Roth IRAs

The Roth IRA differs from the traditional IRA in that contributions are never deductible and, if certain requirements are met, account distributions are free of federal income tax.[1]

Funding a Roth IRA

Annual contributions: A Roth IRA may be established and funded at any time between January 1 of the current year, up to and including the date an individual's federal income tax return is due, (generally April 15 of the following year), not including extensions.

Conversion of a traditional IRA account: A traditional IRA may be converted to a Roth IRA, with the conversion being a *taxable* event. For the year of conversion, the taxpayer must include in gross income previously deducted contributions plus net earnings (or minus net losses). For individual retirement annuities, gross income is generally increased by the fair market value of the contract on the date of conversion (through a re-designation) or distribution (if held inside an IRA). If a retirement annuity is completely surrendered, the cash received is the amount includable in income. Any 10% penalty tax for early withdrawal is waived. However, if a taxpayer withdraws amounts from the Roth IRA within five years of the conversion, the 10% penalty tax will apply to those amounts deemed to be part of the conversion, unless an exception applies.

Prior to 2018, a taxpayer who converted funds in a traditional IRA[2] to a Roth IRA could "undo" the transaction and "recharacterize" the converted funds, moving them back into the traditional IRA. However, for tax years beginning in 2018, the Tax Cuts and Jobs Act of 2017 (TCJA) permanently repealed the ability to recharacterize a Roth conversion to a traditional IRA.

TCJA did *not* repeal the ability of a taxpayer to convert funds in a Roth IRA to a traditional IRA, and then recharacterize the converted funds, moving them back into a Roth IRA.

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[1] Income tax treatment of Roth IRAs at the state or local level may differ.

[2] The law also applies to SEP and SIMPLE plans.

Rollovers from a qualified plan: Distributions from qualified retirement plans, IRC Sec. 457(b) governmental plans, and IRC Sec. 403(b) plans may also be rolled over to a Roth IRA.

These conversions are taxable events, with gross income for the year of conversion being increased by previously deducted contributions plus net earnings (or minus net losses).

Direct rollover from a designated Roth Account: Funds may be rolled into a regular Roth IRA from a designated Roth account that is part of a 401(k), 403(b), or 457(b) governmental plan. Such a rollover is not a taxable event and the filing status and MAGI limitations normally applicable to regular Roth contributions do not apply.

Military death payments: Under the provisions of the Heroes Earnings Assistance and Relief Tax Act of 2008, an individual who receives a military death gratuity and/or a payment under the Servicemembers' Group Life Insurance (SGLI) program may contribute to a Roth IRA an amount no greater than the sum of any military death gratuity and SGLI payment. Such a contribution is considered a qualified rollover contribution and must be made within one year of receiving the death gratuity or insurance payment. The annual dollar contribution limit and income-based phase-out of the dollar contribution limit do not apply to such contributions.

Type of Arrangements Permitted

There are currently two types of Roth IRAs.

- **Individual retirement accounts:** Trusts or custodial accounts with a corporate trustee or custodian.
- **Individual retirement annuities:** Special annuities issued by a life insurance company.

Contribution Limits

Limits: For 2020, an individual may contribute (but not deduct) the lesser of $6,000 or 100% of compensation[1] for the year. For a married couple, an additional $6,000 may be contributed on behalf of a lesser earning (or nonworking) spouse, using a spousal account.

[1] "Compensation" includes taxable wages, salaries, or commissions or the net income from self-employment.

A husband and wife may contribute up to a total of $12,000, as long as their combined compensation is at least that amount.[1] If an IRA owner is age 50 or older, he or she may contribute an additional $1,000 ($2,000 if the spouse is also age 50 or older).

Other IRAs: The contribution limits for a Roth IRA are coordinated with those of a traditional IRA; a taxpayer may not contribute more than the annual limit for that tax year into a single IRA or a combination of traditional and Roth IRAs. Excess contributions to a traditional or Roth IRA are subject to a 6% excise tax.

Contribution phase out: For 2020, the maximum contribution to a Roth IRA is phased out for single taxpayers with MAGI between $124,000 and $139,000. For married couples filing jointly, the phase-out range is a MAGI of $196,000 to $206,000. For married individuals filing separately, the phase-out range is a MAGI of $0 to $10,000.[2]

Taxation of Distributions

A distribution from a Roth IRA that is a "qualified" distribution is excluded from gross income and is not subject to federal income tax. A distribution is qualified if it is made after a five-year waiting period[3] and at least one of the following requirements is met:

- after the taxpayer reaches age 59½; or
- due to the taxpayer's death; or
- because the taxpayer becomes disabled; or
- to pay for first-time-home-buyer expenses up to $10,000.

The **earnings** portion of a "non-qualified" distribution is subject to tax. To determine any taxable distribution, the funds are considered to be withdrawn in a specified order:

- Any withdrawal is considered to come first from nondeductible **contributions**, which are not subject to tax.

[1] These amounts apply to 2020. For 2019, the maximum allowable contribution were also $6,000 for a single individual and $12,000 for a married couple.

