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Roth IRAs Explained: Everything You Need to Know

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Tags: Investing | Retirement | Tax Benefits

Introduction to the Roth IRA

A Roth IRA is an investment account that helps individuals save and prepare for retirement. The Roth IRA was introduced in 1998 following the passage of the Taxpayer Relief Act of 1997, and has since helped millions of people achieve their long-term financial objectives. This retirement account type is a popular method of long-term planning, mainly due to the significant tax benefits it offers.

Why Should I Invest in a Roth IRA?

If managed properly, a Roth IRA could help you attain your financial goals in the long-run, especially since there are flexible withdrawal rules on contributions (more on this later). The most important distinction of the Roth IRA account, though, is the tax advantages such account provides over a standard brokerage account, specifically as it relates to the tax-free growth and withdrawal of investments. Here's why this is important:

Tax-Free Growth

Due to the typical nature of investments appreciating in value over time, one of the best tax benefits an investment account can offer is **tax-free growth**.

When you invest in a standard brokerage account, you pay tax on all investment gains in the year you realize those gains. This means that if you buy $1,000 worth of stock today and sell that same stock for $1,500 in the future, you will incur a tax liability on that $500 gain in the year you sell. Then, if you choose to reinvest the balance, you won't have the full $1,500 to invest with (you will have less) since some of your gain goes to paying capital gains tax.

If you invest in a Roth IRA, however, you won't incur any tax liability on gains, ever! The entire balance in your Roth IRA, whether $1,000 or $1,000,000, is yours to keep and use for retirement. While the benefits of **tax-free growth** are significant when compared to a standard brokerage account, they even outweigh the benefits of **tax-deferred growth** as in the case of the Traditional IRA. Withdrawals from tax-deferred accounts are taxed, while withdrawals from tax-free accounts are not.

Very few investment accounts offer **tax-free growth**. Of those that do, some—such as an HSA or 529 Plan—have specific expense requirements to qualify for tax-free withdrawals. It is this rarity of unrestricted tax-free growth that makes a Roth IRA such an advantageous investment account.

Who Can Own and Contribute to a Roth IRA?

Like Traditional IRAs, Roth IRAs can only belong to a real, living person. For instance, you cannot have a Roth IRA for a business the same way you could a bank account. Similarly, Roth IRAs cannot be jointly owned—they are for one person, only—and there are no age limits for contributing to a Roth IRA, allowing people of all ages to contribute.

Contributions to a Roth IRA are restricted to **earned income** only. Earned income includes wages, salaries, tips, commissions, self-employment income, and any other taxable employee pay. Types of income that are not eligible for IRA contributions include investment income, interest and dividend income, earnings from rental properties, pensions, annuities, welfare benefits, unemployment benefits, worker's comp benefits, and social security benefits.

Finally, there are strict income limitations for those who would like to contribute to a Roth IRA. For those with higher levels of income (calculated using Modified Adjusted Gross Income "MAGI"), contribution limits phase out until being completely eliminated. For single tax filers, the phase-out begins at $146,000 and concludes at $161,000 (at which point Roth IRA contributions are not allowed). For married filing jointly filers, the phase-out begins at $230,000 and concludes at $240,000. For married filing separately filers, the contribution limit is dependent on whether you lived with your spouse at any time during the year.

How Much Money Can I Contribute to a Roth IRA?

In 2024, the maximum contribution to a Roth IRA is $7,000. Those who are at least 50 years old are eligible for an additional "catch-up" contribution of up to $1,000, increasing their contribution limit to $8,000. These limits are occasionally revised in order to adjust for cost of living and inflation.

One thing to keep in mind, however, is that contributions are restricted to earned income only, which may be lower than the $7,000 (or $8,000 for 50+) contribution threshold. For higher income earners, the contribution limit may be reduced or eliminated entirely (see above).

Can I Deduct My Contribution to a Roth IRA?

