

## Roth IRAs and Education IRAs

### ROTH IRAS

Taxpayers with income under certain income limits are permitted to make contributions to a Roth IRA. Unlike regular IRAs, where contributions are deductible and later distributions are taxable, contributions to Roth IRAs are not deductible and later “qualified” distributions are not taxable. Qualified distributions are distributions made five or more years after the Roth IRA is established, provided the distribution is made after the account owner is at least age 59½, has died or become disabled, or uses the money for a first-time home purchase, subject to a \$10,000 lifetime cap. If the distribution is not qualified, a portion of the distribution may be included in gross income and may be subject to the 10 percent early withdrawal penalty. The penalty applies on the amount of the distribution that exceeds the taxpayer’s contributions to the Roth IRA. Roth IRAs are not subject to the MRD rules that apply to regular IRAs when the owner reaches age 70½.

For 2018, taxpayers can contribute up to \$5,500 to a Roth IRA (as long as you have compensation for the year at least equal to the contributed amount). Taxpayers age 50 or older can contribute an additional \$1,000. Thus, the limit is \$6,500 a year for people who will be age 50 (or older) in the applicable taxable year. The same contribution amounts apply for tax year 2019. However, the maximum contribution allowance must be reduced by any other contributions (deductible or nondeductible) the taxpayer makes to IRAs.

For single and head of household taxpayers, and for married taxpayers filing separately who did not live together at any time during the tax year, if 2018 modified adjusted gross income is between \$118,000 and \$133,000 (\$120,000 to \$135,000 for tax year 2019), the \$5,500 maximum contribution is phased out. Modified AGI in excess of \$133,000 (\$135,000 in tax year 2019) prevents a contribution to a Roth IRA for these taxpayers. For married taxpayers filing jointly, no contribution can be made to a Roth IRA if AGI is \$196,000 or more (\$199,000 for tax year 2019), and the \$5,500 maximum (per spouse) is phased out for AGIs between \$186,000 and \$196,000 (\$189,000 and \$199,000 for tax year 2019). For married taxpayers filing separately who lived with their spouse at any time during the tax year, the allowable contribution is phased out for AGIs between \$0 and \$10,000.

**Planning Suggestion:** If you are not eligible to make a Roth IRA contribution due to an income limitation, consider making a nondeductible contribution to a traditional IRA and then converting the entire balance to a Roth IRA. The conversion would be a fully nontaxable event if the conversion takes place immediately because the taxpayer would have basis in the full amount of conversion.

As with regular IRAs, contributions to a Roth IRA may be made as late as the due date for filing your income tax return, excluding extensions. Thus, Roth IRA contributions may be made by most individuals for 2018 until April 15, 2019. Unlike regular IRAs, contributions to a Roth IRA may be made even if the taxpayer is over age 70½, and the taxpayer or spouse has earned income at least equal to the amount of the contribution.

All taxpayers are eligible to convert a traditional IRA, pretax or after-tax, to a Roth IRA because the previous adjusted gross income limitation has been eliminated. Conversions typically generate taxable income as if the regular IRA had made a distribution that was not rolled over. The entire taxable amount from a 2018 conversion must be recognized on the taxpayer’s 2018 income tax return. Even so, the low federal income tax rates created by the tax act make conversion in 2018 particularly attractive before the inflation adjustment is applied for 2019 through 2025, or the pre-tax act rates and brackets come back into effect. The converted amount is not subject to the 10 percent early withdrawal penalty, provided no distributions are made from the account during the five-year period after the initial conversion.

If a taxpayer converts a regular IRA or eligible employer plan into a Roth IRA, the amount that must be included in the distributee's gross income is the amount that would have been includable in gross income had the distribution not been part of a qualified rollover contribution. The entire taxable amount from a 2018 conversion must be recognized on the taxpayer's 2018 income tax return. The converted amount is not subject to the 10 percent early withdrawal penalty, provided no distributions are made from the account during the five-year period after the initial conversion.

