[V23N2]

Introduction to Roth IRAs

- Contributions are made on an after-tax basis
- There's no up-front tax benefit
- Qualified distributions are entirely free from federal income tax
- Caution: Different rules may apply for state tax purposes

Roth IRAs have proliferated since their introduction in 1998. In 2021, approximately 27.3 million, or 21% of, U.S. households, had Roth IRAs. [Source: 2022 Investment Company Fact Book.]

<CLICK> Contributions to Roth IRAs are made on an after-tax basis, so

<CLICK> there's no up-front tax benefit.

<CLICK> But if certain conditions are satisfied, distributions from Roth IRAs are totally free from federal income taxes. It's this potential for tax-free withdrawals that has made Roth IRAs so attractive.

<CLICK> Bear in mind that different state rules may also apply.

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Traditional IRA vs. Roth IRA

Traditional IRA

- Can make annual contribution if you have taxable compensation
- Deductibility depend on income, filing status, and coverage by retirement plan
- Can make after-tax (nondeductible) contributions
- Distributions subject to federal income tax, except for after-tax contributions
- Distributions prior to age 59½ may be subject to additional 10% penalty
- Distributions required after 73
- Funds grow tax deferred

Roth IRA

- Can make annual contribution if you have taxable compensation
- Ability to contribute depends on income and filing status
- All contributions are after-tax (no up-front deduction)
- Qualified distributions are entirely free from federal income taxes
- For nonqualified distributions, earnings subject to federal income tax; 10% penalty may apply if under age 59½
- No lifetime required distributions
- Funds grow tax deferred/tax free

Practically anyone can open and make annual contributions to a traditional IRA. <CLICK> The only requirement is that you have taxable compensation.

<CLICK> Whether or not you can deduct your contributions, though, depends on your income, filing status, and whether you or your spouse is covered by an employer retirement plan.

<CLICK> But even if you're not eligible to deduct your contributions, you can make *nondeductible* contributions to a traditional IRA. This is important, and I'll touch upon this again later. Nondeductible contributions are often called "after-tax" contributions.

<CLICK> When you withdraw funds from your traditional IRA, the entire distribution is taxable, except for your after-tax contributions. That is, your deductible contributions, and any IRA earnings, are taxed when you withdraw them. And if you're not yet 59½, a 10% early distribution penalty may also apply to the taxable amount.

<CLICK> Distributions are required once you reach age 73 (prior to 2023, age could be 72 or 70½, depending on year of birth).

<CLICK> With a Roth IRA, just as with a traditional IRA, you must have taxable compensation to make annual contributions.

<CLICK> But not everyone can make annual contributions to a Roth IRA. Roth IRA contributions are phased out for individuals with higher incomes. Whether you can contribute, and whether you can make a full or partial contribution, depends on your modified adjusted gross income and your income tax filing status.

<CLICK> Unlike traditional IRAs, contributions to a Roth IRA are always made with after-tax dollars — you don't get a deduction for your contributions. When you make a withdrawal from your Roth IRA, your contributions always come out tax free. And if your withdrawal is "qualified," earnings in your Roth IRA are also tax free.

<CLICK> You aren't required to take any distributions during your lifetime.

<CLICK> With both traditional and Roth IRAs, funds grow tax deferred, and for Roth IRAs, potentially tax free.

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Roth Tax-Free Qualified Distributions

Qualified distributions are federal income tax free.

For a distribution to be qualified, it must meet BOTH of the following requirements:

- **Satisfy five-year holding period**

  AND
- **Have qualifying event**
  - Age 59½
  - Disability
  - First-time homebuyer expenses (limited to $10,000 lifetime from all IRAs)
  - Death

If you meet certain conditions, your withdrawals from a Roth IRA will be completely free from federal income tax.

<CLICK> To qualify, you must satisfy a five-year holding requirement,

<CLICK> and you generally must reach age 59½ before making the withdrawal.

<CLICK> Even if you haven't reached age 59½, distributions will be tax free if you satisfy the five-year holding period requirement and you make the withdrawal either because of a disability, or

<CLICK> to pay certain first-time homebuyer expenses.

