ROTH

Maybe you've heard the term "Roth" but don't know exactly what it means. Here are a few facts about Roth accounts to ramp up your knowledge base and increase your financial IQ.

What is a Roth account?

The Roth IRA was named after the late Delaware Senator William Roth. The Roth IRA became a retirement savings option in 1998, followed by the Roth 401(k) in 2006. Roth accounts are set up using after-tax money, and if all IRS rules are followed, are tax-free when you withdraw or take money out of them. Additionally, Roth accounts are usually tax-free to your heirs.

Traditional IRA versus Roth IRA accounts.

As an individual taxpayer with earned income, you have options when saving for retirement. One option is the IRA or "**Individual Retirement Account.**" An IRA is a type of account which acts as a shell or holder. Within your IRA, you can invest in many different types of assets—you can choose between CDs, government bonds, mutual funds, ETFs, stocks, annuities—almost any type of investment available. You can open an IRA account with your financial professional or at a bank, brokerage, mutual fund company, insurance company, or some may be opened directly online.

You get to choose whether your IRA account will be **a traditional IRA or a Roth IRA** account, and must consider many IRS rules and tax ramifications when making the choice. In general, it's best to speak with a qualified financial advisor to get advice about which type is best based on your income level and tax situation.

Are there limits on a Roth IRA?

Roth IRA accounts are subject to both contribution and income limits.

Contribution limits are constantly changing based on factors like inflation and everchanging policy. In 2022, the annual contribution limit for a person younger than 50 years old is $6,000. If you're 50 or older, you can contribute $7,000 to your Roth IRA. (This additional $1,000 per year is called a catch-up contribution.)

Roth IRAs also come with **income limits**. For 2022, a **single** person can contribute the entire amount up to the limit only if their annual gross income is less than $129,000. If their annual gross income is between $129,000 and $144,000, they can contribute a reduced amount, and if their annual gross income is $144,000 or more, they cannot contribute to a Roth IRA account. **Married** couples filing jointly may only contribute the full amount if their combined annual gross income is less than $204,000. If their combined annual gross income is between $204,000 and $214,000, they may contribute a reduced amount, but if it is $214,000 or more, they are not eligible to place money into a Roth IRA.

Again, the changing contribution limits and rules can be confusing, so the best practice is to consult your financial or tax professional.

Roth IRA advantages.

When it comes to Roth IRA accounts, their tax advantages are what can make them attractive. Because Roth IRA accounts are set up using after-tax money, you've already paid income tax on your contributions. But any **earnings**, interest or gains on the account can also be withdrawn tax-free after age 59-1/2 as long as the Roth IRA account has been in place for five years or longer.

In fact, because Roth IRAs use after-tax money, even a younger person can open a Roth IRA as long as they have earned income, and withdraw any amount they have **contributed** tax-free for any reason, as long as they have had the account for five years or longer. This can make a Roth IRA tremendously flexible at any age.

NOTE: If you withdraw any **earnings** on your Roth IRA if you are younger than age 59-1/2, or withdraw money if you have owned the account less than five years, you may owe income tax and penalties on it, subject to certain IRS exemptions.

Another advantage to a Roth IRA account is that it is not subject to RMDs (Required Minimum Distributions). RMDs are required annually starting at age 72 on taxable accounts like traditional IRAs and 401(k)s, with income taxes due on the amounts withdrawn.

Can Roth IRAs be passed on to beneficiaries tax-free?

The answer is yes, but due to the SECURE Act rules, money must be drained out of Roth IRA accounts and they must be closed within 10 years of inheritance.

NOTE: The new 10-year rule also applies to traditional IRA accounts, leaving your heirs liable to a new income tax burden you may not have expected. The SECURE Act did away with the so-called "stretch IRA," an estate planning strategy that used to extend the tax-deferred benefits of an IRA inherited by a non-spouse beneficiary. The beneficiary still had to take distributions from the IRA, but at a rate based on their life expectancy and not the original account owner's. Be sure to talk with your financial advisor about any traditional IRAs you own that you expect to leave to your children or non-spousal heirs.

Why consider Roth conversions?

A financial advisor who specializes in retirement can look at your entire financial picture to determine if a series of Roth conversions might or might not be beneficial in your particular situation as a retirement strategy. Figures that might go into this process include your income, your anticipated Social Security benefit, your retirement accounts, pensions and other sums of taxable money you might receive.

In some cases, if you have the bulk of your funds in tax-deferred accounts like traditional 401(k)s or traditional IRAs, you may come out ahead in the long run if you convert some of the money over a period of three to five years **before** you retire so that you can realize some tax-free gains in retirement along with a reduced tax burden. You might also be able to eliminate or reduce RMDs in retirement.

Your financial advisor in conjunction with your tax professional can help determine any financial advantage to this strategy and help you make sure all IRS tax rules are followed. They will run projections on your current and future income taxes, mapping out when it might be most advantageous times to convert funds. It might be in years you will fall into a lower tax bracket, or before you will be subject to tax increases, like the return to 2017 tax rates coming after 2025 if no new legislation is introduced to keep tax rates and brackets at their current levels.

How do contribution limits figure into Roth conversions?

Contribution limits do not apply to Roth conversions. You can convert as much money as you want from your existing accounts like traditional IRAs or 401(k)s into Roth IRAs, but you will owe income taxes on the amount you convert in the year that you do the conversion.

NOTE: There is a complex financial strategy that high-earners can still use which is called a "Backdoor Roth" which allows them to open a traditional IRA account (which has no income limit), then convert it later into a Roth IRA account. The strategy is subject to many strict tax rules which must be followed.

Can you undo a Roth conversion?

No. The Tax Cuts and Jobs Act of 2017 made Roth conversions permanent, so it is a good idea to consult a tax and financial professional before making any decisions about Roth conversions.

What about Roth 401(k) accounts through my workplace plan?

Not every 401(k) or other group retirement plan at work offers a Roth 401(k) option, but many plans do. If you choose a **Roth 401(k)** option, the money you put into your account via paycheck deduction is after tax, and will most likely be tax-free when you withdraw money from it after age 59-1/2 during retirement. Because a Roth 401(k) uses after-tax dollars, you may pay higher income taxes now than if you choose a traditional 401(k) option.

If you choose a **traditional 401(k)** option, you'll be using pre-tax dollars, which may lower your taxable income now. But with a traditional 401(k), you will owe income taxes on this money later, when you withdraw or take money out after age 59-1/2 during retirement.

NOTE: Company matching amounts are almost always still placed into a traditional 401(k), meaning you will owe taxes in the future on the company matching portion.

If you have any questions about Roth accounts, please give us a call.

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Sources:

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