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M Wealth Perspective

Offering value-added wealth services, including turnkey asset management and investment consulting.

Benefitting from a Roth IRA

Basics

Roth IRAs have been in existence for almost two decades; however, many investors are still unaware of their potential benefits. Roth IRAs are a powerful tool to grow assets tax-free and provide tax-free income during retirement. While Roth IRAs do have significant benefits, there are also some disadvantages depending on the given situation. This piece will discuss various ways investors can take advantage of the Roth IRA structure, and will also illustrate some circumstances where a Roth may not be appropriate.

Unlike traditional IRAs, contributions into a Roth IRA are not tax-deductible. However, in exchange for giving up an immediate reduction in taxable income, an investor will be rewarded with long-term, tax-free earnings and growth. Withdrawals are tax-free, as long as the investor waits until the age of 59½ and the account has been opened for at least five years. Additionally, unlike traditional IRAs, if an investor is older and still employed, a Roth IRA allows them to continue making contributions and growing assets tax-free.

Another advantage of a Roth IRA is the ability to withdraw contributions at any time without incurring penalties or taxes when funds are withdrawn at the appropriate age. Once contributions have been withdrawn, earnings will be tapped; and, if the investor is under 59½, withdrawals of earnings are taxable and subject to a 10% penalty. The good news, however, is that there are exceptions. First time home buyers are allowed to withdraw up to $10,000 of earnings, tax- and penalty-free, as long as the Roth has been owned for at least five years. Another example where earnings (with taxes due) can be withdrawn penalty free is to pay for family higher education expenses.

Roth IRAs are most beneficial when investors expect to be in a higher tax bracket when withdrawing contributions (typically at retirement) than when they are making contributions. This may sound unrealistic, but based on other retirement accounts, required minimum distributions, and Social Security, it is possible to be pushed into a higher tax bracket in retirement. Also, federal taxes have not increased since 2013. There is no way to predict whether they will rise again, but current federal rates are far below historical highs.

Forecasting future tax rates can be a difficult task. As most investors often have some type of tax-deferred retirement account, owning a Roth can serve as a diversification in a world of unknown future income tax rates. Further tax diversification can be accomplished by those with the option to utilize a Roth 401(k) in addition to a traditional 401(k). Note that Roth 401(k)s are subject to RMDs at 70½, but they can be dismissed by being rolled over into a Roth IRA.

Funding a Roth

There are several different methods to fund and move assets into a Roth IRA. The simplest way is to make a direct Roth IRA contribution[1]. The maximum in 2016 is $5,500, or $6,500 for ages 50 and older.

One limitation to Roth IRAs is that contributions are capped for high income earners. However, there are no limits on converting some or all of a high earner's traditional IRA assets into a Roth IRA. The one caveat is the payment of taxes on the conversion. Income tax is owed on all pretax contributions and earnings on the converted amount.

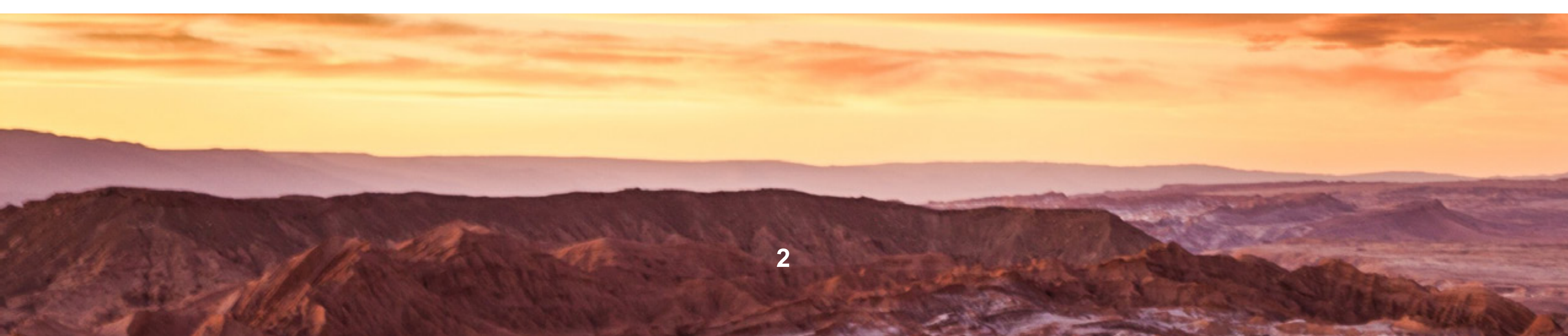
When examining the merits of converting to a Roth, investors should consider their current versus future tax rates. As a general rule, it is most prudent to convert in a low income year so that the assets can then grow tax-free and be withdrawn in a potentially higher tax year in the future. Note that the amount of the conversion will count as income which may push the investor into a higher tax bracket. For this reason, it may be beneficial to spread conversion amounts over several tax years or use deductible charitable contributions to reduce income.

For investors subject to the estate tax, converting traditional IRA assets to a Roth IRA during their lifetimes eliminates the double taxation inherent in traditional IRAs that occurs upon death (estate tax) and when beneficiaries withdraw funds from the inherited IRA (income tax). A conversion also reduces the amount of assets in traditional IRAs, which in turn, reduces the size of RMDs after age 70½.