<CLICK> Payments after your death are also qualified if the five-year holding period is satisfied.

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Roth Qualified Distributions: The Five-Year Holding Period

- Five-year holding period begins on the first day of tax year for which you first made a contribution (annual, rollover, or conversion) to ANY Roth IRA
- Five-year holding period ends after five calendar years
- Applies to your beneficiaries after your death as well
- Spouse beneficiary can roll over to own Roth IRA or treat your Roth IRA as his or her own. In either case, the five-year holding period begins on the *earlier* of:
  - January 1 of tax year your spouse first established any Roth IRA, or
  - January 1 of tax year you first established any Roth IRA

Period begins on January 1 of first tax year for which you made a contribution to any Roth IRA

- Can make a regular (annual) contribution to an IRA for a tax year until April 15 of following year
- If you make regular contribution to first Roth IRA on April 15, 2023, and designate contribution for 2022, five-year holding period begins on January 1, 2022

The five-year holding period begins on January 1 of the tax year for which you first make a contribution to ANY Roth IRA, and

<CLICK> ends after five full calendar years.

You have only one five-year holding period for all Roth IRAs you own for calculating qualified distributions. However, Roth IRAs you inherit are subject to different rules.

<CLICK> The five-year holding period also applies to your beneficiaries after your death. So even though your death is a qualifying event, your beneficiaries will not be able to receive tax-free distributions from your Roth IRA until the five-year holding period is satisfied.

<CLICK> Spouse beneficiaries have additional options. Your spouse can roll your Roth IRA proceeds into his or her own Roth IRA. If your spouse is your sole beneficiary, your spouse can also treat your Roth IRA as his or her own. In either case, your spouse will be able to use either your holding period or his or her own, whichever is more favorable. That is, the five-year holding period will begin on January 1 of the tax year your spouse first established any Roth IRA or, if earlier, January 1 of the tax year for which you first established any Roth IRA.

As I've said, the five-year holding period begins on January 1 of the *tax* year for which you first establish ANY Roth IRA.

Remember that you generally have until April 15 to make an annual contribution to an IRA for the previous tax year.

So, for example, if you make your first contribution to a Roth IRA on April 15, 2023, and you designate that contribution for the 2022 tax year, your five-year holding period will begin on January 1, 2022.

Now let's look at some specific examples of how the qualified distribution rules work.

