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ROTH IRA PLANNING

When a Roth IRA might make sense

Because taxation of a traditional IRA occurs at the back end when withdrawals are made, the account owner ultimately pays tax both on contributions to the account and on the investment returns generated by the account. By paying taxes at the front end when the contributions are made, Roth IRA holders enjoy 100% tax-free growth on their investment. In theory, at least, the account becomes tax-exempt when it's worth the most.

How can I start a Roth IRA?

After you have determined that you are eligible for a Roth IRA and that it is the most appropriate investment for you, it is fairly simple to start your Roth IRA. There are several different providers from which you can choose. Banks and insurance companies typically accept small accounts and are a good starting point for first time investors. Mutual funds companies often give you the flexibility to invest parts of your IRA in different funds. This allows you to create an investment focused on growth, asset protection, or somewhere in between. Many brokerage firms also offer IRA investments that are often known as "self directed IRAs." This type of investment gives you the opportunity to develop a portfolio that consists of specific investments chosen by you. This may be a good choice for more experienced investors.

What are the current contribution limits for a Roth IRA?

The contribution limit is the lesser of earned income or $6,000 for 2019 ($7,000 for those 50 or older). Your adjusted gross income, with certain modifications, must be no more than $193,000 on a joint tax return or $122,000 on a single person's tax return to make the full $6,000 contribution. If your adjusted gross income exceeds $193,000 for a joint return or $122,000 for a single person's return, the amount that you may contribute to a Roth IRA is reduced. It is completely eliminated at $203,000 for a joint return and $137,000 for a single person's return.

How do Traditional IRAs and Roth IRAs differ?

Contributions made to a Traditional IRA are typically tax deductible; however, the distributions are considered income in the year they are withdrawn. Roth IRA contributions are not tax deductible; however, the distributions are tax free if you meet the following two requirements:

1. Five tax years have passed since the first contribution was made.
2. The account owner is at least 59 1/2 or the distribution (up to $10,000) is used for the purchase of a "first" home or is made after the owner's death or disability.

If the first requirement is not met, Roth IRA withdrawals are still tax free to the extent they do not exceed your contributions. The Roth IRA is the only form

33 Blair Park Rd.
Suite 201
Williston, VT 05495

49 North Main St.
Rutland, VT 05702

info@dh-cpa.com
www.dh-cpa.com

info@copperleaffinancial.com
www.copperleaffinancial.com

of retirement savings that provides tax free distributions.

Another difference between Traditional IRAs and Roth IRAs is that Roth IRA owners are not subject to the requirement to take minimum distributions beginning at the age of 70 1/2 (minimum distribution rules to apply to the owner's heirs).

With a few very specific exceptions, withdrawals made from a traditional IRA before the age of 59 1/2 incur an early withdrawal penalty in addition to taxes. With a Roth IRA, contributions that have been in the account for at least five years can be withdrawn without taxes or penalties even before the age of 59 1/2. Note, however, that early withdrawal of account earnings (investment returns) is still subject to a penalty with a Roth.

Lastly, contributions to Roth IRAs can continue past age 70 1/2 as long as the owner has earned income. This is not the case with Traditional IRAs.

Can a Traditional IRA be converted to a Roth IRA?

Converting funds from a Traditional IRA to a Roth IRA is allowed. The conversion triggers taxable income that is normally equal to the amount converted, but then future withdrawals from the Roth IRA are generally tax free.

You should consider the following issues when deciding whether to convert funds to a Roth IRA:

1. How long will the funds remain in the Roth IRA? The longer the better.
2. How will your tax rate change in the future? The lower your tax rate is now compared to the expected future tax rate, the better a Roth IRA conversion looks.
3. Do you have the funds outside your IRA to pay the taxes due on conversions? If not, it will generally not make sense to do a conversion.

Of course, conversion is not a no-brainer. You have to be satisfied that paying the upfront conversion tax bill makes sense in your circumstances. In particular, converting a big account all at once could push you into higher tax brackets, which would not be good. You must also make assumptions about future tax rates, how long you will leave the account untouched, the rate of return earned on your Roth IRA investments, and so forth. If the Roth IRA conversion idea intrigues you, please contact us for a full analysis of the tax consequences.

