

## Roth IRAs

### WHAT IS IT?

A Roth individual retirement account (IRA) is a personal savings plan that offers certain tax benefits to encourage retirement savings. Contributions to a Roth IRA are never tax deductible on your federal income tax return, which means that you can contribute only after-tax dollars. But amounts contributed to the Roth IRA grow tax deferred and, if certain conditions are met, distributions (including both contributions and investment earnings) will be completely tax free at the federal level.

A Roth IRA, like a traditional IRA, is not itself an investment, but a tax-advantaged vehicle in which you can hold some of your investments. You need to decide how to invest your Roth IRA dollars based on your own tolerance for risk and investment philosophy. How fast your Roth IRA dollars grow is largely a function of the investments you choose to fund the IRA.

For 2010, you can contribute up to the lesser of \$5,000 or 100 percent of your taxable compensation to a Roth IRA. You may also be able to contribute up to \$5,000 to a Roth IRA in your spouse's name even if he or she receives little or no taxable compensation. However, not everyone qualifies to use the Roth IRA. Even if you do, you may not qualify to contribute the annual maximum. The amount you can contribute to a Roth IRA (if any) depends on your modified adjusted gross income (MAGI) for the year and your federal income tax filing status.

**TIP:** The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Tax Act) increased the annual IRA contribution limit (combined, for traditional and Roth IRAs) from \$2,000 to \$3,000 per person each year for 2003 and 2004, \$4,000 for 2005 through 2007, and up to \$5,000 each year for 2008 and beyond. These contribution limits are indexed for inflation beginning in 2009. The law also allows taxpayers age 50 and older to make additional "catch-up" contributions. These individuals can put up to \$3,500 each year in their IRAs for 2003 and 2004, \$4,500 for 2005, \$5,000 in 2006 and 2007, and \$6,000 each year for 2008 and beyond.

**TIP:** Consider contributing to a Roth IRA rather than a traditional deductible IRA if you expect that you may be in the same or a higher federal income tax bracket when you retire. If you can't make deductible contributions to a traditional IRA and are trying to decide between making nondeductible contributions to a traditional IRA or contributing to a Roth IRA, you should probably choose the Roth IRA. If you are eligible to contribute to a Roth IRA, there is generally no advantage to making nondeductible contributions to a traditional IRA.

**TIP:** If you participate in a 401(k) or 403(b) plan at work, you may be able to make Roth contributions to the plan. Qualified distributions of these contributions and related earnings may be income tax free (and penalty free) at the federal level. The ability to make Roth

contributions to your employer's plan may be a factor in your decision of whether to contribute to a Roth IRA, or convert funds from a traditional IRA to a Roth IRA. Be sure to discuss your situation with a qualified professional before making any decisions.

**CAUTION:** Special rules apply to qualified individuals impacted by certain natural disaster, certain former Enron employees, certain employees of bankrupt airlines, taxpayers who receive certain Exxon Valdez settlement payments, and certain distributions to reservists and national guardsmen called to active duty after September 11, 2001.

## **WHEN CAN IT BE USED?**

### ***You must receive taxable compensation during the year***

To contribute to an IRA (Roth or traditional), you must receive taxable compensation during the year. For purposes of IRA contributions, taxable compensation includes wages, salaries, commissions, self-employment income, and taxable alimony or separate maintenance. Other taxable income, such as interest earnings, dividends, rental income, pension and annuity income, and deferred compensation, does not qualify as taxable compensation for this purpose. Your contribution for a given year cannot exceed your taxable compensation for that year.

**TIP:** The 2006 Heroes Earned Retirement Opportunities (HERO) Act allows members of the Armed Forces to include nontaxable combat pay as part of their taxable compensation when determining how much they can contribute to an IRA (their own or a spousal IRA) in tax years beginning after December 31, 2003. Prior to the Act, a serviceman or woman with only nontaxable combat pay was unable to make an IRA contribution. For service members with only nontaxable combat pay, Roth IRA contributions will generally make more sense than nondeductible contributions to a traditional IRA.