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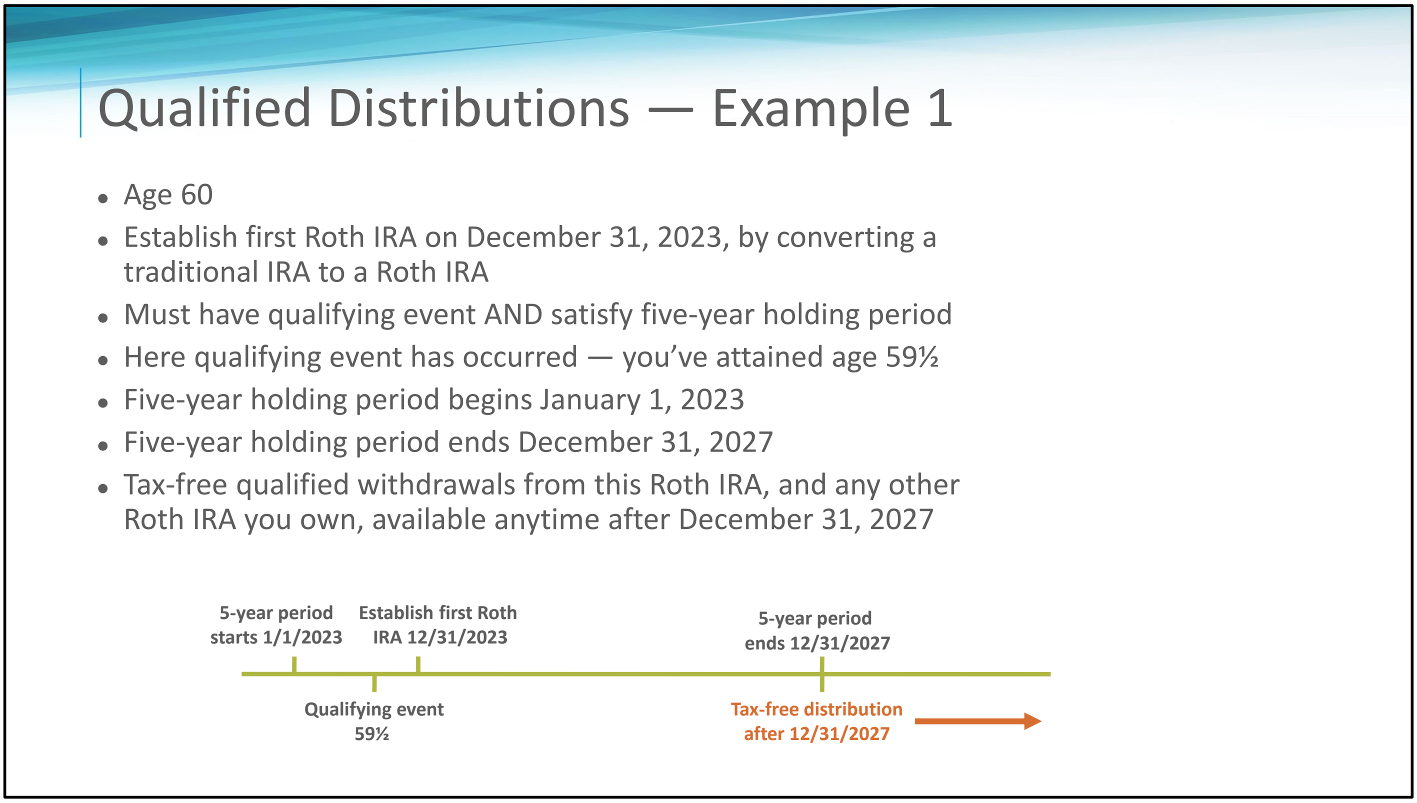

In this example, assume you're 60 years old when you <CLICK> set up your first Roth IRA on December 31, 2023, by converting a traditional IRA to a Roth IRA.

<CLICK> To have tax-free qualified distributions, you must satisfy the five-year holding period and have a qualifying event.

<CLICK> You already have a qualifying event, since you're older than 59½. So you'll be entitled to tax-free distributions after the end of the five-year holding period.

<CLICK> The five-year holding period begins January 1, 2023, the first day of the tax year in which you establish the Roth IRA.

<CLICK> The five-year holding period ends December 31, 2027.

<CLICK> You'll be able to receive tax-free distributions from that Roth IRA, and any Roth IRA you subsequently establish, after that date.

Note that in this example you get credit for all of 2023, even though you set up the Roth IRA on the last day of the year.

