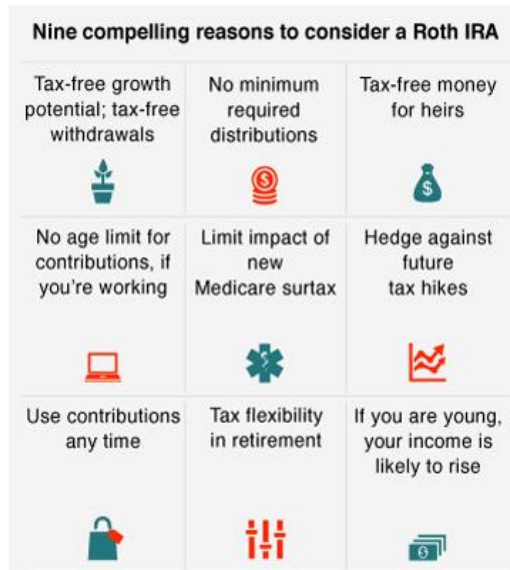
Nine Compelling Benefits of a Roth IRA

Get tax-free growth potential, tax-free withdrawals, no required distributions, and more. **Posted:** 3/31/2016 by Fidelity Viewpoints

Wondering how a Roth IRA works and what its benefits are? A Roth IRA can help lower your taxes and increase your retirement savings (as long as certain requirements are met).[1] But those are just a few of the many benefits of a Roth IRA.

"We believe that most people should consider a Roth IRA," says Ken Hevert, senior vice president of retirement products at Fidelity. "And that's either by contributing to one or converting to one. Besides tax-free withdrawals, a Roth IRA also offers flexibility, doesn't require distributions when you reach a certain age, and can benefit your heirs."

Before we delve into nine key benefits of a Roth IRA, here's an important note: Not everyone can contribute to a Roth IRA, because of IRS-imposed income limits. But even if your income is over the limits, you still may be able to have one by converting existing money in a traditional IRA or other retirement savings account. (See "If you earn too much to contribute," at the end of the article.)



1. Money may grow tax free; withdrawals are tax free, too.

You contribute money that has already been taxed (after-tax dollars) to a Roth IRA. There's no tax deduction on the front end as there can be with a traditional IRA. Any growth or earnings from the investments in the account—and money you take out in retirement—is free from federal taxes (and usually state and local taxes too), with a few conditions. Withdrawals from Roth IRAs are federal income tax free and penalty free if a five-year "aging" period has been met (if a withdrawal is made after a five-year period, beginning with the first taxable year after a contribution to any Roth IRA was made), and the account owner is age 59½ or older, disabled, or deceased. There's also a $10,000 exception for first-time homebuyers.

2. There are no minimum required distributions.

Roth IRAs do not have minimum required distributions (MRDs), also called required minimum distributions (RMDs), during the lifetime of the original owner. Traditional IRAs and, generally, 401(k), 403(b), and other employer-sponsored retirement savings plans—both Roth and traditional—do. If you don't need your distributions for essential expenses, MRDs may be a nuisance. They have to be calculated and withdrawn each year, and may result in taxable income. If you miss taking one, there could be a big penalty as well—50% of the MRD not taken. Because a Roth IRA eliminates the need to take MRDs, it may also enable you to pass on more of your retirement savings to your heirs (see below).

3. Leave tax-free money to heirs.

In many cases, a Roth IRA has legacy and estate planning benefits, but you need to consider carefully the pros and cons—which can be subtle and complex. Be sure to consult an attorney or estate planning expert before attempting to use Roth accounts as part of an estate plan.

For instance, if you're planning to leave your retirement savings to your heirs, consider how doing so may potentially affect their taxes. MRDs from inherited traditional IRAs generate taxable income for heirs, often during their peak earning years, which could unintentionally push them into a higher marginal tax bracket. While MRDs are also required for inherited Roth IRAs, those distributions generally remain tax free.