**TIP:** The Heroes Earnings Assistance and Relief Tax Act of 2008 permits an individual who receives a military death gratuity or Service members' Group Life Insurance ("SGLI") program payment to contribute the funds to a Roth IRA within one year of receiving the death benefits. These contributions are treated as rollover contributions to the Roth IRA account, and are not subject to normal income or contribution limits. The Act applies to payments made on account of deaths from injuries occurring on or after June 17, 2008. In the event of a subsequent distribution from a Roth IRA that is not a qualified distribution, the amount of the distribution attributable to the contribution of the military death gratuity or SGLI payment is treated as nontaxable investment in the contract.

**TIP:** Beginning in 2009, the Heroes Earnings Assistance and Relief Tax Act of 2008 provides that differential pay received by service members is considered compensation for IRA contribution purposes. Differential pay is defined as any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer.

***Your ability to make annual contributions depends on your income and filing status during the year***

If you file your federal income tax return as single or head of household and your MAGI for 2010 (and 2009) is \$105,000 or less, you can make a full contribution to your Roth IRA. Similarly, if you file your return as married filing jointly or qualifying widow(er) and your MAGI for 2010 is \$167,000 (\$166,000 for 2009) or less, you can make a full contribution. Otherwise, your allowable Roth IRA contribution is reduced or eliminated as follows:

If your federal filing status is:	Your Roth IRA contribution is reduced if your MAGI is:	You cannot contribute to a Roth IRA if your MAGI is:
Single or head of household*	More than \$105,000 but less than \$120,000 (for 2009 and 2010)	\$120,000 or more (for 2009 and 2010)
Married filing jointly or qualifying widow(er)*	More than \$167,000 but less than \$177,000 (\$166,000-\$176,000 for 2009)	\$177,000 or more (\$176,000 for 2009)
Married filing separately	More than \$0 but less than \$10,000	\$10,000 or more

*\*These income ranges are indexed for inflation each year.*

If you are married filing a joint return, you may be able to contribute to a Roth IRA for your spouse even if he or she has little or no taxable compensation. If you are married filing separate returns and you lived apart from your spouse at all times during the taxable year, you are treated as a single taxpayer for purposes of the Roth IRA rules.

**TIP:** To calculate the exact amount of your allowable Roth IRA contribution, a step-by-step worksheet is available. See IRS Publication 590, Individual Retirement Arrangements (IRAs).

**TIP:** These income limits don't apply to rollover contributions to your Roth IRA.

***You must not have already contributed the annual maximum to your traditional IRA***

Total contributions to all of your IRAs (traditional and Roth) cannot exceed \$5,000 for 2010 (\$6,000 if you're age 50 or older). If you contribute the maximum allowed to your traditional IRA for any year, you cannot contribute to your Roth IRA at all for that year. If you make a partial contribution to your traditional IRA, your allowable Roth IRA contribution for that year is equal to the difference between the annual IRA contribution limit and the amount contributed to your traditional IRA (or vice versa).

**EXAMPLE(S):** You have a traditional IRA and a Roth IRA. You contribute \$2,900 to your traditional IRA for the year. You can contribute no more than \$2,100 to your Roth IRA for that year (\$3,100 if age 50 or older).

**TIP:** The annual contribution limits (\$5,000 in 2009 and 2010) don't apply to rollover contributions.

**CAUTION:** The Pension Protection Act of 2006 provides that an active reservist or guardsman who receives a qualified reservist distribution can repay all or part of that distribution to an IRA at any time during the two year period beginning on the day after active duty ends (or, if later, the two year period beginning August 17, 2006). The regular IRA contribution limits don't apply to these repayments. A qualified reservist distribution is a payment from an IRA, or a payment of elective deferrals and earnings from a 401(k) plan or 403(b) plan, to an active reservist or guardsman who is called to duty after September 11, 2001 for a period in excess of 179 days (or for an indefinite period).

**CAUTION:** The Pension Protection Act of 2006 allows certain individuals who participated in the Enron Corporation 401(k) plan to make special IRA catch-up contributions of up to \$3,000 per year for tax years 2007 through 2009. Taxpayers who make these special contributions aren't allowed to make age 50 catch-up contributions.

**CAUTION:** The Worker, Retiree, and Employer Recovery Act of 2008 allows certain employees of bankrupt airlines to transfer, within 180 days of receipt, all or part of certain payments authorized by the bankruptcy court to a Roth IRA. These transfers are treated as rollovers, and the annual Roth IRA contribution limits do not apply.