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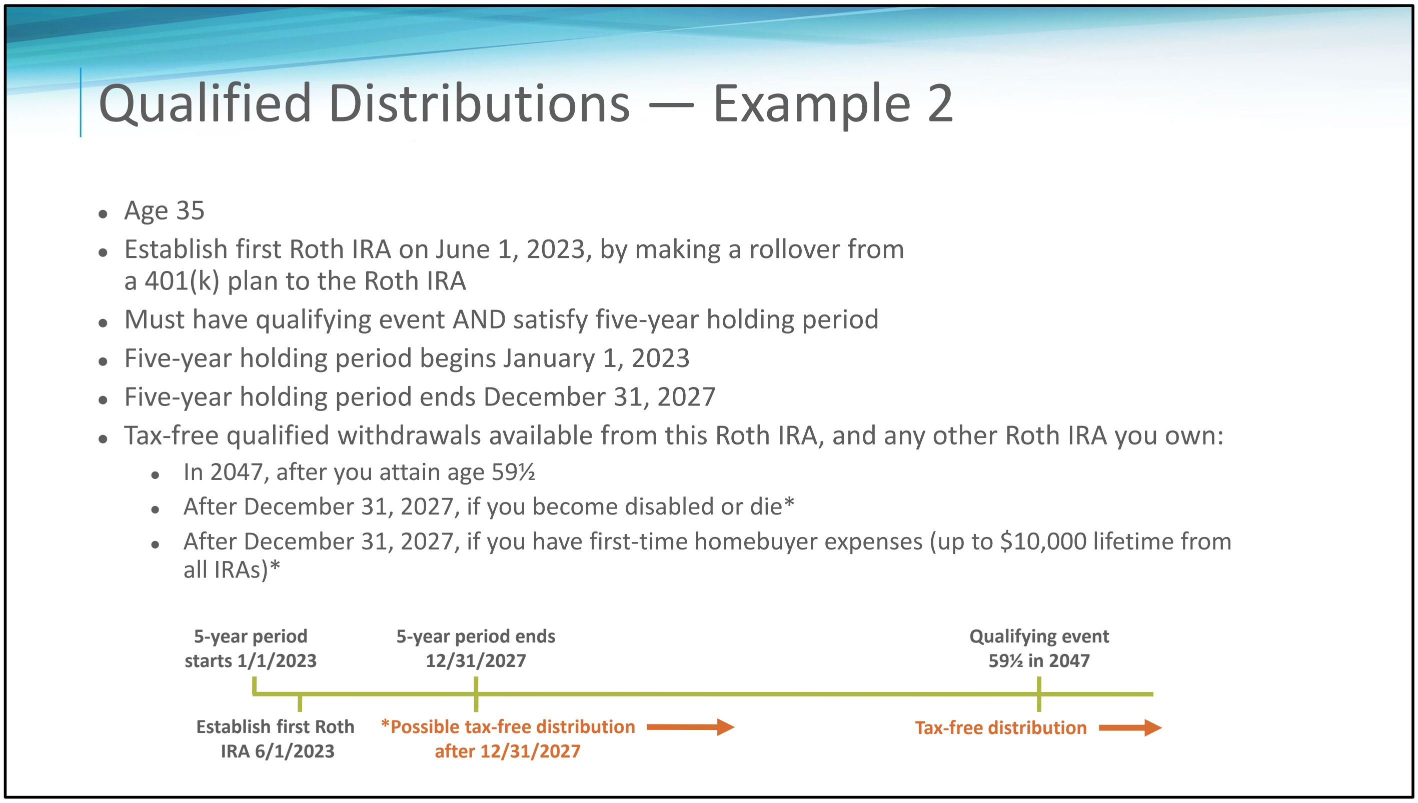

Now assume you're 35 years old, and

<CLICK> you set up your first Roth IRA on June 1, 2023, by making a rollover from your 401(k) plan to your Roth IRA.

<CLICK> To have tax-free qualified distributions, you must satisfy the five-year holding period and have a qualifying event.

<CLICK> The five-year holding period begins January 1, 2023, the first day of the tax year in which you establish the Roth IRA.

<CLICK> The five-year holding period ends December 31, 2027.

Even though you'll satisfy the five-year holding period on December 31, 2027, you won't be able to receive tax-free qualified distributions until you have a qualifying event after that date.

<CLICK> In general, you won't be able to take qualified withdrawals until 2047, when you attain age 59½.

<CLICK> But you may be eligible for qualified withdrawals earlier, if you become disabled or have eligible first-time homebuyer expenses.

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Qualified Distributions — Example 3

- You inherit a Roth IRA from your mother in 2023
- Your mother established her first Roth IRA in 2020 by making a regular annual contribution
- Must have qualifying event AND satisfy five-year holding period
- Qualifying event is your mother’s death
- Five-year holding period begins January 1, 2020
- Five-year holding period ends December 31, 2024
- Tax-free qualified withdrawals are available from the inherited Roth IRA anytime after December 31, 2024

In this example, assume you inherit a Roth IRA from your mother in 2023.

<CLICK> Your mother established her first Roth IRA in 2020 by making a regular annual contribution.

<CLICK> To have tax-free qualified distributions, you must have a qualifying event AND satisfy the five-year holding period.

<CLICK> Your mother’s death is the qualifying event.

<CLICK> The five-year holding period begins January 1, 2020,

<CLICK> and ends on December 31, 2024.

<CLICK> So you’ll be entitled to tax-free qualified distributions any time after December 31, 2024.

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