

# Roth IRAs: How They Work and How to Use Them

Roth IRAs differ from other tax-favored retirement plans, including other IRAs (called "traditional IRAs"), in that they promise complete tax exemption on distribution. But there are other important differences as well, and many qualifications about their use. This Financial Guide shows how they work, how they compare with other retirement devices--and why YOU might want one, or more.

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With most tax-favored retirement plans, the contribution to (i.e., investment in) the plan is deductible, the investment compounds tax-free until distributed, and distributions are taxable as received. There are variations from this pattern, as with 401(k)s where the exemption for salary diverted to a 401(k) takes the place of a deduction and for after-tax investments where invested capital is tax-free when distributed.

With a Roth IRA, there's never an up-front deduction for contributions. Funds contributed compound tax-free until distributed (standard for all tax-favored plans) and distributions are completely exempt from income tax.

## How Contributions Are Treated

The 2012 annual contribution limit to a Roth IRA is \$5,000, (same in 2011). An additional "catch-up" contribution of \$1,000 (same as 2011) is allowed for persons age 50 or over bringing the contribution total to \$6,000 for certain taxpayers. To make the full contribution, you must earn at least \$5,000 in 2012 from personal services and have income (modified adjusted gross income or MAGI) below \$110,000 if single or \$173,000 on a joint return in 2012. The \$5,000 limit in 2012 phases out on incomes between \$110,000 and \$125,000 (single filers) and \$173,000 and \$183,000 (joint filers). Also, the \$5,000 limit is reduced for contributions to traditional IRAs though not SEP or SIMPLE IRAs.

You can contribute to a Roth IRA for your spouse, subject to the income limits above. So assuming earnings (your own or combined with your spouse) of at least \$10,000, up to \$10,000 (\$5,000 each) can go into the couple's Roth IRAs. As with traditional IRAs, there's a 6% penalty on excess contributions. The rule continues that the dollar limits are reduced by contributions to traditional IRAs.

## How Withdrawals Are Treated

You may withdraw money from a Roth IRA at all time; however, taxes and penalty could apply depending on timing of contributions and withdrawals.

### Qualified Distributions

Since all your investments in a Roth IRA are after-tax, your withdrawals, whenever you make them, are often tax-free. But the best kind of withdrawal, which allows earnings as well as contributions and conversion amounts to come out completely tax-free, are qualified distributions. These are withdrawals meeting the following conditions:

1. At least 5 years have elapsed since the first year a Roth IRA contribution was made or, in the case of a conversion, since the conversion occurred and
2. At least **one** of these additional conditions is met:
  - The owner is age 59 ½ .
  - The owner is disabled.
  - The owner has died (distribution is to estate or heir).
  - Withdrawal is for a first-time home purchase (lifetime limit up to \$10,000).

**Note:** A distribution used to buy, build or rebuild a first home must be used to pay qualified costs for the main home of a first time home buyer who is either yourself, your spouse or you or your spouse's child, grandchild, parent or other ancestor.

### Non-Qualified Distributions

To discourage the use of pension funds for purposes other than normal retirement, the law imposes an additional 10% tax on certain early distributions from Roth IRAs unless an exception applies. Generally, early distributions are those you receive from an IRA before reaching age 59 1/2.

**Exceptions:** You may not have to pay the 10% additional tax in the following situations:

- You are disabled.
- You are the beneficiary of a deceased IRA owner.
- You use the distribution to pay certain qualified first-time homebuyer amounts.
- The distributions are part of a series of substantially equal payments.
- You have significant unreimbursed medical expenses.
- You are paying medical insurance premiums after losing your job.
- The distributions are not more than your qualified higher education expenses.
- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution.

Part of any distribution that is not a qualified distribution may be taxable as ordinary income and subject to the additional 10% tax on early distributions. Distributions of conversion contributions within a 5-year period following a conversion may be subject to the 10% early distribution tax, even if the contributions have been included as income in an earlier year.

### Ordering Rules for Distributions

If you receive a distribution from your Roth IRA that is not a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Order the distributions as follows.

1. Regular contributions.
2. Conversion contributions, on a first-in-first-out basis (generally, total conversions from the earliest year first). See Aggregation (grouping and adding) rules, later. Take these conversion contributions into account as follows:
  - Taxable portion (the amount required to be included in gross income because of conversion) first, and then the
  - Nontaxable portion.
3. Earnings on contributions.

Disregard rollover contributions from other Roth IRAs for this purpose.

## Aggregation (grouping and adding) rules.

Determine the taxable amounts distributed (withdrawn), distributions, and contributions by grouping and adding them together as follows.

- Add all distributions from all your Roth IRAs during the year together.
- Add all regular contributions made for the year (including contributions made after the close of the year, but before the due date of your return) together. Add this total to the total undistributed regular contributions made in prior years.
- Add all conversion and rollover contributions made during the year together. For purposes of the ordering rules, in the case of any conversion or rollover in which the conversion or rollover distribution is made in 2011 and the conversion or rollover contribution is made in 2012, treat the conversion or rollover contribution as contributed before any other conversion or rollover contributions made in 2012.