## **STRENGTHS**

### ***Qualified distributions are completely tax free***

A withdrawal from a Roth IRA (including both contributions and investment earnings) is completely tax free (and penalty free) if (1) made at least five years after you first establish any Roth IRA, and (2) one of the following also applies:

- You have reached age 59½ by the time of the withdrawal
- The withdrawal is made due to qualifying disability
- The withdrawal is made for first-time homebuyer expenses (\$10,000 lifetime limit)
- The withdrawal is made by your beneficiary or estate after your death

Withdrawals that meet these conditions are referred to as qualified distributions. If the above conditions aren't met, any portion of a withdrawal that represents investment earnings will be subject to federal income tax and may also be subject to a 10 percent premature distribution tax if you are under age 59½. See Questions & Answers.

**TIP:** The five-year holding period begins on January 1 of the tax year for which you make your first contribution (regular or rollover) to any Roth IRA. Each taxpayer has only one five-year holding period for this purpose.

**EXAMPLE(S):** You make an annual Roth contribution on April 15, 2011, and designate the contribution for the 2010 tax year. If this is your first Roth contribution, your five-year holding period begins on January 1, 2010.

**TIP:** Because the five-year holding period runs from the first day of the tax year in which you establish any Roth IRA you should establish one as soon as you can, even if you can afford only a minimal contribution. The earlier you satisfy the five-year holding period, the sooner you may be able to receive tax-free qualified distributions from your Roth IRA.

### ***Fewer restrictions on making withdrawals prior to retirement***

The ability to make tax-free withdrawals from a Roth IRA under certain conditions ("qualified distributions") can be a compelling reason to use this type of IRA. Furthermore, even if you make a withdrawal that fails to meet those conditions (a "nonqualified" distribution), you may not be taxed on the full amount of the withdrawal. That's because when you withdraw funds from your Roth IRA, distributions are treated as consisting of your contributions first and investment earnings last. Since amounts that represent your contributions have already been taxed, they are not taxed again or penalized (even if you are under age 59½) when you withdraw them from the Roth IRA. Only the portion of a nonqualified distribution that represents investment earnings will be taxed and possibly penalized.

**CAUTION:** If you convert funds from a traditional IRA to a Roth IRA, special penalty provisions may apply if you subsequently withdraw funds from the IRA within five years of the conversion (and prior to age 59½).

### ***You can contribute to a Roth IRA after age 70½***

Unlike traditional IRAs, you can contribute to a Roth IRA for every year that you have taxable compensation, including the year in which you reach age 70½ and every year thereafter.

### ***Your funds can stay in a Roth IRA longer than in a traditional IRA***

The IRS requires you to take annual required minimum distributions from traditional IRAs beginning when you reach age 70½. These withdrawals are calculated to dispose of all of the money in the traditional IRA over a given period of time. Roth IRAs are not subject to the required minimum distribution rule. In fact, you are not required to take a single distribution from a Roth IRA during your life (although distributions are generally required after your death). This can be a significant advantage in terms of your estate planning.

**TIP:** The Worker, Retiree, and Employer Recovery Act of 2008 waives Roth IRA post-death required minimum distributions for the 2009 calendar year.

### ***You can contribute even if covered by an employer-sponsored retirement plan***

Unlike a traditional IRA where you make deductible contributions, your ability to contribute to a Roth IRA (or to make nondeductible contributions to a traditional IRA) does not depend on whether you or your spouse is covered by an employer-sponsored retirement plan. The fact that one of you is covered by such a plan has no bearing on your allowable contribution to a Roth IRA. However, remember that your ability to contribute to a Roth IRA does depend on your tax filing status and MAGI for the year.

### ***Investment choices are broad and diverse***

Like a traditional IRA, you can establish a Roth IRA with a bank, mutual fund company, life insurance company, or stockbroker. You can even have multiple IRA accounts with more than one institution. Furthermore, you can choose from a wide range of specific investments to fund your Roth IRA. Intense competition for IRA dollars has led to a large number of IRA providers and investment choices.

**CAUTION:** The IRS has ruled that the wash sales rules apply if you sell stock or other securities outside of your IRA for a loss, and purchase substantially identical stock or securities in your IRA (traditional or Roth) within 30 days before or after the sale. The result is that you cannot take a deduction for your loss on the sale of the stock or securities. In addition, your basis in your IRA is not increased by the amount of the disallowed loss.