**Planning Suggestion:** It may be especially beneficial for taxpayers to convert an existing IRA to a Roth IRA in 2018, even though taxes will have to be paid, due to tax reform's historically low tax rates in 2018, which will rise due to inflation starting in 2019. The advisability of converting depends on various factors, including the age of the taxpayer, current tax bracket, whether the taxpayer has funds from other sources to pay the income taxes on the accelerated income, and whether the taxpayer intends to withdraw funds from the account after age 59½, or after 70½. Two of the advantages of converting a regular IRA or eligible employer plan into a Roth IRA are avoiding the minimum distribution rules and avoiding income taxes on distributions after death to the beneficiary of the Roth IRA. Any decision to convert should also consider the estate tax effects.

Consider a multi-year conversion strategy if you have a relatively large balance that could push you into a higher tax bracket. For example, if you are single and expect your 2018 taxable income to be about \$110,000, your marginal federal income tax rate is 24 percent. Converting a \$100,000 traditional IRA into a Roth account in 2018 would cause about half of the extra income from the conversion to be taxed at 32 percent. But if you spread the \$100,000 conversion 50/50 over 2018 and 2019 (which you are allowed to do), almost all of the extra income from converting would be taxed at 24 percent.

You may want to consider converting all or a portion of your traditional IRA to a Roth IRA if you have a net operating loss (NOL). You may be able to make a conversion without creating taxable income and make use of your NOL, especially if the NOL carryforward is due to expire soon.

**Caution:** Note that recharacterization was repealed under the 2017 tax reform. Accordingly, a 2018 Roth IRA conversion cannot be undone. Recharacterizing amounts rolled over to a Roth IRA from other retirement plans, such as 401(k) or 403(b) plans, is also prohibited. Also, assuming that you do not have an NOL or other tax attribute to completely offset the income on the conversion, you are going to need cash outside the IRA to pay tax on the conversion.

**Example:** Individual D makes a \$5,000 contribution to a regular IRA in November 2018. D files his 2018 tax return on April 15, 2019. Immediately before filing the 2018 tax return, when the value of the IRA has increased to \$5,500, D converts the account as a Roth IRA. D will be considered to have made a \$5,000 contribution to a Roth IRA for 2018. The \$500 of appreciation is not treated as a contribution to the Roth IRA.

These rules are complicated, but may provide tax-planning opportunities if securities held in IRAs fluctuate significantly within short periods of time. Your advisor can help you with your Roth IRA questions.

## **COVERDELL EDUCATION SAVINGS ACCOUNTS (EDUCATION IRAS)**

Education IRAs may be established to help meet the cost of education for certain individuals. For 2018, annual, nondeductible contributions to an education IRA are limited to \$2,000 per beneficiary and may not be made after

the beneficiary reaches age 18. Contributions cannot be made prior to the child's birth. Contributions must be made by the due date of the return without extension. Only eligible donors within certain income limits can make contributions to education IRAs. Eligibility is phased out for single donors with AGI between \$95,000 and \$110,000, and married donors filing jointly with AGI between \$190,000 and \$220,000.

**Planning Suggestion:** If you are not eligible to make a contribution to your education IRA, consider making a gift to an eligible person.

Distributions from an education IRA are not subject to tax to the extent the distributions do not exceed qualified education expenses. Qualified education expenses include elementary, secondary and higher education school expenses. In the year amounts are distributed from an education IRA, the beneficiary is also eligible for an American Opportunity Tax (Hope) Credit or Lifetime Learning Credit, provided the same expenses are not used for each credit. Education IRAs can be rolled over, before the beneficiary reaches age 30, to benefit another person in the same family. If the beneficiary does not use the funds for qualified education expenses by age 30, the money must be withdrawn and will be subject to tax and penalty on the portion attributable to the earnings.

**Planning Suggestion:** Taxpayers who desire a larger nondeductible contribution to an education fund should consider a 529 account. Tax reform expanded the allowable expenses that may be paid from a 529 account to include up to \$10,000 of expenses for tuition at an elementary or secondary public, private, or religious school in addition to qualified higher education expenses.