Add any re-characterized contributions that end up in a Roth IRA to the appropriate contribution group for the year that the original contribution would have been taken into account if it had been made directly to the Roth IRA.

Disregard any re-characterized contribution that ends up in an IRA other than a Roth IRA for the purpose of grouping (aggregating) both contributions and distributions. Also disregard any amount withdrawn to correct an excess contribution (including the earnings withdrawn) for this purpose.

**Example:** On October 15, 2007, Justin converted all \$80,000 in his traditional IRA to his Roth IRA. His Forms 8606 from prior years show that \$20,000 of the amount converted is his basis. Justin included \$60,000 (\$80,000 - \$20,000) in his gross income. On February 23, 2007, Justin makes a regular contribution of \$4,000 to a Roth IRA. On November 7, 2007, at age 60, Justin takes a \$7,000 distribution from his Roth IRA.

- The first \$4,000 of the distribution is a return of Justin's regular contribution and is not includible in his income.
- The next \$3,000 of the distribution is not includible in income because it was included previously.

## Distributions After Owner's Death

Qualified distributions after the owner's death are tax-free to heirs. Nonqualified distributions after death, which are distributions where the 5-year holding period wasn't met, are taxable income to heirs as they would be to the owner (the earnings are taxed), except there's no penalty tax on early withdrawal. However, an owner's surviving spouse can convert an inherited Roth IRA into his or her own Roth IRA. This way, distribution can be postponed, so that nonqualified amounts can become qualified, and the tax shelter prolonged.

Roth IRA assets left at death are subject to federal estate tax, just as traditional IRA assets are.

## Converting From a Traditional IRA or Other Eligible Retirement Plan to A Roth IRA

The conversion of your traditional IRA to a Roth IRA was the feature that caused most excitement about Roth IRAs. Conversion means that what would be a taxable traditional IRA distribution can be made into a tax-exempt Roth IRA distribution. Starting in 2008, further conversion or rollover opportunities from other eligible retirement plans were available to taxpayers.

**2010 conversions and rollovers to Roth IRAs**, if you converted or rolled over amounts to your Roth IRAs in 2010 and did not elect to include the entire amount in income in 2010, you must include part of the amount in income for 2011.

### Conversion Methods

You can convert a traditional IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used.

You can convert amounts from a traditional IRA to a Roth IRA in any of the following three ways.

- *Rollover.* You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
- *Trustee-to-trustee transfer.* You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
- *Same trustee transfer.* If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

**Note:** Conversions made with the same trustee can be made by re-designating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Prior to 2008, you could only rollover (convert) amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You can now roll over amounts from the following plans into a Roth IRA. A qualified pension, profit-sharing or stock bonus plan (including a 401(k) plan),

- An annuity plan,
- A tax-sheltered annuity plan (section 403(b) plan),
- A deferred compensation plan of a state or local government (section 457 plan), or
- An IRA.

Any amount rolled over is subject to the same rules for converting a traditional IRA into a Roth IRA. Also, the rollover contribution must meet the rollover requirements that apply to the specific type of retirement plan.

There is a cost to the rollover. The amount converted is fully taxable in the year converted, except for the portion of after-tax investment in the traditional IRA. So you must pay tax now (though there's no early withdrawal penalty) for the opportunity to withdraw tax-free later, an opportunity that can extend to your heirs.

Conversion is now allowed to all taxpayers in 2011. The prior income restriction allowing conversion only for taxpayers of income (again, MAGI) of \$100,000 or less in the conversion year has been terminated. All taxpayers are able to convert a regular IRA to a Roth IRA starting in 2010. The conversion is a taxable distribution, which can be taken into income in the conversion year or averaged over the next two years. The conversion will not be subject to the 10% early distribution penalty.

## Undoing a Conversion to a Roth IRA

Since everyone recognizes that conversion is a high-risk exercise, the law and liberal IRS rules provide an escape hatch: You can undo a Roth IRA conversion by what IRS calls a "re-characterization". This move, by which you move your conversion assets from a Roth IRA back to a traditional IRA, makes what would have been a taxable conversion into a tax-free rollover between traditional IRAs. Re-characterization can be done any time until the due date for the return for the year of conversion.

**Tip:** One reason to do this would be where you find you've exceeded the \$100,000 income ceiling for Roth IRA conversions.

**Tip:** Another reason to do this, dramatized by a volatile stock market, is where the value of your portfolio drops sharply after the conversion.

**Example:** If your assets are worth \$180,000 at conversion and fall to \$140,000 later, you're taxed on up to \$180,000, which is \$40,000 more than you now have. Undoing-re-characterization-avoids the tax, and gets you out of the Roth IRA.