Unlike Traditional IRAs, Roth IRAs do not provide individuals with tax deductibility of contributions. However, the fact that contributions to Roth IRAs are on a post-tax basis is what allows the investments to grow tax-free, which is the core benefit of a Roth account. For many, paying taxes today in order to achieve tax-free growth is a valuable trade-off.

What are the Withdrawal Rules of a Roth IRA?

A Roth IRA is more flexible than other retirement accounts in that contributions you made to your Roth IRA can be withdrawn from the account anytime without triggering taxes or penalties. This is imperative for those who would like to access the benefits of **tax-free growth** without having to lock up their money until later in life. The investment earnings in a Roth IRA are subject to different rules, as defined below.

Withdrawals of earnings from a Roth IRA are tax- and penalty-free if they are considered **qualified distributions**. In order for a distribution to be considered qualified, your Roth IRA account must be at least five years old and meet one of the following criteria: (a) you are at least 59½ years old, (b) you have a permanent disability, (c) a beneficiary of your estate is taking a withdrawal after your death, or (d) the distribution is related to a first-time home purchase (up to $10,000). Withdrawals of earnings after age 59½ but before an account is five years old are subject to taxes but not penalties.

Earnings withdrawals that are not considered qualified are therefore considered non-qualified and are subject to ordinary income tax rates plus a 10% penalty. Withdrawals of earnings before age 59½ and before the account is five years old triggers both taxes and a 10% penalty. The 10% penalty (but not taxes) may be avoided if you have a qualifying exception. The most common exceptions include distributions related to first-time homebuyers (up to $10,000), birth or adoption expenses (up to $5,000 per child), emergency personal expenses (up to $1,000 per year), higher education expenses, federally declared disasters (up to $22,000), certain unreimbursed medical expenses, and death or disability of the IRA owner.

The IRS also applies a very specific withdrawal order to assets in a Roth IRA. Contributions come out first, then converted funds (as from a Traditional IRA, perhaps), then earnings.

Roth IRA account owners are not subject to any **required minimum distribution (RMD)** rules. Beneficiaries of a late Roth IRA account owner, on the other hand, may be subject to RMDs under certain circumstances.

<u>What Types of Assets Can I Invest in with a Roth IRA?</u>

A Roth IRA allows its account owner to invest in a fairly broad spectrum of assets. Stocks, exchange-traded funds (ETFs), mutual funds, bonds, money market funds, and certificates of deposit (CDs) are all permitted assets in an IRA. Examples of investments that are prohibited in a Roth IRA include life insurance, artwork and collectibles, S corporation stock, and real estate for personal use, among others.

It is important to establish an allocation of assets in your IRA that best matches your financial objectives and risk tolerance. A dynamic portfolio that evolves over time can help you meet your financial needs, wants, and wishes.

<u>Are There Other Types of Individual Retirement Accounts (IRAs)?</u>

Yes, there are other forms of IRAs that may have specific use cases. These include:

- <u>Traditional IRA</u> – A pre-tax IRA that has tax-free growth but taxation on withdrawals
- <u>Custodial IRA</u> – An IRA held on behalf of a minor or incapacitated adult.
- <u>Inherited IRA</u> – An IRA one inherits as the beneficiary upon the death of someone.
- <u>SEP IRA</u> – An IRA with special perks for self-employed individuals or small business owners.
- <u>SIMPLE IRA</u> – Another type of IRA with special perks for self-employed individuals or small business owners.

- Self-Directed IRA – An IRA that allows for a broader range of investment assets, such as real estate, precious metals, commodities, and other alternative investments.

How Can I Start Investing in a Roth IRA?

If you think a Roth IRA is right for you, reach out to us at **FreeMind Financial Advisory** and we would be happy to provide a **free strategy session** personalized for you. We can help determine if a Roth IRA is the best investment account for you, and if it is, we can assist in setting up your account, choosing an initial investment allocation, and actively monitoring and managing your retirement balance.

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