

Five Things to Know About Roth IRAs



How do Roth IRAs offer tax savings?

The primary benefit of a Roth IRA is the ability to withdraw accumulated earnings tax free. Therefore, the earlier you begin saving and investing in a Roth IRA, the greater the potential for earnings. There is no up-front income tax deduction or tax credit you receive for making contributions to a Roth IRA, but your investments grow tax deferred (they are not taxed as you earn them).

Qualified distributions – those that are income tax free – can be received if you have held the Roth IRA for at least five years and you are:

- aged 59 ½ or older,
- disabled,
- using the withdrawal for a first-time home purchase (a \$10,000 lifetime limit), or
- the beneficiary of a deceased Roth IRA account owner.

You can also always receive withdrawals of what you contributed at any time without tax repercussions.

However, when you withdraw more than what you contributed, and those tax-deferred earnings are received prematurely or otherwise don't meet the requirements for a qualified distribution, your earnings will be taxable and may also be subject to a 10% early withdrawal penalty.

What are the Roth IRA contribution limits?

The 2024 annual Roth IRA contribution limit is \$7,000. For 2023 contributions, which can be made through April 15, 2024, the limit is \$6,500. You can also make an additional \$1,000 catch-up contribution if you are aged 50 or older.

However, to make Roth IRA contributions, you must also have earned income and be within modified adjusted gross income (AGI) limits for the year. For the earned income requirement, either you (or your spouse, if married) must have earned income and if your earned income is less than \$7,000, you can only contribute up to the amount of your earned income.

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For the AGI limit requirement, that will depend on your tax filing status. For 2023 and 2024, the limits are:

Tax Filing Status	Year	Full Contribution if MAGI* is at or below...	Partial Contribution if MAGI is between...	No Contribution if MAGI is at or above...
Single or Head of Household	2024	\$146,000	\$146,000 - \$161,000	\$161,000
	2023	\$138,000	\$138,000 - \$153,000	\$153,000
Married, Filing Jointly	2024	\$230,000	\$230,000 - \$240,000	\$240,000
	2023	\$218,000	\$218,000 - \$238,000	\$238,000
Married, Filing Separately **	2024	\$0	\$0 - \$10,000	\$10,000
	2023	\$0	\$0 - \$10,000	\$10,000

* Modified Adjusted Gross Income

** If married, filing separately, and did not live with your spouse at any time during the year, see MAGI for Single or Head of Household

In addition, the annual contribution limit is aggregated between traditional and Roth IRAs. Therefore, you cannot contribute \$7,000 each to a traditional and Roth IRA. Instead, you can contribute \$7,000 in total between the two types of IRAs.

Who is eligible to invest in a Roth IRA?

There are two criteria to be eligible for a Roth IRA. You must have earned income, and you must fall within IRS MAGI limits discussed above. Therefore, not everyone is eligible to make an annual contribution to a Roth IRA.

That is why for higher income individuals who are ineligible to make annual Roth IRA contributions, other strategies for Roth savings may be used. Those strategies include converting traditional IRA or workplace retirement plan assets to Roth, saving a portion of your salary in a workplace retirement plan that offers designated Roth accounts, such as a Roth

401(k) or Roth 403(b), or even possibly funding a Roth IRA through the “back door”. These other strategies may not be right for everyone, but you can ask your tax professional about them if you are ineligible to fund a Roth IRA with annual contributions.

Are there penalties for early withdrawals?

In general, the penalties for early withdrawal for a Roth IRA are the same as they are for a traditional IRA, but how and when they apply are slightly different. For example, with a traditional IRA, unless you have made non-deductible contributions, every dollar that is withdrawn is taxed as income. And if you receive a distribution prior to age 59 ½, an additional 10% penalty applies on your taxable withdrawal, unless an exception applies.

With a Roth IRA, you can withdraw your contributions at any time, and because those contributions were after-tax dollars when they went in, there is no tax liability when you distribute them. If you make a non-qualified Roth IRA withdrawal of earnings, one that does not meet the conditions to be income tax free as discussed above, the earnings would be both taxable and subject to a 10% penalty – the same 10% penalty that applies for early traditional IRA withdrawals. And the same exceptions to the 10% penalty apply to both traditional and Roth IRAs.

However, with a Roth IRA you can receive qualified tax-free withdrawals of your earnings early (before age 59 ½) after you meet the combination of having held the Roth IRA for five years, and the distribution is for: first-time home purchase, disability, or beneficiary distributions after death. Therefore, in the case of these three exceptions, when in

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combination with the Roth IRA five-year rule, they are not just penalty free, but also income tax free. Whereas with a traditional IRA, first-time home purchase, disability and beneficiary distributions would be taxable, but not subject to the 10% early withdrawal penalty.

There is a growing list of exceptions to the 10% early withdrawal penalty for distributions prior to age 59 ½, and more options to repay them. In fact, recent legislation added qualified terminal illness distributions in 2023, and in 2024 two more were added. One is for qualified domestic abuse withdrawals and one for emergency withdrawals. Emergency withdrawals might benefit more people but are limited to \$1,000 annually for unforeseen or immediate financial need. There is a three-year repayment period, and you must repay the prior emergency withdrawal before taking a new one.

What are the benefits of the Roth having no withdrawal requirements?

Because Roth accounts do not have withdrawal requirements during your lifetime, you have more flexibility with your retirement savings. You get to choose when, or if, you will use them. If you need retirement income, Roth accounts offer tax diversification. In general, there are three types of accounts to draw income from: taxable, tax deferred, and tax free. Roth IRAs fall into the last category if you wait to take qualified distributions,

and therefore, can be used to better manage taxable income in retirement. Because qualified withdrawals don't increase your AGI, managing AGI can reap other benefits and may help control things like the taxation of Social Security or the Medicare premiums you pay due to the IRMAA (income-related monthly adjustment amount).

Roth accounts are also great for legacy planning purposes, although there are withdrawal requirements for most non-spouse beneficiaries. Non-spouse beneficiaries are generally required to withdraw retirement account assets they inherit within 10 years, although there are a few exceptions where they can be distributed over the beneficiary's single life expectancy. Because of the 10-year rule, inheriting a large traditional IRA or 401(k) can create significant income tax consequences for the beneficiary. Inheriting a Roth IRA, on the other hand, would allow the beneficiary to not only take whatever amounts they want during those 10 years, but if they left the entire inherited Roth IRA alone until year 10, they would make the most of the tax-free earnings that the Roth IRA provides.

If you would like to learn more about saving and investing with a Roth IRA, contact a financial advisor today. They can work with you to develop a saving strategy that is consistent with your goals and objectives. ■

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