Can you undo one Roth IRA conversion and then make another one-a reconversion? Yes-once, subject to these requirements: Reconversion must take place in the tax year following the original conversion to Roth IRA, and the reconversion date must also be more than 30 days after the previous re-characterization transfer from the Roth IRA back to the traditional IRA.

## Withdrawal Requirements

You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs

Also, unlike traditional IRAs (but like other tax-favored retirement plans), a Roth IRA owner who continues working may continue to contribute to the Roth IRA.

## Retirement Savings Contributions Credit

Also known as the saver's credit, this credit helps low and moderate income workers save for retirement. Taxpayers age 18 and over are allowed a tax credit for their contributions to a workplace retirement plan, traditional or Roth IRA if their modified adjusted gross income (MAGI) in 2012 for a married filer is below \$57,500 (\$56,500 in 2011), heads-of-household below \$43,125 in 2012 (\$42,375 in 2011) and others (single, married filing separately) below \$28,750 in 2012 (\$28,250 in 2011). These amounts are indexed for inflation each year. The credit, up to \$1,000, is a percentage from 10-50% of each dollar placed into a qualified retirement plan up to the first \$2,000. The lower the MAGI, the higher the credit percentage; are resulting in the maximum credit of \$1,000 (50% of \$2,000).

**Note:** Both you and your spouse may be eligible to receive this credit if you both contributed to a qualified retirement plan and meet the adjusted gross income limits.

The following table details the percentage of Saver's credit based on Adjusted Gross Income (AGI):

| <b>2012 Saver's Credit</b> | <b>Single Filers AGI</b> | <b>Head of Household AGI</b> | <b>Joint Filers AGI</b> |
|----------------------------|--------------------------|------------------------------|-------------------------|
| 50% of contribution        | \$0-\$17,250             | \$0-\$25,875                 | \$0-\$34,500            |
| 20% of contribution        | \$17,251-\$18,750        | \$25,876-\$28,125            | \$34,501-\$37,500       |
| 10% of contribution        | \$18,751-\$28,750        | \$28,126-\$43,125            | \$37,501-\$57,500       |
| Credit Not Available       | more than \$28,750       | more than \$43,125           | more than \$57,500      |

| <b>2011 Saver's Credit</b> | <b>Single Filers AGI</b> | <b>Head of Household AGI</b> | <b>Joint Filers AGI</b> |
|----------------------------|--------------------------|------------------------------|-------------------------|
| 50% of contribution        | \$0-\$17,000             | \$0-\$25,500                 | \$0-\$34,000            |
| 20% of contribution        | \$17,001-\$18,250        | \$25,501-\$27,375            | \$34,001-\$36,500       |
| 10% of contribution        | \$18,251-\$28,250        | \$27,376-\$42,375            | \$36,501-\$56,500       |
| Credit Not Available       | more than \$28,250       | more than \$42,375           | more than \$56,500      |

| <b>2010 Saver's Credit</b> | <b>Single Filers AGI</b> | <b>Head of Household AGI</b> | <b>Joint Filers AGI</b> |
|----------------------------|--------------------------|------------------------------|-------------------------|
| 50% of contribution        | \$0-\$16,750             | \$0-\$25,125                 | \$0-\$33,500            |
| 20% of contribution        | \$16,751-\$18,000        | \$24,751-\$27,000            | \$33,501-\$36,000       |
| 10% of contribution        | \$18,001-\$27,750        | \$27,001-\$41,625            | \$36,001-\$55,500       |
| Credit Not Available       | more than \$27,750       | more than \$41,625           | more than \$55,500      |

**Note:** The saver's credit is available in addition to any other tax savings that apply. Further, IRA contributions can be made until April 15 of the following year and still be considered in the current tax year.

## **Use In Estate Planning**

Though Roth IRAs enjoy no estate tax relief, they are already figuring in estate plans. The aim is to build a large Roth IRA fund—largely through conversion of traditional IRAs—to pass to beneficiaries in later generations. The beneficiaries will be tax exempt on withdrawals (of qualified distributions) and the Roth IRA tax shelter continues by spreading withdrawal over their lifetimes.

**Long-term planning with Roth IRAs.** If you would be allowed a deduction for a contribution to a traditional IRA, contributing to a Roth IRA means surrendering current tax reduction for future tax reduction (to zero) for qualified distributions. This can be presented as an after-tax return-on-investment calculation involving assumed future tax rates. The higher the projected tax rate at withdrawal, the more tax Roth IRA saves.

Comparable considerations apply to conversions to Roth IRAs. Here the taxpayer incurs substantial current tax cost (directly or indirectly reducing the amount invested) for future tax relief to the taxpayer or an heir. So the return on investment resulting from conversion increases as projected future rates rise.

A key element in making such projections is the possibility that current and future federal deficits will lead to future tax rate increases-a factor which would tend to encourage current Roth IRA investment and conversion. On the other hand, there's the question whether Roth IRA benefits currently promised will survive into future decades.

Highly sophisticated planning is required for Roth IRA conversions. Consultation with a qualified advisor is a must. Please call us if you have any questions.