Roth is treated as a distribution, subject to income tax, but is not subject to any early withdrawal penalty. Because the amount converted is included in gross income, the taxpayer needs to have additional non-IRA funds available to pay the resulting tax. However, once the tax is paid, the Roth IRA grows without tax, and ultimately provides tax-free funds in retirement, or to your heirs.

Income Tax Considerations

A Roth conversion may create a significant increase in income tax liability to the extent that such a conversion will not make financial sense. However, a Roth conversion is not "all or nothing"; you can convert only a portion of your regular IRA. This approach may work well in a year in which you experience a business loss or lower than usual income from other sources. Also, a Roth conversion can be "re-characterized" before the due date of your tax return, thus effectively returning your retirement funds to your regular IRA and eliminating any tax on conversion should you change your mind.

Opportunities for Minor Children and Students with Jobs

If your son or daughter receives wages (including from a family-owned business), you can establish a Roth IRA for the amount of taxable wages or $5,500, whichever is less. Consider the advantages of lifetime tax-free accumulation and eventual tax-exempt distributions from that IRA, in addition to the opportunity you have to begin teaching financial acumen!

Cautionary Note

The tax rules governing retirement benefits are much more complex than the basics provided here, and it is easy to make costly mistakes. We highly recommend that you consult with us about the potential pitfalls of any moves you're considering with regard to these accounts.