Roth IRAs – Roadblocks Ahead?

A Deep Dive into understanding this powerhouse player for tax-free income

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What we'll cover

- The basics of Roth IRAs and designated Roth accounts
- Defining a qualified distribution
- The separate 5-year rule that is often overlooked
- Proposed changes affecting retirement accounts
- Strategies to consider to leverage the power of the Roth

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Roth IRA Basics

Contribution Limit: $6,000 (plus $1,000 if age 50 or older)

- ✓ Subject to AGI limits but not "active participation" rules like Traditional IRAs are.
- ✓ Must have earned income to contribute (or be the spouse of an earner)
- ✓ Contributions are non-deductible, therefore do not reduce taxable income in the year made
- ✓ Limit is an aggregate limit between Traditional and Roth IRAs

Conversion Limit – None

- ✓ No AGI restrictions (1998 – 2009, AGI limit was 100K)
- ✓ Do not need to have earned income
- ✓ Conversions are income taxable unless conversion is of after-tax dollars

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Roth IRA Basics – Pros vs. Cons

Pros:

- Qualified distributions are tax-free (tax-deferred growth is never taxed)
- Mitigates tax risk in retirement
- Tax-free legacy to heirs (beneficiary must meet what’s left of 5-year holding period)
- If taxes go up in retirement, converting before makes economic sense
- No lifetime RMDs
- Contributing/converting at a younger age allows tax-free growth to compound
- Won’t increase provisional income used to determine whether a portion of Social Security is taxable
- Qualified distributions won’t increase MAGI for Medicare IRMAA surcharges.

Cons:

- Contributions are not deductible and won’t reduce tax burden when made.
- If taxes go down in retirement, converting pre-retirement could cost more.
- A Roth conversion is taxable in the year it is distributed from an IRA or employer sponsored plan.
- Contributing/converting at an advanced age may still make sense but less time to compound tax-free growth.

The Designated Roth Account (DRA)

What is a DRA?

An election within a 401(k), 403(b),TSP or governmental 457(b) that permits employee elective deferrals to be made on an after-tax basis.

Finer Points:

- DRAs are not aggregated with IRA limits and are not subject to the same AGI phase outs as Roth IRA contributions are.
- Just like a Roth IRA contribution, DRAs do not reduce taxable income when contributed.
- The employer must permit DRAs within the plan document.
- Any employer matching or non-elective contributions must be made on a pre-tax basis.
- DRA contributions must be aggregated with other elective deferral plans under the 402(g) limit ($19,500 plus $6,500 age 50 catch-up in 2021).
- A DRA distribution that does not satisfy the 5-year holding period may not carry the holding period to a Roth IRA.
- Consider having clients convert even a small amount to start the 5-year hold on the Roth IRA.

The Designated Roth account (DRA)

What is considered a qualified distribution from a DRA?

Made after a 5-taxable-year period of participation and meets one of these qualifying events:

- Made on are after the employee attains age 59 ½
- Made on or after the employee's death
- Made on account of a disability as defined under IRC Section 72(m)(7)

When does the 5-year period begin?

- On January 1st of the first tax year for which a DRA is made
- Example: First DRA is made on November 12, 2021 – 5-year period begins on January 1, 2021 and ends on December 31, 2025.
- A subsequent rollover to a Roth IRA in which the 5-year period was not met must apply the 5-year period rules applicable to Roth IRAs for any gain rolled over.
- If the rollover to a Roth IRA has satisfied both the 5-year holding period and a qualifying event, the entire rollover is considered basis.

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Roth IRAs – Qualified Distributions

What is considered a qualified distribution (fully tax-free) from a Roth IRA?
The distribution is made after a 5-year period beginning with the first Roth contribution, conversion, or rollover made and meets one of these qualifying events:

- Made on are after the employee attains age 59 ½
- Made on or after the employee's death
- Made on account of a disability as defined under IRC Section 72(m)(7)
- First-time home purchase, subject to $10,000 lifetime limit (not on DRAs)

The Finer Points:

- A prior year contribution's 5-year period begins on January 1st of the year for which the contribution is made.
- Only one 5-year holding applies to all aggregated Roth IRAs when measuring when gain is tax-free.
- Both the 5-year holding period AND a qualifying event must be satisfied for the gain to be tax-free.
- If the DRA rollover to a Roth IRA has satisfied both the 5-year holding period and a qualifying event, the entire rollover is considered basis. But any subsequent gain would be subject to the 5-year hold on the Roth IRA.