### ***When you die, your beneficiaries may pay no income tax on proceeds***

As long as any Roth IRA you have established has been in existence for at least five years at the time of your death, your beneficiaries will not have to pay any federal income tax on post-death distributions from any Roth IRA you own. Even if you haven't satisfied the five-year holding period at the time of your death, distributions to your beneficiary will still be tax free if he or she waits until the date you would have satisfied the five-year holding period before taking distributions from the Roth IRA. Tax-free distributions to your beneficiary can make the Roth IRA a very valuable estate planning tool. However, bear in mind that the value of your Roth IRA will be included in your taxable estate to determine if federal estate tax is due.

**CAUTION:** The five-year holding period applies independently to Roth IRAs you hold as a beneficiary, and Roth IRAs you hold as your own.

If your sole beneficiary is your surviving spouse, and your spouse treats your Roth IRA as his or her own when you die, then distributions from the Roth IRA will be tax-free only if your spouse satisfies the requirements for a qualified distribution (that is, your spouse satisfies the five-year holding period, and the distribution is made after your spouse attains age 59½, becomes disabled, dies, or incurs qualifying first-time homebuyer expenses). The five-year holding period--for both the inherited IRA and any other Roth IRAs your spouse may own--ends on the earlier of (a) the end of your five-year holding period, or (b) the end of the five-year holding period applicable to your spouse's own Roth IRAs.

### ***Contributions are discretionary***

Like a traditional IRA, you do not have to make a contribution to your Roth IRA for any year unless you choose to. Within the limits on the amount that you can contribute each year, you can exercise complete discretion in deciding how much and when to save.

### ***A Roth IRA is relatively simple to maintain***

Like a traditional IRA with deductible contributions, a Roth IRA is relatively simple to maintain. There are no annual reporting requirements for Roth IRAs.

### ***Traditional IRAs can be converted to Roth IRAs***

If you qualify, you can convert your traditional IRA funds to a Roth IRA. This may be advisable if you have determined that you will reap more benefits from the Roth IRA than the traditional IRA. However, you should carefully consider the income tax consequences and other issues associated with converting funds.

### ***"Catch-up" contributions are allowed if you're at least 50***

Individuals age 50 and older may make an additional yearly "catch-up" contribution up to \$1,000 to a traditional or Roth IRA (over and above the regular contribution limit). The purpose of this provision is to help older individuals increase their savings as they approach retirement.

### ***You may qualify for a tax credit***

Certain low- and middle-income taxpayers can claim a partial, nonrefundable income tax credit for amounts contributed to a traditional or Roth IRA. The maximum annual contribution eligible for the credit is \$2,000. The maximum credit is \$1,000 (50 percent of \$2,000) per taxpayer, but the actual amount of the credit (if any) depends on your MAGI. Here are the credit rates based on 2010 MAGI limits (these limits are adjusted annually for inflation):

Joint Filers	Heads of Household	All Other Filers	Credit Rate	Maximum Credit (Per Taxpayer)
\$0 - \$33,500	\$0 - \$25,125	\$0 - \$16,750	50% of contribution (up to \$2,000)	\$1,000
\$33,500 - \$36,000	\$25,125 - \$27,000	\$16,750 - \$18,000	20%	\$400
\$36,000 - \$55,500	\$27,000 - \$41,625	\$18,000 - \$27,750	10%	\$200
Over \$55,500	Over \$41,625	Over \$27,750	0%	\$0

To claim the credit, you must be at least 18 years old and not a full-time student or a dependent on another taxpayer's return. The credit is in addition to any income tax deduction you might qualify for with respect to your IRA contribution.

**CAUTION:** The amount of any contribution eligible for the credit may be reduced by any taxable distributions you (or your spouse if you file a joint return) receive from an IRA or employer-sponsored retirement plan (or any nontaxable distributions from a Roth IRA) during the same tax year, during the period for filing your tax return for that year (including extensions), or during the prior two years.

## TRADEOFFS

### *You can contribute only after-tax dollars*

Contributions to a Roth IRA are never tax deductible on your federal income tax return. In other words, you can contribute only after-tax dollars to a Roth IRA. This is in contrast to a traditional IRA, which may allow you to deduct your contributions under certain conditions.

### *Contributions are limited to the annual maximum (or possibly even less)*

You cannot contribute a total of more than \$5,000 per year to all of your IRAs (Roth and traditional) for 2010 (\$6,000 if you're age 50 or older by the end of the calendar year).

