

Roth IRAs: What Are They and How Do They Work?

A Roth IRA is perhaps one of the most powerful financial and estate planning tools we have to use. Roth IRAs were initially created in 1997 to allow people to save for buying their first home, and are named after Senator William V. Roth, Jr., who was their early champion. In a nutshell, Roth IRAs are like regular IRAs in most ways, with one major difference: The contributions to and earnings inside a Roth IRA are tax free, whereas the contributions to and earnings in a regular IRA are generally tax deferred.

Roth IRAs are designed to be tax-free saving vehicles that allow people to accumulate wealth for a number of specified purposes. Most often Roth IRAs are used to accumulate wealth to provide retirement income for the owner, his or her spouse, and perhaps descendants. However, Roth IRAs can be used earlier than retirement on a tax-free basis, including to make a first-time home purchase.

At one time, there were limits on who could contribute to Roth IRAs and who could convert funds from a traditional IRA into a Roth IRA. Many of these rules have been simplified and limits relaxed so that there are fewer impediments to forming and funding Roth IRAs. In a subsequent article, we will discuss the rules that apply to contributing funds to a Roth IRA, as well as the rules that govern "converting" traditional IRA funds into Roth IRA funds.

Roth IRAs are very powerful estate and financial planning tools because they allow a tax-free investment fund to be developed by a senior generation and left to one or more junior generations over a very extended period of time. The significant tax rules that allow Roth IRAs such tremendous financial, estate and tax planning flexibility are these:

- During the Roth IRA owner's lifetime, no distributions are required to be made regardless of the age of the IRA owner.
- If the Roth IRA owner leaves the Roth IRA to his or her surviving spouse, likewise the surviving spouse does not have any required distributions during the surviving spouse's lifetime. Accordingly, the Roth IRA can continue to grow and accumulate tax free as long as either the owner or the owner's surviving spouse is living.
- After the death of the IRA owner and the surviving spouse, if any, the Roth IRA can be distributed over the life expectancy of a "designated beneficiary," and thus the Roth IRA can stay alive for an extended period of time even after the

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death of the owner and the owner's spouse. As long as the Roth IRA exists, its earnings are tax free and so the "stretch" feature of the IRA makes for tremendous intergenerational wealth transfer possibilities.

- As long as the Roth IRA has been open for five or more taxable years all distributions are free of income tax.

Subsequent articles in this series will address other related topics, including:

- Creating and funding a Roth IRA.
- Leveraging a Roth IRA's tax-free growth into multigenerational wealth transfers.
- Roth 401(k) plans.

Roth IRAs are not a panacea for all financial, tax and estate planning needs. However, the special attributes that Roth IRAs create allow people to use their Roth IRAs to achieve many of their long-range goals.

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