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Reacquainting yourself with the Roth IRA

Synopsis - When looking into retirement planning, many people read about Roth IRAs. But the timing isn't always right to take on one of these arrangements. This article recommends getting reacquainted with the Roth IRA — including its concept, contribution limits and conversion rules.

Full Article - If you've looked into retirement planning, you've probably heard about the Roth IRA. Maybe in the past you decided against one of these arrangements, or perhaps you just decided to sleep on it. Whatever the case may be, now's a good time to reacquaint yourself with the Roth IRA and its potential benefits, because you have until April 18, 2016, to make a ***2015*** Roth IRA contribution.

Free withdrawals

With a Roth IRA, you give up the deductibility of contributions for the freedom to make tax-free qualified withdrawals. This differs from a traditional IRA, where contributions may be deductible and earnings grow on a tax-deferred basis, but withdrawals (less any prorated nondeductible contributions) are subject to ordinary income taxes — plus a 10% penalty if you're under age 59½ at the time of the distribution.

With a Roth IRA, you can withdraw your contributions tax-free and penalty-free anytime. Withdrawals of account earnings (considered made only after all your contributions are withdrawn) are tax-free if you make them after you've had the Roth IRA for five years and you're age 59½ or older. Earnings withdrawn before this time are subject to ordinary income taxes, as well as a 10% penalty (with certain exceptions) if withdrawn before you are age 59½.

On the plus side, you can leave funds in your Roth IRA as long as you want. This differs from the required minimum distributions (RMD) starting after age 70½ for traditional IRAs.

Limited contributions

For 2015 and 2016, the annual Roth IRA contribution limit is $5,500 ($6,500 for taxpayers age 50 or older), reduced by any contributions made to traditional IRAs. Your modified adjusted gross income (MAGI) may also affect your ability to contribute, however.

In 2016, the contribution limit phases out for married couples filing jointly with MAGIs between $184,000 and $194,000. The 2016 phase-out range for single and head-of-household filers is $117,000 to $132,000.

Conversion question

Regardless of MAGI, anyone may convert a traditional IRA into a Roth to turn future tax-*deferred* potential growth into tax-*free* potential growth. From an income tax perspective, whether a conversion makes sense depends on whether you're better off paying tax now or later.

When you do a Roth conversion, you have to pay taxes on the amount you convert from your traditional IRA. So if you expect your tax rate to be higher in retirement than it is now, converting to a Roth may be advantageous — provided you can afford to pay the tax using funds from outside an IRA. However, if you expect your tax rate to be lower in retirement, it may make more sense to leave your savings in a traditional IRA or employer-sponsored plan.

Estate planning consideration

The net value of assets in your estate exceeding the lifetime exclusion ($5,450,000 in 2016) are subject to *estate* tax. This includes a Roth IRA. But a major advantage of the *Roth* IRA is that your beneficiary can inherit this *income* tax-free. In contrast, an inherited *traditional* IRA is taxable to the beneficiary.

Retirement radar

Roth IRAs have become a fundamental part of retirement planning. Even if you're not ready for one just yet, be sure to keep the idea of opening one on your radar.