**EXAMPLE(S):** You have two traditional IRAs and a Roth IRA. You can contribute no more than \$5,000 overall in 2010. You can contribute the entire \$5,000 to any of the three IRAs, or you can divide the \$5,000 contribution among them in any manner you choose.

**TIP:** The annual contribution limits don't apply to rollover contributions.

**TIP:** You may also be able to contribute up to \$5,000 to an IRA in your spouse's name in 2010 even if he or she has little or no taxable compensation (\$6,000 if your spouse is age 50 or older).

**CAUTION:** The Pension Protection Act of 2006 provides that an active reservist or guardsman who receives a qualified reservist distribution can repay all or part of that distribution to an IRA at any time during the two year period beginning on the day after active duty ends (or, if later, the two year period beginning August 17, 2006). The regular IRA contribution limits don't apply to these repayments.

**CAUTION:** The Pension Protection Act of 2006 allows certain individuals who participated in the Enron Corporation 401(k) plan to make special IRA catch-up contributions of up to \$3,000 per year for tax years 2007 through 2009. The regular IRA contribution limits don't apply to these repayments. Taxpayers who make these special contributions aren't allowed to make age 50 catch-up contributions.

**CAUTION:** The Worker, Retiree, and Employer Recovery Act of 2008 allows certain employees of bankrupt airlines to transfer, within 180 days of receipt, all or part of certain payments authorized by the bankruptcy court to a Roth IRA. These transfers are treated as rollovers, and the annual Roth IRA contribution limits do not apply.

***Your ability to contribute in 2010 depends on your income and tax filing status***

If your federal income tax filing status is:	Your allowable Roth IRA contribution is reduced if your MAGI is:	You cannot contribute to a Roth IRA if your MAGI is:
Single or head of household*	More than \$105,000 but less than \$120,000	\$120,000 or more
Married filing jointly or qualifying widow(er)*	More than \$167,000 but less than \$177,000	\$177,000 or more
Married filing separately	More than \$0 but less than \$10,000	\$10,000 or more

*\*These income ranges are indexed for inflation each year.*

**TIP:** If you are married but did not live with your spouse at any time during the year and you file a separate return, you are considered single for Roth IRA contribution eligibility purposes.

***Withdrawals are taxable under certain conditions***

A withdrawal from a Roth IRA (including both contributions and investment earnings) is completely tax free only if it is a qualified distribution (see Strengths, above).

If your withdrawal is a nonqualified distribution, the portion of your distribution that represents investment earnings will be subject to federal income tax, and may also be subject to a 10 percent premature distribution tax if you are under age 59½ (unless one of the exceptions applies). Only the portion of a nonqualified distribution that represents your contributions will not be taxed or penalized, since those dollars were taxed once already.

***Special penalty provisions may apply to withdrawals of Roth IRA funds that were converted from a traditional IRA***

If you roll over or convert funds from a traditional IRA to a Roth IRA, special rules apply. If you are under age 59½, any nonqualified withdrawal that you make from the Roth IRA within five years of the rollover or conversion may be subject to the 10 percent premature distribution tax (to the extent that the withdrawal consists of converted funds that were taxed at the time of conversion). The reason for this special rule is to ensure that taxpayers don't convert funds from a traditional IRA solely to avoid the early distribution penalty.

**TIP:** The five-year holding period begins on January 1 of the tax year in which you convert the funds from the traditional IRA to the Roth IRA. When applying this special rule, a separate five-year holding period applies each time you convert funds from a traditional IRA to a Roth IRA.

**CAUTION:** This five-year period may not be the same as the five-year period used to determine whether your withdrawal is a qualified distribution.

**EXAMPLE(S):** In 2007, you open your first Roth IRA account by converting a \$10,000 traditional IRA to a Roth IRA. You include \$10,000 in your taxable income for 2007. You make no further contributions. In 2010, at age 55, your Roth IRA is worth \$12,000, and you withdraw \$10,000. The distribution is not a qualified distribution because five years have not elapsed from the date you first established a Roth IRA. And because you are making a nonqualified withdrawal within five years of your conversion, the entire \$10,000 is subject to a 10 percent premature distribution tax unless you qualify for an exception. This "recaptures" the early distribution tax you would have paid at the time of the conversion.

