Reinhart

Creating and Building a Roth IRA

POSTED:

Oct 1, 2015

RELATED PRACTICES:

[Trusts and Estates](https://www.reinhartlaw.com/practices/trusts-and-estates)

https://www.reinhartlaw.com/practices/trusts-and-estates

Creating and Building a Roth IRA

As mentioned in a prior article, Roth IRAs are powerful estate, financial and tax planning devices. Given their power for wealth transfer planning, it is important to understand the rules that apply to how Roth IRAs are formed and funded. This article will address these two issues.

The first important concept is that Roth IRAs are funded on an after-tax basis. That is, contributions to Roth IRAs are not deductible against your income tax and so eventually the amounts contributed can be withdrawn without being subject to income tax either.

There are four basic ways to fund a Roth IRA:

- Annual contributions.
- Rollover from Roth 401(k) plan.
- Conversion of funds from traditional IRA.
- Surviving spouse's rollover of deceased spouse's Roth IRA.

---

1. Annual Contributions.
The first approach to funding a Roth IRA is to make annual contributions. Only specified taxpayers are allowed to make contributions to Roth IRAs. Single taxpayers must have adjusted gross income of less than $131,000 (in 2015). Joint filers can make contributions, provided their adjusted gross income is under $193,000. In addition, the taxpayer must have earned income at least equal to the amount of the Roth IRA contribution. Finally, the annual contribution is limited to $5,500 for taxpayers who have not attained age 55 during the calendar year in which the contribution is made. For taxpayers who have attained age 55 in the calendar year, an additional $1,000 annual "catch-up" contribution is allowed, subject to the other limits described above.

2. Rollover from Roth 401(k) Plan.
Some qualified plan sponsors permit participants to open a Roth 401(k) account.

The operation of Roth 401(k) accounts is beyond the scope of this article, but for those participants who have Roth 401(k) accounts, the funds in the Roth 401(k) accounts can be rolled over to a Roth IRA at the same time and under the same circumstances as the pretax assets in the regular 401(k) account can be rolled over to a traditional IRA. Generally speaking, these rollovers will occur at the participant's retirement or other separation from service from the employer.

3. Conversion from Traditional IRA.
The most typical approach for substantial funding of a Roth IRA relates to converting a traditional IRA to a Roth IRA. The rules for converting a traditional IRA to a Roth IRA have changed over the years, but at this time, there are no limits on the age of the IRA owner who can convert a traditional IRA to a Roth IRA, or the gross income of the owner in the year of the conversion. The only rule that applies is that the conversion will trigger ordinary income tax on the full amount that is converted from the traditional IRA to the Roth IRA, and therefore the person making the conversion must be prepared to pay that income tax liability. Although the owner of a traditional IRA can use funds from the traditional IRA to pay the income tax created by the conversion, financial planning generally suggests that optimal tax planning is achieved by using funds other than the traditional IRA to pay the income tax.

Prior law created special rules to allow the income tax liability triggered by a Roth IRA conversion to be spread out over two years, or, in one case, over four years. These special tax rules no longer apply for Roth IRA conversions after 2010.

Under certain circumstances, a taxpayer may wish to "undo" a Roth IRA conversion. For example, if the value of the assets that were moved from the traditional IRA to the Roth IRA substantially declined in value, the taxpayer may wish to "recharacterize" the funds back into the traditional IRA in order to avoid paying income tax on value that has "disappeared." A taxpayer can make a recharacterization of a converted Roth IRA provided the assets are moved back to the traditional IRA before the taxpayer files his or her income tax return (including extensions) for the year of the conversion. Only one conversion and recharacterization can be made for any calendar year. Recharacterizations can be made after the taxpayer's death provided that the decedent's income tax return has not been filed at the time of the recharacterization.

4. Surviving Spouse's Rollover.
If a Roth IRA owner dies and leaves the Roth IRA to his or her surviving spouse, the surviving spouse can roll over the Roth IRA into his or her existing Roth IRA, or

can open a Roth IRA and roll over the funds into his or her Roth IRA. As mentioned in a prior article, the surviving spouse is not required to take any distributions from the Roth IRA, but is free to do so if desired.