Roth IRA Basics

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Overview

- General concepts
- Taxation of Roth IRA conversions
- Taxation of Roth IRA distributions
- Mathematics of Roth IRA conversions
- Recharacterizations
- Estate tax considerations
- Other considerations

General Concepts

General Concepts

- 100% of growth is tax-exempt
- No required minimum distributions at age 70½
  - NOTE: Distributions from Roth IRAs cannot be used to fulfill the RMD from a traditional IRA
- RMDs on Inherited Roth IRAs

General Concepts

- Convertible accounts
  - Traditional IRAs
  - 401(k) plans
  - Profit sharing plans
  - 403(b) annuity plans
  - 457 plans
  - "Inherited" 401(k) plans (see Notice 2008-30)
- Non-convertible accounts
  - "Inherited" IRAs
  - Education IRAs

General Concepts

- Reasons for converting to a Roth IRA
  - Taxpayers have special favorable tax attributes including charitable deduction carry-forwards, investment tax credits, net operating losses (NOLs), high basis non-deductible traditional IRAs, etc.
  - Suspension of the minimum distribution rules at age 70½ provides a considerable advantage to the Roth IRA holder
  - Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax
  - Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields

General Concepts

- Reasons for converting to a Roth IRA
  - Taxpayers who need to use IRA assets to fund their Basic Exclusion Amount (BEA) bypass trust are well advised to consider making a Roth IRA election for that portion of their overall IRA funds
  - Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, thereby lowering the effect of higher estate tax rates
  - Federal tax brackets are more favorable for married couples filing joint returns than for single individuals
  - Post-death distributions to beneficiaries are tax-free
  - Tax rates are expected to increase in the near future
  - Impact of the new 3.8% Medicare surtax

Taxation of Roth IRA Conversions

Taxation of Roth IRA Conversions

- When a traditional IRA has non-deductible contributions, a portion of the conversion to a Roth IRA will be non-taxable “basis” to the IRA owner
- In determining the non-taxable portion of a Roth IRA conversion, all traditional IRAs and IRA distributions during the year (including outstanding rollovers) must be combined for apportioning “basis”
  – See IRS Form 8606

Taxation of Roth IRA Conversions

Current year non-deductible IRA contributions	$	1,000
Prior year non-deductible IRA contributions		6,000
Total non-deductible IRA contributions	$	7,000
FMV of all IRAs	$	580,000
Outstanding rollovers		20,000
Distributions		-
Roth IRA conversions		100,000
Total value of IRAs, distributions and Roth IRA conversions	$	700,000
"Basis apportionment" factor		**0.0100**
Gross Roth IRA IRA conversion	$	100,000
Non-taxable portion		(1,000)
Taxable Roth IRA conversion	$	99,000

Taxation of Roth IRA Conversions

TAX REFORM REPEALED THE ABILITY TO RECHARACTERIZE A ROTH CONVERSION

Taxation of Roth IRA Distributions

Taxation of Roth IRA Distributions

- Qualified distributions
  - Not subject to income tax
- Non-qualified distributions
  - Potentially subject to income tax

Taxation of Roth IRA Distributions

- A Roth IRA distribution will be treated as a "qualified distribution" if both of the following requirements are met:
  - The distribution is made:
    - On or after the IRA owner turns 59½
    - To a beneficiary (or the IRA owner's estate) on or after the death of the IRA owner
    - Because the IRA owner is "disabled"
    - For a "qualified special purchase" (i.e. first-time home buyer)
  - A five-year mandatory holding period has passed

CAUTION: If both requirements are not met, then the distribution is a "non-qualified distribution"

Taxation of Roth IRA Distributions

- For purposes of determining a “qualified distribution”, the five-year holding period for all of a participant’s Roth IRAs begins as of January 1st of the first year in which a contribution or conversion was made to any Roth IRA owned by that participant
  - If the participant dies during the five-year holding period, then the five-year holding period “tacks” to the beneficiary (i.e. the holding period of the decedent and the beneficiary combined must be five years)

Taxation of Roth IRA Distributions

- If a distribution is a “non-qualified distribution”:
  - The distribution is first determined to be a non-taxable return of the Roth IRA owner’s previously taxed amounts (i.e. basis)
  - If the distribution exceeds the Roth IRA owner’s previously taxed amounts, the excess distribution will be subject to income tax

Taxation of Roth IRA Distributions

Step 1:
(Non-taxable)

Contributions
> Regular contributions
> Rollovers from other Roth IRAs
> Rollovers from “designated Roth accounts”

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Step 2:
(Non-taxable)

Conversions (First-in, first-out basis)
> Taxable portion of prior conversion
> Non-taxable portion of prior conversion

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Step 3:
(Taxable)

Earnings

Taxation of Roth IRA Distributions

- To the extent that an IRA owner is less than age 59½ at the time he/she receives a non-qualified distribution, the taxable portion of the distribution (i.e. "earnings") will be subject to the 10% early withdrawal penalty
  - Exceptions to the 10% early withdrawal penalty:
    - Death
    - Disability
    - Substantially Equal Periodic Payments (SEPPs)
    - Medical expenses > 7½ % of adjusted gross income
    - Health insurance premiums paid by unemployed individuals
    - Qualified higher education expenses
    - Qualified first-time homebuyer expenses

Taxation of Roth IRA Distributions

- To the extent that an IRA owner is less than age 59½ at the time he/she receives a non-qualified distribution, the taxable portion of a previous conversion amount will be subject to the 10% early withdrawal penalty if the distribution is within a five-year period following the conversion
  - The five-year holding period is determined on a conversion-by-conversion basis
  - The five-year holding period for each conversion begins as of January 1st
  - If the year in which the conversion is made the exceptions to that apply to the taxable portion of a non-qualified distribution (i.e. “earnings”) also apply to the taxable portion of a prior conversion amount (e.g. death, disability, etc.)

Taxation of Roth IRA Distributions

- The amount of a non-qualified distribution subject to the 10% early withdrawal penalty is determined as follows:

  Gross non-qualified Roth IRA distribution
- First-time homebuyer expenses
- Prior year Roth IRA contributions

  Gross non-qualified Roth IRA distribution subject to 10% tax
- Taxable portion of prior year Roth IRA conversions > 5 years
- Non-taxable portion of prior year Roth IRA conversions

  Net non-qualified Roth IRA distribution subject to 10% tax

Taxation of Roth IRA Distributions

	Distribution within 5 years	Distribution beyond 5 years
Age < 59½	Income Tax: Yes (earnings only) 10% Penalty : Yes (earnings & taxable portion of prior conversion amounts)	Income Tax: Yes (earnings only) 10% Penalty: Yes (earnings only)
Age ≥ 59½	Income Tax: Yes (earnings only) 10% Penalty: No	Income Tax: No 10% Penalty: No

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