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Roth IRAs – Ordering Rules

1. Contributions
2. Taxable conversions and nontaxable conversions (after-tax)
3. Earnings

Notables:

- Unlike NQ annuities, where withdrawals are LIFO, Roth IRAs come out FIFO!
- A person can convert $100,000 today and withdraw $50,000 a year from now when the account is worth $110,000 and pay no income taxes (defeating the purpose of the Roth IRA, but it could be done)
- What about conversions made prior to age 59 ½? Beware of the 2nd 5-year rule that applies to those!

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Roth IRAs – The 2nd 5-year holding period

When does the 2nd 5-year rule apply?

- Only on a conversion that is executed BEFORE 59 ½!
- This 5-year holding period applies to each pre-59 ½ conversion.
- This 5-year rule is used to determine whether a 10% penalty applies, even to the converted amount, unless an exception to the penalty exists (i.e. turning 59 ½).
- May be ignored for all conversions done at or beyond age 59 ½.
- Added this rule to close a loophole because the 10% penalty generally doesn't apply to after-tax withdrawals.

Example:

Frank, age 58, opened his first Roth IRA in 2015. He converts $35,000 from his Traditional IRA this year. In 2023, when Frank turns 59, he makes a withdrawal of $40,000. His account value at the time is $75,000, of which $35,000 represents his conversion, $28,000 in contributions, and $12,000 in gain. Is there any tax consequences to his withdrawal? What if he waited to age 59 ½?

A: None of his withdrawal is subject to federal income taxes. But 12K of it is subject to the 10% early withdrawal penalty (first 28K is a return of contributions, next 12K comes from converted amount)

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Roth IRAs – Qualified or Not?

Example 1:

Suzie, age 62, made her first Roth IRA contribution in 2014 and subsequently withdrew the full balance of her Roth IRA in 2019. She wants to set up a new Roth IRA and fund it for 2021. If she elects to fully distribute her Roth IRA in 2023, will the distribution be qualified?

A: YES! Even though she fully distributed he Roth IRA from 2014, there is only one 5-year holding period and she is over 59 ½.

Example 2:

John, age 62, has contributed to a DRA in his 401(k) since 2015. In 2021, he rolls his 401(k) including his DRA to a Roth IRA (no other Roth IRAs owned). 3 years later, at age 63, he makes a full withdrawal. Is the withdrawal a qualified distribution?

A: NO! If there is gain on his withdrawal, he will pay taxes on it because he hasn't satisfied the 5-year holding period on the Roth IRA.

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Proposed changes to retirement accounts

- ✓ House passed the Build Back Better Act on November 19, 2021
- ✓ No more IRA contributions for high income earners with aggregate defined contribution and IRA balances over $10M. (over 400K single, 450K MFJ, 425K HOH) beginning in 2029.
- ✓ Mandatory distributions on aggregate balances in excess of $10M (50% of the excess withdrawn by 12/31 of following year (effective in 2029).
- ✓ Balances in excess of $20M, require 100% of amount over to be distributed the following year (2029).
- ✓ Both only required with taxable income above thresholds outlined above.
- ✓ No more Roth conversions for high-income taxpayers (effective for tax years after 2031)
- ✓ No conversions of after-tax dollars from DC plans or IRAs, beginning after 12/31/21, regardless of income level (backdoor Roth strategies).

Potential Strategies to Consider:

- ✓ Encourage clients to evaluate Roth conversions before year end to get a head start on the 5-year holding period and to potentially save taxes should taxes go up next year.
- ✓ Clients with DRAs – start a Roth IRA to simultaneously tackle the 5-year holding period since the DRA "5" doesn't carry over to the IRA "5".
- ✓ Consider converting after-tax monies in qualified plans before year end in case that part of the bill passes. This is slated to go into effect next year.
- ✓ High income clients – convert serially over the next 10 years if legislation passes. Serial conversions are a good strategy, regardless.
- ✓ Discuss the Roth IRA as a better legacy planning vehicle vs. its sister, the Traditional IRA. They both must be distributed to most non-spousal beneficiaries by 12/31 of 10^{th} anniversary of death but at least one of them isn't a ticking tax bomb!
- ✓ For conversions at 72 or later, offset the RMD on Traditional IRAs by using the QCD and converting above that amount to avoid taxes on the RMD and pay taxes only on the conversion.
- ✓ Be a matchmaker! Introduce your clients to the Roth IRA and the FIA and have the best of both worlds – TAX-FREE and GUARANTEED income in retirement.

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Thank You

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