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Roth IRAs – Planning Beyond the Basics

By Richard M. Morgan & Loraine M. DiSalvo

Roth IRAs can be an incredible investment vehicle. Roth IRAs provide the potential for you to make investments and enjoy the results without any income taxes or penalties, and with great income tax deferral opportunities. Roth IRAs can also be a great way for you to pass assets to your loved ones after your passing. The tax advantages of a Roth come in part from the opportunity for an original account owner or beneficiary of an inherited account to realize income-tax free investment returns. However, for original owners of Roth IRA accounts (but not for beneficiaries of inherited Roth IRAs), additional tax advantages result from the fact that the minimum required distribution ("MRD") rules do not apply to Roth IRAs during the original account owner's lifetime. The MRD rules do apply to traditional IRAs, so that the owner of a traditional IRA is forced to take distributions which he or she may not need or want after reaching the age of 70 1/2. If you have to take MRDs, they are added to your other income for income tax purposes, which directly increases your income taxes. MRDs can also indirectly increase your income taxes, by reducing otherwise allowable tax deductions which are subject to income-based phaseouts, possibly causing you to be subject to the Alternative Minimum Tax ("AMT"), and potentially increasing the percentage of Social Security benefits on which you pay income tax.

We discussed the general topic of Roth conversions, and ways to determine whether a Roth conversion is right for you, in the February 2010 issue of "The Passionate Estate Planner." Since the income tax rates are scheduled to increase as of January 1, 2011, we thought it was a particularly good time to revisit the topic of Roth IRAs. Our goal in this newsletter is to go beyond the basics, and help you consider some additional planning issues relating to Roth IRAs.

I.Now is the time to set up a Roth IRA if you are at least 54 1/2. If you take a distribution from a Roth IRA, and if (1) you created your first Roth IRA within 5 years before the distribution and (2) you are younger than age 59 1/2 at the time you take the distribution, then some or all of that distribution may be subject to income tax and, possibly, a 10% penalty. The general rules can be summarized as follows:

For penalty and tax free distributions. A distribution from a Roth IRA will be completely free of income taxes and penalties if you meet two requirements. One, you must be at least 59 1/2 years old at the time you take the distribution. Two, you must have had assets in any Roth IRA account (not necessarily the one from which you actually take the distribution) for at least 5 years before you take the distribution. If you have not had a Roth IRA open for at least 5 years prior to the distribution, then all earnings which are deemed to be withdrawn from the Roth IRA will be subject to income tax as ordinary income. The good news here is that Roth IRA earnings (interest, dividends, and capital gains generated by the assets held in the account) are not considered to have been distributed until all of the previously contributed assets have been withdrawn. If the account owner is over 59 1/2, then "contributed" assets includes both contributions originally made to a Roth IRA and those assets received as part of the conversion of a traditional IRA.

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A. Penalties and income taxes may apply to assets distributed before the account's original owner is 59 1/2 years old. If you are under 59 1/2, you can still withdraw any assets which you originally contributed to your Roth IRA account at any time, without either income taxes or penalties, as long as you have owned any Roth IRA for at least five years before the withdrawal. Even if you have had a Roth IRA for at least 5 years, however, if you are under 59 1/2 and you converted any traditional IRA to a Roth IRA, then you must wait 5 years after the conversion before withdrawing any portion of the converted assets (in effect, assets converted from a traditional IRA to a Roth IRA do not count as "contributed" assets until 5 years after the actual date of the conversion). If you withdraw any portion of converted assets within 5 years after the conversion date and while you are still under 59 1/2, the 10% early withdrawal penalty will apply to the withdrawn converted assets. In addition, if you are under 59 1/2 and you withdraw more than your previous contributions to the Roth IRA (i.e., the amount you made as original contributions plus any assets received as part of a conversion more than 5 years prior to the withdrawal), then a portion of the earnings on the Roth IRA assets will come out. In general, Roth IRA earnings withdrawn before the account's original owner is at least 59 1/2 years old are subject to income tax as ordinary income. They are also subject to a 10% early withdrawal penalty. There are some exceptions which may allow you to avoid the penalty, but not the income taxes. (In order to keep this article as short and focused as possible, we are not going to discuss the exceptions here. Please feel free to call us if you have questions about this issue or any other issue discussed in this article.)

B. Planning Opportunity. If you do not already have a Roth IRA but you think you may want to have one in the future, you may want to consider creating one now. Even if you do not meet the income limit on contributions directly to a Roth IRA, you may be able to create one by converting part or all of an existing traditional IRA, since conversions are no longer subject to an income limit. Creating a Roth IRA now can help ensure that you will be able to meet at least one of the tests for income tax and penalty free distributions from your Roth IRA accounts in the future, since one test is that you have to have held a Roth IRA account for at least 5 years before taking any distribution from a Roth IRA account. The new Roth IRA does not have to have a lot of assets initially, as long as you find an account which can be maintained at a low- or no-cost basis. If you create a Roth IRA before you reach the age of 54 1/2, however, you will be able to fully satisfy the requirements to obtain income tax and penalty free Roth IRA distributions as soon as you reach the age of 59 1/2.