Now Could Be the Right Time to Convert to a Roth IRA

In light of the 2018 sweeping tax law changes now might be the perfect time to consider a Roth conversion. Why? While a majority of taxpayers will have lower tax bills beginning in 2018, the most impactful cuts are scheduled to expire in 2025. This means that there is a limited window to make a Roth conversion at a lower rate than would otherwise be possible in the future.

While no one can predict tax rates post 2025, the expectation is that taxes will need to go up as a result of the country's rising debt and need to fund programs including Social Security and Medicare. And historically, tax rates have been much higher than what they are right now.

Can a Roth IRA be combined with a SIMPLE?

Yes. They can be combined as long as the income thresholds are not exceeded. By combining the two, an individual could put aside up to $19,000 per year for retirement—$13,000 SIMPLE plus $6,000 Roth IRA ($23,000 for those over 50).

Consider Contributing to 401(k) Plans that Accept Roth 401(k) Contributions

Earnings on funds in a Roth IRA grow tax-free (as opposed to merely tax-deferred as in a traditional IRA or 401(k) plan). However, higher-income taxpayers are ineligible to make Roth IRA contributions. Currently, taxpayers covered by a 401(k) plan may be able to designate some or all of their 401(k) contributions as Roth 401(k) contributions. Thus, they may be able to take advantage of tax-free growth in their retirement account just like those who are able to contribute to Roth IRAs. The 2019 contribution limit for Roth 401(k) plans is $19,000 ($25,000 if age 50 or older), which is much higher than the $6,000 ($7,000 if age 50 or older) limit on Roth IRA contributions.

One Caution: Unlike “regular” 401(k) contributions, contributions that you designate as Roth 401(k) contributions are taxed to you the year they’re made. But, the benefit of tax-free earnings and distributions on those contributions (provided they’re held in the plan for a certain amount of time) will often outweigh the tax-deferral on a regular 401(k) plan contribution. This is especially true if your tax rate is higher when you withdraw the money from your 401(k) plan than it was when the funds were contributed (which could be the case given the current federal deficit picture).

Ways to Open a Roth IRA and How to Get Around the Income Limits

Many high-income taxpayers will find that they cannot make a direct creation of a Roth IRA due to income limitations. Individuals with adjusted gross income of $137,000 or more, and married couples filing jointly with an AGI of $203,000 or more, cannot make contributions to a Roth IRA for tax year 2019. However, it’s still possible for these taxpayers to create a Roth IRA through an IRA conversion, also knows as the “back-door” method.

To use the back-door method, an investor puts money into a traditional IRA, most often by making a contribution. Anyone with earned income can contribute to a traditional IRA; the only apparent disadvantage for those with higher incomes is that their contributions are nondeductible. However, since the goal of a back-door conversion is to create a Roth IRA, paying tax on the contribution is desirable anyway.

Once the traditional IRA is established, the account holder can convert it to a Roth IRA. Conversion to a Roth used to be subject to income limits, but present-day laws allow anyone to perform such a conversion.

Bear in mind that if the taxpayer holds one or more traditional IRAs containing contributions made on both a pre-tax and after-tax basis, the pro-rata rule applies. Basically, this rule states that one cannot segregate contributions made to a traditional IRA for the purpose of converting after-tax contributions into a Roth. In other words, if 70 percent of contributions to the taxpayer’s existing IRAs were made on a pre-tax basis, then 70 percent of converted funds will be taxed even if the taxpayer only converts a portion of the existing accounts equal to their past after-tax contributions.

Estate Transfer Benefits

With a Roth IRA there are no mandatory distributions. If the account owner never needs the money in the account, a Roth IRA can be passed along to heirs, who can spread out their own tax-free withdrawals from the account over as many years.

What rules apply to Roth IRA beneficiaries?

If the owner of a Roth IRA dies, the beneficiary is subject to most of the same rules. For example, the beneficiary cannot make tax free distributions unless the funds have been in the account for a minimum of five years. However, the five year period does not start over if the owner dies. In most cases, the beneficiary is required to begin withdrawing from the Roth IRA following the year of the owner’s death. This means that if the funds had not been in the account for five years when you are required to withdraw funds, you should not withdraw more then the original contributions to avoid being taxed on the distribution.

If the sole beneficiary is the spouse, he or she can delay distributions until the descendent would have reached age 70 1/2 or treat the Roth IRA as their own. This results in the five year period being based on the earlier of the inherited Roth IRA or the spouse’s previously existing Roth IRA.

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