Roth IRAs

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WHAT'S COVERED

In this lesson, you will explore how a Roth IRA provides savings and tax benefits. You will consider how this financial tool can help you be more agile and productive. Specifically, this lesson will cover:

1. Overview of Roth IRAs

Agility: Skill Reflect

Being agile is all about exploring your options. As you complete this lesson, ask yourself, "How might a Roth IRA give me more options for saving and spending? Can a Roth IRA help me during emergencies, work to build long-term wealth, or maybe both?"

1a. Roth IRAs Defined

Traditionally, Congress has promoted retirement savings at the household level by allowing individuals to put money into accounts, such as 401(k)s, 403(b)s, and traditional IRAs (we will talk about each of these in more detail in future lessons), on a **pretax basis**. That is, contributions to these accounts lower taxable income and, as long as the money remains in these accounts, the earnings grow tax-deferred (see Hint). Taxes are usually paid when the money is taken out. If individuals take money out before retirement, they usually pay a 10% penalty plus taxes on the money withdrawn!

HINT

Tax-deferred just means that investment income in the account is not currently taxed.

More than 20 years ago, Congress flipped the formula and created the Roth IRA as a special investment account that allows individuals to put money aside on an **after-tax basis** (contributions do not lower taxable income), with the caveat that if the money is held until retirement no taxes ever need to be paid on the growth of the account! A **Roth IRA**, therefore, is an individual retirement account that offers two significant advantages:

1. Investments held in the account accumulate earnings on a tax-deferred basis.
2. Money pulled from the account is tax-free if certain conditions are met (we will discuss those conditions later in this topic).

The following table shows the similarities and differences between traditional and Roth IRAs.

Traditional IRA	Roth IRA
Make a contribution	Make a contribution
Receive an income tax deduction	No income tax deduction
Pay less tax today	Postpone tax advantage to the future
Money grows tax-deferred	Money grows tax-deferred
Pay taxes on money taken out of the account in the future	Pay no taxes on money taken out of the account in the future

TERMS TO KNOW

Pre-Tax Basis
Contributions to savings accounts that lower taxable income; earnings grow tax-deferred.

After-Tax Basis
The value of an asset after accounting for taxes already paid.

Roth IRA
An individual retirement savings account that has two significant advantages: Investments held in the account accumulate earnings on a tax-deferred basis and money pulled from the account is tax-free if certain conditions are met.

1b. Tax-Deferred Earnings

Tax-deferred earnings mean that there is no tax assessed on the earnings in the account in the year that the earnings are received.

- For example, if your marginal tax rate is 22% and you earn $1,000 in interest in your Roth IRA, you will not have to pay any taxes on those earnings this year.
- However, if you earn the $1,000 in a traditional savings account, then you will have to pay as much as $220 in taxes on the earnings (even if you leave the interest in the bank, you will still have to pay taxes on it). After taxes, you will be left with only $780.
- Tax-deferred growth is a great benefit!

In addition to tax-deferred growth, withdrawals from Roth IRAs receive special tax treatment. This is the feature that allows you to use a Roth IRA effectively as a source of emergency funds. We will talk about these withdrawals next.

TERM TO KNOW

Tax-Deferred Earnings
There is no tax assessed on the earnings in the account in the year that the earnings are received.

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2. Roth IRA Withdrawals

To make sense of Roth IRA withdrawal options, you first need to remember two key terms. The*principal* is the amount that you deposit into the account. *Earnings* are generated from the different types of investments within the account. We are now ready to look at Roth IRA withdrawals in more detail.

There are three types of withdrawals available when a Roth IRA is used.

1. Withdrawal of principal occurring any time after the account is initially funded.
2. Qualifying withdrawal of earnings.
3. Nonqualifying withdrawal of earnings.

2a. Withdrawal of Principal

With Roth IRAs, you can withdraw your principal at any time for any purpose without having to pay taxes on the withdrawal.

HINT

Remember that you already paid tax on the money contributed to a Roth IRA.