II. Consider making non-traditional investments in your Roth IRA. Even though it is now possible for higher income people to convert to a Roth IRA, the ability to make ongoing contributions to a Roth IRA will still be limited for those with adjusted gross income above a certain level. This may mean that many people will still be limited in their ability to build wealth inside their Roth IRAs. One way to maximize investment returns on smaller investments is to look for higher-risk, higher-potential reward investments which can be made inside the Roth IRA (assuming that your overall investments, including those outside the Roth IRA, are still appropriate for your age, lifestyle, future needs, and risk tolerance). If the higher-risk investments pay off,

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the higher reward realized inside the Roth IRA may be permanently sheltered from income taxes and penalties (assuming you qualify for future tax-and-penalty free distributions at some point). Additionally, if you converted a traditional IRA to the Roth IRA, you may also be able to use your ability to undo the conversion to help mitigate the effects of any loss if the the higher-risk investments do not pay off.

You can undo a Roth conversion if you transfer the converted Roth IRA assets and any related earnings on those assets back to a traditional IRA, as long as you meet several requirements. First, the transfer back to the traditional IRA must be made by a "a Trustee to Trustee transfer," which means that the IRA custodian for the Roth IRA has to work with the custodian for the traditional IRA, and that you cannot at any time receive any of the assets. Second, the transfer back to the traditional IRA must take place either during the same year you made the conversion or by the due date for your income tax return for the conversion year (which could be as late as October 15th of the year following the year of the conversion, if you timely request all possible due date extensions). Third, both the converted assets and any earnings on those assets have to be reconverted. If a conversion is undone properly, you can at least avoid having to pay income taxes on the converted assets. However, if the risky investment pays off, you can leave the conversion in place and pay income tax only on the converted assets in exchange for potentially permanent tax-free treatment on your investment returns.

What sort of high-risk, high-potential-reward investments could be used with a Roth IRA? Of course, you should speak with your investment advisor about possible opportunities, and about the level of risk which may be appropriate for you. However, for those who feel they have some room for risky investments in their overall portfolio, the Roth IRA may be perfect for investing in special opportunities. There are restrictions on the types of investments which can be made through a Roth IRAs. However, those restrictions are not nearly as restrictive as one may think. Roth IRAs generally cannot or should not invest in assets such as life insurance policies, collectibles, businesses which will generate and pass through active trade or business income (technically, this would be "unrelated business taxable income" or" UBTI" which could be taxable to the Roth IRA) or investments which rely heavily on leverage (and generate debt financed income). In addition, Roth IRAs cannot and should not engage, either directly or indirectly, in "related party" transactions (harsh penalties can apply to such transactions, and it is best to stay far, far away from potential related party situations). Outside of the above-listed investments, you may be able to use pretty much any other type of investment, although more business oriented or more exotic investments often need more pre-investment consideration and more careful planning in order to avoid trouble.

By way of example, you may be aware of a great deal on raw land which you believe has a very high appreciation potential. You might want to make a private equity investment in an unrelated business (one which will not generate and pass through UBTI). You may want to invest in gold or other precious metals (not through a fund, but in the actual metals). You can keep your eyes open for opportunities. Remember when considering opportunities that normal IRA planning does not generally consider these types of investments, and so you have to be creative. **However, if there is a relatively risky investment which provides a potentially high reward, if you can reasonably take the risk with some of your assets, and if you would like to be able to benefit from the potentially high reward on an income tax free basis, then a Roth**

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IRA may be the best place to make the investment. The potential tax benefits of using a Roth IRA can be especially nice if the investment is one which would more likely generate ordinary income instead of capital gains.

If you want to invest your Roth IRA assets in investments which are not commonly held in IRA accounts, especially if the asset must be physically held by a custodian (such as gold coins, for example), then you may need to find a non-traditional IRA custodian. Many traditional IRA custodians such as brokerage houses and banks will only allow IRA assets to be invested in traditional IRA type investments. Non-traditional IRA custodians may be willing to allow IRA assets to be invested in any legally permissible investment. However, depending on the desired investment, you may still need to use an additional strategy to fully accomplish your goals. One additional, more sophisticated, strategy is commonly known as a Roth IRA LLC. A Roth IRA LLC is a manager-managed, single member limited liability company ("LLC"), where you serve as the manager. The non-traditional IRA custodian has your Roth IRA invest its assets in the Roth IRA LLC. As the manager of the LLC, you can then control the invested assets while the IRA custodian handles the administrative duties relating to the Roth IRA.

III. What should you do now?

A. Consider a Roth IRA conversion if you haven't already done so. If you have not yet considered whether a Roth IRA conversion is a good idea for you, then you should consult your financial advisor for help with this determination. Please also consider our February 2010 newsletter on this topic. We can send you a copy of that newsletter if you don't have ready access to one.

B. Create a Roth IRA if you don't already have one and you are already at least 54 1/2 years old. If you think you may ever want to use a Roth IRA account in the future, you are at least 54 1/2 years old, and you do not already have a Roth IRA account, then you should seriously consider creating one as soon as possible. As discussed above, creating a Roth IRA lets you start the clock on the 5 year test for income tax fee Roth IRA distributions after 59 1/2. You can either make a contribution to the new Roth IRA (if your income does not exceed the AGI limit for contributions), or you can convert some portion of an existing traditional IRA. The key is to create a Roth IRA account and keep the ongoing maintenance cost as low as possible, so that creating the Roth IRA keeps your options open, potentially improves your future tax position, and has no real downside.

C. Consider non-traditional Roth IRA investments when appropriate for your situation. If you have a relatively small Roth IRA and a limited ability to contribute additional assets to the account (either because your income is too high or the economic cost of additional conversions does not make converting worthwhile), and if you want to try and maximize the benefits of the Roth IRA with the assets it holds, you may want to consider investing some or all of the Roth IRA assets in non-traditional investments with a relatively high risk and high potential reward profile. Speak to your financial advisor and keep your eyes open for other special opportunities.

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