[2] For 2019, the phase-out ranges were: (1) MFJ – MAGI of $193,000 - $203,000 and (2) Single - $122,000 - $137,000. For those using the MFS filing status, the phase-out range is $0 - $10,000, which does not change.

[3] Generally, five years after a contribution is first made, or amounts are converted to a Roth IRA.

- After all contributions have been withdrawn, any **conversion** amounts are considered next. A distribution of converted funds is not included in gross income, but may be subject to the 10% premature distribution penalty if the funds are withdrawn within five years of being converted.
- Once all contributions and conversions have been withdrawn, any remaining funds are deemed to be **earnings**, and, when distributed, are included in gross income.

Premature Distributions

If a **taxable** distribution is received prior to age 59½, a 10% penalty tax is added to the regular income tax due, unless one or more of the following exceptions apply:

- A distribution is made because of the death or disability of the account owner.
- A withdrawal is part of a scheduled series of substantially equal periodic payments.
- A distribution is rolled-over into another Roth IRA.
- A withdrawal is used to pay for deductible medical expenses.
- The distribution is used to pay for certain qualified higher-education expenses.
- Amounts are withdrawn to pay for first-time homebuyer expenses of up to $10,000.
- In certain situations, to pay health insurance premiums for unemployed individuals.
- Distributions by certain military reservists called to active duty after 09/11/2001.
- A distribution is transferred to a Health Savings Account (HSA).
- In case of an IRS levy on the account.
- To pay expenses (up to $5,000 per parent) related to the birth or adoption of a child.

Distribution Requirements

Roth IRAs are not subject to the mandatory required minimum distribution (RMD) rules during the life of the owner (triggered at age 72), applicable to traditional IRAs.[1] However, there are mandatory distribution requirements applicable to non-spouse beneficiaries who *inherit* a Roth account.[2]

Qualified Charitable Distributions (QCD)

Federal income tax law provides for an exclusion from gross income of up to $100,000 for distributions made from a Roth or traditional IRA *directly* to a qualified charitable organization. Such a distribution is known as a Qualified Charitable Distribution, or QCD. The amount excluded from gross income may be reduced if an individual continues to make deductible IRA contributions after reaching age 70½. If applicable, a QCD counts towards the taxpayer's RMD requirements. The IRA owner (or beneficiary of an inherited IRA) must be at least age 70½ when the distribution is made. No charitable deduction is allowed for a QCD.

Transfers to Health Savings Accounts (HSAs)

Federal law allows for a limited, one-time, direct transfer of funds from an IRA to an HSA. If certain requirements are met, any otherwise taxable portion of the distribution is excluded from income and the 10% early distribution penalty will not apply.

Investment Alternatives

- **Banks, savings and loans, credit unions:** Certificates of deposit in Roth IRAs are generally insured by either the FDIC or the NCUA for amounts up to $250,000. Fixed and variable rates are available. There may be stiff penalties for early withdrawal.
- **Annuities:** Traditional, fixed individual retirement annuities issued by life insurance companies can guarantee fixed monthly income at retirement and may include a disability-waiver-of-premium provision. Variable annuities do not guarantee a fixed monthly income at retirement.

[1] The age 72 "trigger" date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

[2] Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the RMD requirement for 2020 (including an RMD applicable to the beneficiary of an inherited account) is waived. The next RMD will be for 2021.

- **Money market:** Yield fluctuates with the economy. Investor cannot lock in higher interest rates. It is easy to switch to other investments.
- **Mutual funds:** A wide variety of mutual funds with many investment objectives are available.
- **Zero coupon bonds:** Bonds are issued at a deep discount from face value. There are no worries about reinvesting interest payments. Zero coupon bonds are subject to inflation risk and interest rate risk.
- **Stocks:** A wide variety of investments (and risk) is possible. Losses are generally not deductible.
- **Limited partnerships:** Some limited partnerships are especially designed for qualified plans, specifically in the areas of real estate and mortgage pools.

Prohibited Investments or Transactions

- **Life insurance:** Roth IRAs cannot include life insurance contracts.
- **Loans to IRA taxpayer:** Self-borrowing triggers a constructive distribution of the entire amount in an IRA.
- **Collectibles:** Purchase of art works, antiques, metals, gems, stamps, etc., will be treated as a taxable distribution. Coins issued under state law and certain U.S. gold, silver and platinum coins are exceptions. Certain kinds of bullion may be purchased.

Other Factors to Consider

- What is the yield? More frequent compounding will produce a higher return. Is the interest rate fixed or variable? If interest rates drop, a fixed rate may be better, especially if you can make future contributions at the same fixed rate. If interest rates go up, you may be able to roll the account to another Roth IRA.
- How often can you change investments? Is there a charge?
- Refunds of federal income taxes may be directly deposited into an IRA.
- Federal bankruptcy law protects assets in Roth IRA accounts, up to $1,362,800.[1] Funds rolled over from qualified plans are protected without limit.

[1] Effective April 1, 2019. The limit is indexed for inflation every three years.