You open a regular Roth IRA account in 2003 with a contribution of \$100, and make no further contributions to the account. In 2007, at age 60, you convert a \$100,000 traditional IRA to a Roth IRA. In 2010 you withdraw \$50,000 from this Roth IRA. Because you are over age 59½ in 2010, and because more than five years have elapsed from January 1, 2003 (the year you first established any Roth IRA), your withdrawal is a qualified distribution and is totally free of federal income taxes. Even though your withdrawal was within five years of the conversion, no penalty tax applies.

### ***States differ in their treatment of Roth IRAs***

Although most states follow the federal income tax treatment of Roth IRAs, some may not. You should check with your tax advisor regarding the tax treatment of Roth IRAs in your particular state. In addition, some states may provide Roth IRA funds with less creditor protection than they provide traditional IRA funds.

**TIP:** Federal law provides protection for up to \$1,095,000 (as of April 1, 2007) of your aggregate Roth and traditional IRA assets if you declare bankruptcy. (Amounts rolled over to your Roth IRA from an employer qualified plan or 403(b) plan, plus any earnings on the rollover, aren't subject to this dollar cap and are fully protected.) The laws of your particular state may provide additional bankruptcy protection, and may provide protection from the claims of your creditors in cases outside of bankruptcy.

### ***The law may change in the future***

Most of the advantages offered by the Roth IRA depend on the federal government's promise that qualifying distributions from Roth IRAs will always be tax free. It is unlikely, but if the law changes, all bets are off. Remember that Social Security benefits were once not subject to federal income tax, but federal law was later changed to tax a percentage of such benefits in certain situations.

## HOW TO DO IT

### *Establish a Roth IRA*

Where you choose to establish your Roth IRA and the specific investments you choose depends on your own personal needs and preferences. You have a wide variety of choices, and you should carefully consider the matter before making your decision. How fast your Roth IRA dollars grow is more a function of investment strategy and performance than of tax exemption. Consider whether you want to establish a Roth IRA with a:

- Bank
- Financial institution
- Mutual fund company
- Stockbroker
- Life insurance company

You should also consider the types of investments (e.g., stocks, bonds, mutual funds, CDs, annuities) that will best suit your goals and risk tolerance, as well as the fees that are associated with opening and maintaining your Roth IRA. Finally, keep in mind that you can establish multiple IRA accounts with more than one institution.

**TIP:** Employers who maintain certain retirement plans (like 401(k), 403(b), or 457(b) plans) can allow employees to make their regular IRA contribution--traditional or Roth--to a special account set up under their retirement plan. These accounts, called "deemed IRAs," function just like regular IRAs. Advantages include the fact that your retirement assets can be consolidated in one place, contributions can be made automatically through payroll deduction, you can take advantage of any special investment opportunities offered in your employer's plan, and your protection from creditors may be greater than that available in a stand-alone IRA. The downside is that your investment choices in your employer's plan may be very limited in comparison to the universe of investment options available to you in a separate IRA. Also, the distribution options available to you and your beneficiaries in a deemed IRA may be more limited than in a stand-alone IRA. Because of the administrative complexity involved, most employers have so far been reluctant to offer these arrangements. Check with your plan administrator to see if this is an option for you.

### ***You have until the due date of your federal tax return for the year (usually April 15) to make a contribution for that year***

If you want to make a Roth IRA contribution for the year, you have until the due date of that year's federal income tax return. For most people, this is April 15 of the following year. Your contribution deadline is not extended by any extension you may receive to file your return. So, if you obtain an automatic four-month extension, you may have additional time to file your tax return but you don't have any additional time to make a Roth IRA contribution.

**TIP:** You can direct the IRS to deposit all or part of your federal income tax refund directly to an IRA (subject to the normal rules governing the amount, timing, and deductibility of IRA contributions).

### ***Designate the IRA as a Roth IRA***

To be a Roth IRA, the IRA must be designated as a Roth IRA at the time you establish it.

### ***Designate the year for which the contribution is made***

If you contribute to your Roth IRA after December 31, you should tell the Roth IRA trustee or custodian for which year the contribution is being made. For example, if you make a contribution in February 2011 for the 2010 tax year, you should clearly identify the contribution as being made for 2010. Otherwise, the trustee or custodian may assume that the contribution is for 2011 (the year in which it is received) and report it as such. Talk to your custodian or trustee about how you should identify your contribution.