- This means that you can have your principal hard at work for you, generating tax-deferred earnings.
- Then, if you have a financial emergency, you can take out the principal and use it. The money that you leave in the Roth IRA account will continue to earn interest to help you reach your long-term financial goals.
- Think of it this way: you can take out everything you put in totally tax- and penalty-free at any time!

2b. Qualifying Distribution

What if you are fortunate enough to never have a financial emergency that requires you to take money out of your Roth IRA? In this case, your principal and earnings in the Roth IRA will continue to grow tax-deferred and accumulate additional earnings until you take the money out. A **qualifying distribution** of earnings from a Roth IRA is tax-free if it meets the following two conditions:

1. You are at least 59½ years old, disabled, or use the funds to purchase a first home (up to $10,000).
2. The Roth IRA account has been open for at least five years.

If you start saving when you are young, a Roth IRA can save you hundreds of thousands of dollars in taxes over the long run! This is the reason that holding some investment assets in a Roth IRA is generally highly recommended.

TERM TO KNOW

Qualifying Distribution (from a Roth IRA)

A dispersal from a Roth IRA after an account holder is 59½ years of age or older and the Roth IRA account has been open for at least five years.

2c. Nonqualifying Distribution

Unfortunately, there may be instances when you might need to withdraw principal and earnings but you have not met the conditions for a qualifying distribution. When this happens:

- You will owe ordinary income taxes plus penalties on the earnings you withdraw. Penalties are 10% of the taxable portion of the distribution. If you are 59½ years of age or older, however, the penalty will be waived (but not the tax if the account has been open less than five years).

- You should avoid taking nonqualifying distributions if at all possible as the costs – taxes and penalties – can add up quickly and hurt you at tax filing time.

The table below shows the financial consequences of making a nonqualified withdrawal if your Roth IRA includes $3,000 of principal and $600 of earnings (for a total balance of $3,600) and if you are in a 22% marginal tax bracket.

$3,600 Nonqualifying Distribution
$3,000 returned (tax- and penalty-free)
$60 penalty (10% of $600)
$132 federal income tax (22% of $600)
$192 in total taxes and penalty

2d. Traditional IRA Withdrawals

It is important to remember that the strategies described so far apply only to Roth IRAs.**Traditional IRAs** do not provide the same flexibility in terms of withdrawals:

- Some or all future withdrawals from traditional IRAs will be fully taxable.
- Traditional IRAs are subject to early withdrawal penalties (see Hint). Exceptions to the penalty include withdrawals after age 59½, due to disability, on account of the owner's death, first-time home purchase (up to $10,000), qualified higher education expenses, or to purchase medical insurance if you are unemployed.

HINT

Because distributions from traditional IRAs are fully taxable and may be subject to an early withdrawal penalty, traditional IRAs should not be used for emergency funds.

You have options when it comes to a Roth IRA. You can use your productivity skill to compare your options and choose the best fit for you given your situation and financial goals.

TERM TO KNOW

Traditional IRA

An investment account that allows someone to save for retirement on a tax-deferred basis; depending on the account owner's income and access to retirement plans, contributions to a traditional IRA may be tax-deductible.

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3. Roth IRA Investment Options