If an investor converts to a Roth IRA in a given year, and the value of those assets declines, they have the right to reverse the conversion (known as "recharacterization") and move the assets back into the traditional IRA. The assets can then be converted, at a likely lower valuation, in a subsequent year.

Another way to move assets into a Roth and minimize the tax burden is to implement a strategy known as the "back door Roth" where after-tax dollars are invested into a non-deductible traditional IRA and immediately converted to a Roth IRA. This strategy allows high income investors to fund Roth IRAs despite the income limits on contributions. One key factor to this strategy is if an investor has any other traditional or deductible IRAs. Having multiple deductible IRAs can complicate the tax situation when using the back door Roth strategy. If other deductible IRAs are owned, then the tax bill will be based on the percentage of taxable and tax-free assets in all of the IRAs, not just the non-deductible IRA that is being converted. For example, if an investor has a $10,000 in a non-deductible IRA and $40,000 in a deductible IRA and converts $10,000 to Roth IRA, then only 20% ($2,000) of the $10,000 would be tax-free.

1 In 2016, single taxpayers with modified adjusted gross income (MAGI) of $132,000 or more are ineligible to contribute to a Roth IRA. Those that have a MAGI between $117,000 and $132,000 can contribute but at a reduced amount. For married filers, the income limits begin to phase out between $184,000 and $194,000, and those at or over $194,000 are ineligible to contribute. See the "Funding a Roth" section of this document for various methods to fund a Roth IRA for investors who are ineligible to contribute due to these income limitations



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Flexibility

There are no required minimum distributions (RMDs) that kick in at 70½ for Roth IRAs, so withdrawals can be made at any time after 59½. This creates a great amount of flexibility, as investors can elect when to withdraw from their account. If there is no immediate need for the money, leaving it to heirs is an option. Heirs may also withdraw funds tax-free; however, any amount passed on must be distributed annually over the heirs' life expectancy.

Roth IRAs are an important part of an investor's "tax diversification" strategy at retirement. There are several reasons to hold assets in taxable, tax-deferred and Roth accounts. The traditional rule of thumb is to withdraw RMDs from tax-deferred accounts first, followed by withdrawals from taxable accounts, and finally by assets in Roth IRAs. However, there are situations when Roth IRA withdrawals earlier in retirement are beneficial.

For example, a Roth IRA can be useful to help maximize Social Security income. By supplementing spending needs early in retirement, tax-free Roth distributions provide the ability to delay taking Social Security income in order to receive a higher annual benefit later in retirement.

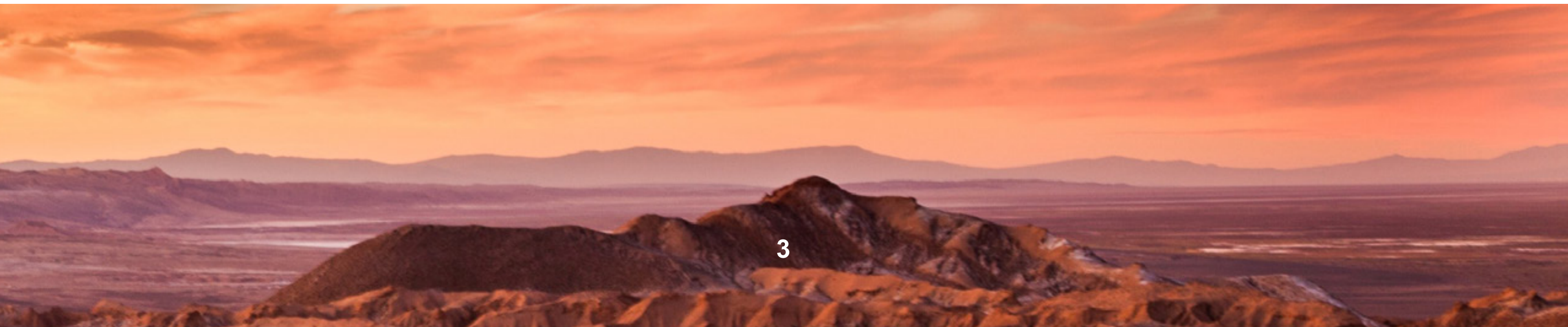
There is the possibility that the withdrawals from a traditional IRA could push an investor into a higher tax bracket. This additional income could create other costly consequences, such as higher Medicare premiums and Medicare surtaxes on investment income. In this situation, withdrawing funds from a Roth IRA alleviates the need to withdraw taxable amounts from traditional IRAs.

Gifting and Estate Planning

From a gifting and estate planning perspective, a Roth IRA can be a useful tool. $5,500 to $6,500 can be gifted to any individual, as long as that individual has earned income that does not exceed the income limit. These contributions will grow tax-free, and in the case of young recipients, can do so for many decades. These gifts reduce the size of an investor's estate and pass along assets to the next generation tax-free.

Conclusion

A Roth IRA should always be considered in the financial planning process given its unique and powerful tax-sheltered growth and tax-free distribution characteristics. Furthermore, a portfolio consisting of Roth IRA retirement accounts, along with tax-deferred retirement accounts and taxable accounts, provides the most flexibility in managing current and future income goals to maximize tax efficiency. Finally, when appropriate, Roth IRAs can be used to maximize an investor's gifting and estate planning strategies.



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