## **TAX CONSIDERATIONS**

### ***Income Tax Contributions to a Roth IRA are made with after-tax dollars***

Unlike deductible contributions to a traditional IRA, you do not have the option of deducting Roth IRA contributions and reducing your taxable income on your federal income tax return. You can contribute only after-tax dollars to a Roth IRA.

### ***Qualified distributions are tax free***

A withdrawal from a Roth IRA (including both contributions and investment earnings) is completely tax free (and penalty free) at the federal level if made at least five years after you first establish any Roth IRA, and if one of the following also applies:

- You have reached age 59½ by the time of the withdrawal
- The withdrawal is made due to qualifying disability
- The withdrawal is made to pay for first-time homebuyer expenses (\$10,000 lifetime limit)
- The withdrawal is made by your beneficiary or estate after your death

**TIP:** The five-year holding period begins on January 1 of the tax year for which you make your first contribution (regular or rollover) to any Roth IRA. Each taxpayer has only one five-year holding period for this purpose.

### ***Even if a withdrawal does not qualify for tax-free treatment, only the portion representing earnings is taxable***

If you make a withdrawal from a Roth IRA that does not meet the above conditions, the portion of the withdrawal that represents investment earnings will be subject to federal income tax at ordinary income tax rates (even if the funds represent long-term capital gains or qualifying dividends), and may also be subject to a 10 percent premature distribution tax if you are under age 59½. However, the portion of the withdrawal that represents Roth IRA contributions will not be subject to federal income tax or penalty

as those dollars were already taxed. Roth IRA withdrawals are treated as being made from contributions first and investment earnings last. All of your Roth IRAs are aggregated when determining the taxable portion of your nonqualified distribution.

**TECHNICAL NOTE:** Technically, a distribution from a Roth IRA that is not a qualified distribution, and is not rolled over to another Roth IRA, is included in your gross income to the extent that the distribution, when added to the amount of any prior distributions (qualified or nonqualified) from any of your Roth IRAs, and reduced by the amount of those prior distributions that were previously included in your gross income, exceed your contributions to all your Roth IRAs. For this purpose any amount distributed to you as a corrective distribution is treated as if it was never contributed.

**CAUTION:** If you convert funds from a traditional IRA to a Roth IRA, special rules may apply if you subsequently withdraw funds from the Roth IRA.

### ***Gift and Estate Tax***

When you die, the assets in your Roth IRA are considered when determining if estate tax is due.

Unless you name your spouse as beneficiary (unlimited marital deduction) or a charity as beneficiary (charitable deduction), the full value of your Roth IRA at the time of your death is included in your taxable estate to determine if federal estate tax is due. In addition, your state may impose a state death tax.

## **QUESTIONS & ANSWERS**

***If your ability to contribute to a Roth IRA is limited because of your income, how much can you contribute?***

If your MAGI falls within the applicable range for your tax filing status (see the **WHEN CAN IT BE USED?** section above), you can make only a partial contribution to your Roth IRA.

***Are there restrictions on making withdrawals from a Roth IRA?***

Yes and no. You are free to make withdrawals at any time from your Roth IRA, but only qualified distributions receive tax-free treatment. A qualified distribution is not subject to federal income tax or a 10 percent premature distribution tax. See **TAX CONSIDERATIONS**, above.

If your withdrawal is nonqualified the portion of such distribution that represents investment earnings is subject to federal income tax and may also be subject to the 10 percent premature distribution tax if you are under age 59½. However, the portion that represents your Roth IRA contributions is not subject to tax or penalty as those dollars have been taxed once already.

**EXAMPLE(S):** In 2010, you establish your first Roth IRA and you contribute \$5,000 in after-tax dollars. You make no further contribution to the Roth IRA. Two years later, your Roth IRA

has grown to \$5,300. You withdraw the entire \$5,300. Because you withdrew the funds within five tax years, your withdrawal does not meet the requirements for a qualified distribution. You already paid tax on the \$5,000 you contributed, so that portion of your withdrawal is not taxed or penalized. However, the \$300 that represents investment earnings is subject to tax and possibly the 10 percent premature distribution tax (unless an exception applies).

**TIP:** Distributions from Roth IRAs are generally treated as being made from contributions first and earnings last (see ordering rules below). In the previous example, if you withdrew only \$5,000 (leaving \$300 in the Roth IRA), the withdrawal would be tax free (and penalty free) since the entire amount would be considered a return of your contributions.