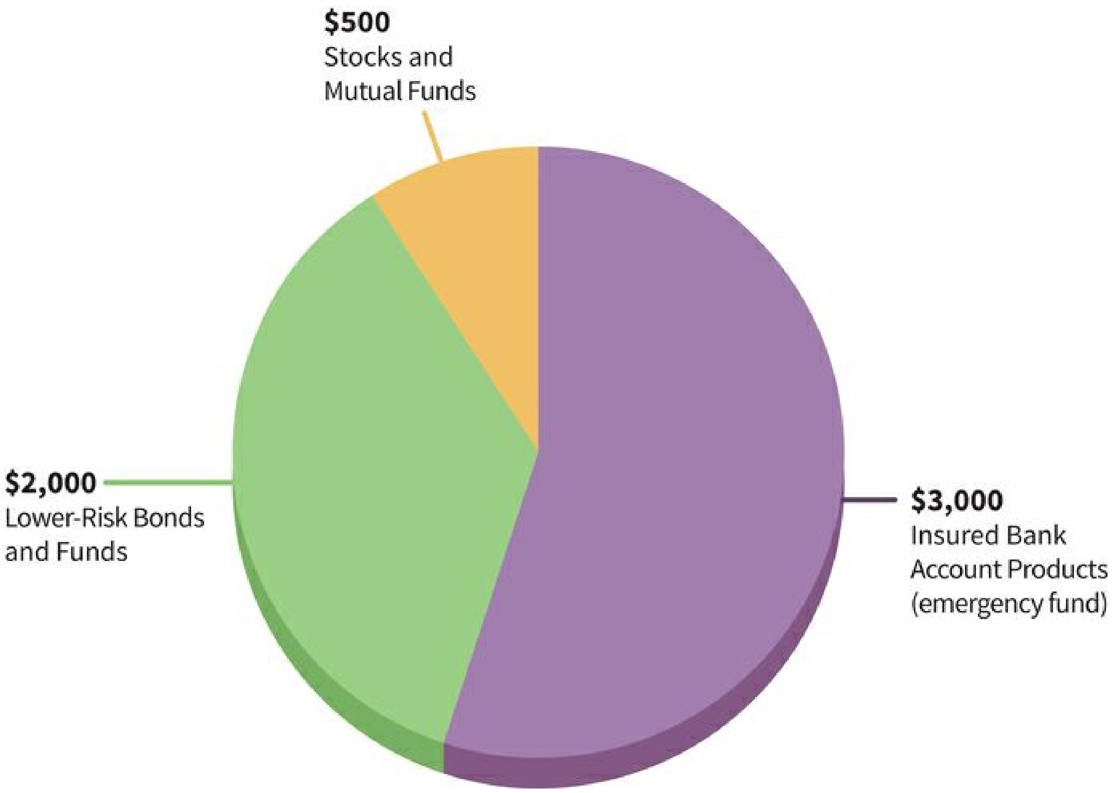
As with most products and services that offer multiple benefits, the use of a Roth IRA can be complicated, especially when compared to holding money in a savings account. When you set up a Roth IRA, you need to tell the financial institution how you want to invest your money. Typically, you will have many different alternatives, including:

- Bank products (like certificates of deposit and money market accounts)
- Mutual funds

- Exchange-traded funds (ETFs)
- Stocks
- Bonds

Keep in mind that only deposits at FDIC- and NCUA-insured institutions are protected against losses. Investments that you can purchase through your Roth IRA may provide a higher rate of return, but they will also entail more risk (we will discuss mutual funds, ETFs, and other investments in a later lesson).
If you do decide to use a Roth IRA for an emergency fund:

- Revisit your risk tolerance and anticipate how often you may need to dip into the account to pay expenses.
- The pie chart below shows how a married couple with two children, a mortgage, two cars, and a modest lifestyle might allocate their $5,500 Roth IRA investments to serve the purpose of saving for retirement and holding emergency fund assets.
- As shown in the chart, it is possible to hold a variety of investment and saving products in a Roth IRA. In fact, it is possible to create a diversified portfolio comprised of different asset classes, including stocks, bonds, cash, commodities, and other investments.



SUMMARY

In this lesson, you completed an **overview of Roth IRAs**. When **defining Roth IRAs**, one of the most important considerations is that the accounts have **tax-deferred earnings**. This means there is no tax assessed on the earnings in the account in the year that the earnings are received. However, there are some unique rules around **Roth IRA withdrawals**. You can **withdraw your principal** at any time for any purpose without having to pay taxes on the withdrawal. Consumers appreciate this aspect! But if you plan to withdraw a portion of your earnings, it must be a **qualifying distribution** that meets certain conditions. If not, it's classified as a **nonqualifying distribution** and you might owe taxes and penalties.

You can utilize your productivity skill to determine if the Roth IRA is right for you.

Once you set up a Roth IRA, you'll have several **investment options** to choose from. This can help you be agile when a change is needed. Always remember that Roth IRA withdrawals are NOT the same as **traditional IRA withdrawals**. Traditional IRAs do not offer the same flexibility as Roth IRAs, so know the difference between them to avoid unnecessary taxes and penalties.

TERMS TO KNOW

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The value of an asset after accounting for taxes already paid.

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