A Roth IRA's Many Benefits

Why do so many people choose them over traditional IRAs?

Provided by Harry D. Toro

The IRA that changed the whole retirement savings perspective. Since the Roth IRA was introduced in 1998, its popularity has soared. It has become a fixture in many retirement planning strategies, because it offers savers so many potential advantages.

The key argument for going Roth can be summed up in a sentence: ***Paying taxes on your retirement contributions today is better than paying taxes on your retirement savings tomorrow.***

Think about it. All other variables aside, would you like to pay more taxes in retirement or less?

What if federal tax rates are higher in the future than they are today? Would you like to see a) your retirement savings taxed at those higher rates tomorrow, when you may have medical bills or other emergency expenses to contend with, or b) have the dollars you are saving for retirement today taxed at possibly lower rates?

Here is a closer look at the trade-off you make when you open and contribute to a Roth IRA – a trade-off many savers are happy to make.

You contribute after-tax dollars. You have already paid federal income tax on the dollars going into the account. But in exchange for paying taxes on your retirement savings contributions today, you could potentially realize great benefits tomorrow.[1]

You position the money for tax-deferred growth. Roth IRA earnings aren't taxed as they grow and compound. If, say, your account grows 6% a year, that growth will be even greater when you factor in compounding. The earlier in life that you open a Roth IRA, the greater compounding potential you have.[2]

You can arrange tax-free retirement income. Roth IRA earnings can be withdrawn tax-free as long as you are age 59½ or older and have owned the IRA for at least 5 years. (That 5-year clock starts on January 1 of the tax year in which you make your initial Roth IRA contribution.)[3]

The IRS calls such tax-free withdrawals *qualified distributions*. They may be made to you, to your estate after you are deceased, and/or to a beneficiary. (If you die before the Roth IRA meets the 5-year rule, your IRA beneficiary will see the IRA earnings taxed until it is met.)[4]

If you withdraw money from a Roth IRA before you reach age 59½, it is called a *nonqualified distribution.* If you do this, you can still withdraw an amount equivalent to your total IRA contributions to that point tax-free and penalty-free. If you withdraw more than that amount, though, the rest of the withdrawal may be fully taxable and subject to a 10% IRS penalty as well. (If you are younger than 59½ and have owned a Roth IRA for at least 5 years, you are allowed to withdraw 100% of your contributions and up to $10,000 of IRA earnings tax- and penalty-free to buy a principal residence, assuming the buyer has not owned a home within the past 2 years.)[1,3]

You never have to make a withdrawal. When you own a traditional IRA, you must start pulling money out of it in your in your seventies. These withdrawals are called Required Minimum Distributions (RMDs), and the amount is calculated for you using an IRS formula. These forced withdrawals saddle some traditional IRA owners with tax problems. In contrast, Roth IRA owners never have to take RMDs. They are never required to take a penny out of their IRAs.[1]

Withdrawals don't affect taxation of Social Security benefits. If your total taxable income exceeds a certain threshold – $25,000 for single filers, $32,000 for joint filers – then your Social Security benefits may be taxed. (These limits are not adjusted for inflation, incidentally.) An RMD from a traditional IRA represents taxable income, and may push retirees over the threshold – but a qualified distribution from a Roth IRA isn't taxable income, and doesn't count toward it.[5]

You can direct Roth IRA assets into many different kinds of investments. Invest them as aggressively or as conservatively as you wish – but remember to practice diversification. The range of investment choices is often broader than that offered in a typical workplace retirement plan.[1]

You can shift dividend-producing investments into a Roth IRA from a taxable account. As dividends are being taxed at higher rates in 2013, keeping dividend-producing stocks out of a taxable account has definite virtues.

You can potentially "stretch" the assets. If an original Roth IRA owner passes away after owning the IRA for at least five years, then its earnings can be withdrawn tax-free by its beneficiaries. (Relevant estate taxes may need to be paid, of course.) If a Roth IRA beneficiary is not a spouse, then other factors come into play: that beneficiary cannot contribute to the inherited Roth IRA, or combine it with an IRA he or she owns. The non-spouse beneficiary can decide to a) receive a distribution of 100% of the inherited Roth IRA assets by December 31st of the fifth year following the year of the IRA owner's death, or b) receive periodic payments from the IRA over the course of his or her life, an option which may potentially be "stretched" (given proper planning) and extended to subsequent beneficiaries.[6]

You have 16 months to make a Roth IRA contribution for a given tax year. For example, IRA contributions for the 2012 tax year may be made up until April 15, 2013. While April 15 is the annual deadline, many IRA owners who make lump sum contributions for a given tax year make them as soon as that year begins, not in the following year. Making your Roth IRA contributions earlier gives the funds in the account more time to grow and compound with tax deferral.[1]

Who can open a Roth IRA? Anyone with earned income (and that includes a minor).[1]

How much can you contribute to a Roth IRA annually? The 2013 contribution limit is $5,500, with an additional $1,000 "catch-up" contribution allowed for those 50 and older. (The annual contribution limit is adjusted periodically for inflation.)[7]

You can keep making annual Roth IRA contributions all your life. You can't make annual contributions to a traditional IRA once you reach age 70½.[7]

Does a Roth IRA have any drawbacks? Actually, yes. One, you will generally be hit with a 10% penalty by the IRS if you withdraw Roth IRA funds before age 59½ or you haven't owned the IRA for at least five years. (This is in addition to the regular income tax you will pay on the funds withdrawn, of course.) Two, you can't deduct Roth IRA contributions on your 1040 form as you can do with contributions to a traditional IRA or the typical workplace retirement plan. Three, you might not be able to contribute to a Roth IRA as a consequence of your filing status and income; if you earn a great deal of money, you may be able to make only a partial contribution or none at all.[3,7]

Rollovers are permitted if you make too much to contribute. Even if your income prevents you from funding a Roth IRA, you can still roll traditional IRA assets into a Roth with the help of a financial professional. While this is a taxable event, you may realize significant long-term financial benefits as a result of it – tax-free retirement income withdrawals, and the potential for some of the Roth IRA assets to pass tax-free to your heirs with further growth and compounding. You also will gain the relief of never having to take an RMD each year.[8]

All this may have you thinking about opening up a Roth IRA or creating one from existing IRA assets. A chat with the financial professional you know and trust will help you evaluate whether a Roth IRA is right for you given your particular tax situation and retirement horizon.

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