

Roth IRAs

Similar in concept to the traditional IRA, the Roth IRA differs in that contributions are never deductible and, if certain requirements are met, distributions from the account may be received free of federal income tax.¹

Establishing 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. The account must be designated as a Roth IRA at the time it is established.

Conversion of existing IRA account: IRC Sec. 408A, which provides for Roth IRAs, allows an existing, traditional IRA (either an annual contribution IRA or a rollover IRA) to be converted to a Roth IRA. The conversion from the old traditional IRA to the Roth IRA results in a taxable event. Previously deducted IRA contributions and all earnings in the account are added to the taxpayer's gross income for the year of conversion.²

Any 10% excise tax (penalty for withdrawals before age 59½), which might apply to converted amounts, is waived. However, if a taxpayer withdraws amounts from the converted Roth IRA within five years of the year of conversion, the 10% excise tax will apply to those amounts deemed to be part of the conversion.³

The taxpayer making the conversion must have an adjusted gross income (AGI) of \$100,000 or less in the year of conversion or no conversion is permitted.⁴ The law also prohibits conversion if a taxpayer is using the married filing separate status. A taxpayer who converts amounts from a traditional IRA to a Roth IRA may reverse the transaction⁵ and recharacterize the converted funds. Only one such conversion and recharacterization is permitted during a tax year. For example, assume that a taxpayer converts and then unconverts a Roth IRA in 2003. In general, the taxpayer must wait until tax year 2004 before again converting amounts from a traditional IRA to a Roth IRA.⁶ The recharacterization of converted amounts must generally be made by the due date for the taxpayer's return, plus any extensions.⁷

¹ Income tax treatment of Roth IRAs at the state level may differ.

² See IRC Reg. 1.408A-4, Q & A7.

³ The 10% penalty will apply to the extent that converted amounts would have been included in income because of the conversion. See IRC Sec. 408A(d)(3)(F).

⁴ Converted amounts are not included in determining if AGI is \$100,000 or less. The converted amounts are, however, taken into account for all other income tax purposes.

⁵ For example, a taxpayer may find, after the close of the tax year, that AGI exceeded \$100,000.

⁶ See IRC Reg. 1.408A-5, Q&A9.

⁷ See IRC Reg. 1.408A-5, Q&A1.

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Type of Arrangements Permitted

There are currently two types of Roth IRAs.

Individual retirement accounts: These are trusts with a corporate trustee.

Individual retirement annuities: These are special annuities issued by a life insurance company.

Contribution Limits

Limits: For 2003, a wage earner may contribute (but not deduct) the lesser of \$3,000 or 100% of compensation earned for the year. If the wage earner is married, an additional \$3,000 may be contributed on behalf of a lesser earning (or nonworking) spouse, using a spousal account. A husband and wife may contribute up to a total of \$6,000, as long as their combined compensation is at least that amount.¹

Contribution phase out: The maximum contribution to a Roth IRA is phased out for single taxpayers with adjusted gross income between \$95,000 and \$110,000. For married couples filing jointly, the phaseout range is an AGI of \$150,000 to \$160,000. For married individuals filing separately, the phaseout range is an AGI of \$0 to \$10,000.

Other IRAs: The contribution limits for a Roth IRA are coordinated with those of the traditional IRA; a taxpayer may not contribute more than \$3,000 (\$6,000 for a married couple) per year into a single IRA or a combination of traditional and Roth IRAs. Excess contributions to a Roth IRA are subject to a 6% excise tax, for each year that any excess remains in the account.¹

Taxation of Distributions

Qualified distributions from a Roth IRA are not subject to federal income tax. Distributions are qualified if they are made:

- after a five-year waiting period;²
- after the taxpayer reaches age 59½;
- due to the taxpayer's death;
- because the taxpayer becomes disabled; or
- to pay for qualified first-time-home-buyer expenses.³

¹ These amounts apply to 2002 – 2004. Also, if an IRA participant is age 50 or older, he or she may contribute an additional \$500 (\$1,000 if the spouse is also over age 50).

² Five years after a contribution is first made, or amounts are converted to, a Roth IRA. Subsequent contributions or conversions do not start a new five-year waiting period. See IRC Sec. 408A(d)(2)(B), as amended by the Internal Revenue Restructuring and Reform Act of 1998.

³ Limited to \$10,000, which must be used within 120 days of withdrawal. Distribution must be used to acquire or rebuild a first home of the taxpayer, spouse or any descendent or ancestor of the taxpayer or spouse.

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Distributions which are not qualified are subject to tax. Amounts withdrawn are first considered to come from nondeductible contributions and conversion amounts (all Roth IRAs are aggregated for this calculation) and are not subject to tax. After all regular contributions have been withdrawn, any conversion contributions would be next in order, remaining amounts are considered to be income earned within the IRA and, if withdrawn, are taxable. If taxable distributions are received prior to age 59½, a 10% penalty tax may be added.¹

A taxpayer who converted a traditional IRA to a Roth IRA in 1998 could have elected to recognize any taxable income from the conversion ratably, over a four-year period. If such a taxpayer withdraws amounts from the Roth IRA prior to the year 2001, however, the benefits of any remaining deferral will be lost and recognition of any remaining, unrecognized income will be accelerated, up to the amount of the distribution allocable to the 1998 conversion.²

Other Differences

There are several other significant differences between the traditional IRA and the Roth IRA.

Contributions after age 70½: Unlike the traditional IRA, contributions to a Roth IRA may be made even after the taxpayer has reached age 70½, as long as the taxpayer has compensation.

Distribution requirements: Roth IRAs are not subject to the mandatory distribution requirements during the life of the owner (triggered at age 70½), which apply to traditional IRAs.

Factors Favoring Conversion to a Roth IRA

Factors which would favor converting an existing traditional IRA to a Roth IRA include the following.

The dollar amount in an existing IRA is relatively small.

The majority of contributions in an existing IRA consist of nondeductible contributions.

A taxpayer has at least five years before withdrawals are planned.

A taxpayer anticipates that the funds in an IRA will not be needed at retirement and would like to continue tax-free growth for as long as possible.

Sufficient non-IRA funds are available to pay the additional income tax due as a result of the conversion from a traditional IRA to a Roth IRA.

It is anticipated that a taxpayer's marginal tax bracket during retirement will be the same as, or higher than, the current marginal bracket.

¹ Penalty tax will be assessed unless certain exceptions apply.

² See IRC Sec. 408A(d)(3)(E)(i), as added by the Internal Revenue Restructuring and Reform Act of 1998.

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Investment Alternatives

Banks and savings and loans: Certificates of deposit are generally insured by the FDIC. 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.

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 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

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.

What is the yield? More frequent compounding will produce a higher return.

How often can you change investments? Is there a charge?