On the other hand, if your heirs' combined federal and state income tax rates are expected to be lower than yours, depending on the situation, they may be better off inheriting a traditional IRA rather than a Roth IRA. This may sound counterintuitive, because the heir would not have to pay taxes on distributions from the Roth IRA, but you should consider the total tax cost—including income taxes paid by both parties as well as any applicable estate taxes—not just the income taxes paid by the heir.

Because Roth IRAs don't require MRDs during your lifetime, these accounts could potentially grow larger over the years for your heirs. And because you pay the income taxes due up front, when you contribute to a Roth, a Roth IRA conversion may also help reduce the size of your taxable estate.

However, be aware that if you're planning to leave assets to a charity rather than to your heirs, conversion to a Roth IRA has the potential to be disadvantageous. This is because in many cases IRAs can be left to a charity directly, without any tax liability to either the IRA owner or the charity. In such cases, a conversion would incur taxes that could be avoided.

4. Tax flexibility in retirement.

You've already paid the taxes on the money in a Roth IRA, so as long as you follow the rules, you get to take out your money tax free. Mixing how you take withdrawals between your traditional IRAs and 401(k)s, or other qualified accounts, and Roth IRAs may enable you to better manage your overall income tax liability in retirement. You could, for example, take withdrawals from a traditional IRA up to the top of a tax bracket, and then take any money you need above that bracket from a Roth IRA. "The opportunity for tax diversification is one reason we believe most investors should at least consider having a Roth IRA as part of their overall retirement plan," says Hevert.

5. Help reduce or even avoid the Medicare surtax.

A Roth IRA may potentially help limit your exposure to the Medicare surtax on net investment income. This is because qualified withdrawals from a Roth IRA don't count toward the modified adjusted gross income (MAGI) threshold that determines the surtax. MRDs from traditional (i.e., pretax) accounts such as a workplace retirement plan—like a traditional 401(k)—or a traditional IRA, are included in MAGI and do count toward the MAGI threshold for the surtax. Depending on your income in retirement, MRDs could expose you to the Medicare surtax.

6. Hedge against future tax hikes.

Federal tax rates rose in 2013. Will they rise further in the future? There's no way to know for certain, but the top tax rate remains far below its historical highs, and if you think it might go up again, a Roth IRA may make sense.

7. Use your contributions at any time.

A Roth IRA enables you to take out 100% of what you have contributed at any time and for any reason, with no taxes or penalties. Only earnings in the Roth IRA are subject to restrictions on withdrawals. Generally, withdrawals are considered to come from contributions first. Distributions from earnings—which can be taxable if the conditions are not met—begin only when all contributions have been withdrawn.

8. If you're older, you can continue to contribute as long as you work.

As long as you have earned compensation, whether it is a regular paycheck or 1099 income for contract work, you can contribute to a Roth IRA—no matter how old you are. There is no age requirement for contributions, as there is for a traditional IRA, where you cannot contribute if you are older than age 70½—even if you have earned income.

9. If you're young, your income is likely to rise.

The younger you are, the more chance there is that your income will be higher when you retire. For instance, if you're under age 30, it's likely that your income and spending during retirement will be significantly higher than it is now, at the beginning of your career. And the greater the difference between your income now and your income in retirement, the more advantageous a Roth account can be.

If you earn too much to contribute

In order to contribute to a Roth IRA, you must have employment compensation, and then there are income limits. If your income is over the IRS limits, the only way you can take advantage of a Roth IRA's tax-free withdrawals is by converting money from an existing retirement account, such as a traditional IRA.[2] A caveat: Although you may be tempted to pay for the costs of a Roth IRA conversion by using proceeds from the qualified account you're converting, doing so can reduce the potential benefits of conversion. This is doubly true if you're not yet age 59½, because you may have to pay a 10% withdrawal penalty in addition to regular income taxes.

In conclusion

No matter what your age, because a Roth IRA may improve your tax picture, it makes sense to take the time to learn how a Roth works and see whether you would benefit from one, notes Hevert. The key is to discuss your situation with a tax or financial adviser to help you fully assess your situation.