### ***Can you roll over funds to a Roth IRA?***

Yes. Funds in one Roth IRA can be rolled over tax free to another Roth IRA. This can be done as a direct transfer of funds from one Roth IRA trustee or custodian to another, or you can have the funds distributed to you and then roll them over to the new Roth IRA trustee or custodian yourself. If you choose the latter method and fail to complete the rollover within 60 days (from the date you received the funds), you may be subject to tax and penalty on the investment earnings portion of the funds (unless you qualify for tax-free withdrawals from the Roth IRA).

Funds can also be rolled over from a Roth 401(k) or Roth 403(b) account to a Roth IRA. You can establish a Roth IRA and roll over a distribution from a Roth 401(k)/403(b) account even if you would not otherwise be eligible to make regular or conversion contributions to a Roth IRA because of income limits. If the distribution from the Roth 401(k)/403(b) account is a tax-free qualified distribution, then the entire amount of the rollover is treated as part of your basis in the Roth IRA. If the distribution from the Roth 401(k)/403(b) account is nonqualified, then only the nontaxable portion of the distribution is treated as part of your basis in the Roth IRA, and the taxable portion is treated as earnings. Rollovers can be either direct or 60-day rollovers.

**CAUTION:** Separate five-year holding periods apply to Roth IRAs and Roth 401(k)/403(b) accounts. A rollover from a Roth 401(k)/403(b) account does not affect the Roth IRAs five-year holding period, regardless of how long the dollars rolled over resided in the 401(k)/403(b) plan. However, if the rollover is your first contribution to the Roth IRA, it will start the clock on your Roth IRA five-year holding period.

**CAUTION:** You cannot make a rollover from a Roth IRA to a Roth 401(k)/403(b) account.

You can also make a direct rollover from a non-Roth 401(k), 403(b), or governmental 457(b) account to a Roth IRA, but only if you meet the same income limits and other requirements that apply when converting a traditional IRA to a Roth IRA. The taxable portion of your distribution from the 401(k), 403(b), or 457(b) plan will be included in your gross income in the year you make the rollover. (Prior to 2008, to accomplish the same result you needed to first make a rollover from your employer's plan to a traditional IRA, and then convert the traditional IRA to a Roth IRA. The new rules streamline this procedure.)

**TIP:** Funds can also be converted or rolled over from a traditional IRA to a Roth IRA, though special rules and limitations apply.

***When you withdraw funds from a Roth IRA, in what order are the funds considered withdrawn?***

Withdrawals from Roth IRAs are considered made in the following order:

- Regular Roth IRA contributions (i.e., contributions other than rollover or conversion contributions).
- Rollover or conversion contributions, in the order made (i.e., first in, first out). If any rollover or conversion included nondeductible contributions, the withdrawal is considered made first from funds that were subject to federal income tax at the time of the rollover or conversion.
- Any investment earnings.

All Roth IRAs you maintain are aggregated (i.e., treated as a single Roth IRA) for purposes of classifying withdrawals.

***Can you recognize a loss on Roth IRA investments?***

If you have a loss on your Roth IRA investment, you can recognize (include) the loss on your federal income tax return, but only when all the amounts in all of your Roth IRA accounts have been distributed to you, and the total distributions are less than your unrecovered basis, if any. Your basis is the total amount of your contributions to your Roth IRAs. You claim the loss as a miscellaneous itemized deduction, subject to the 2 percent-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040.

**EXAMPLE(S):** Bill has made nondeductible contributions to a Roth IRA totaling \$2,000, giving him a basis at the end of 2008 of \$2,000. By the end of 2009, his IRA earns \$400 in interest income. In that year, Bill receives a distribution of \$700, reducing the value of his Roth IRA to \$1,700 (\$2,000 plus \$400 minus \$700). The entire \$700 is considered to be a return of Bill's contributions, reducing his basis in the Roth IRA to \$1,300. In 2010, Bill's Roth IRA has a loss of \$500. At the end of that year, Bill's Roth IRA balance is \$1,200 (\$1,700 minus \$500), and Bill withdraws the entire amount. Bill does not have any other Roth IRAs. He can claim a loss for 2010 of \$100 (the \$1,300 basis minus the \$1,200 distribution of the Roth IRA balance).

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