Motley Fool's *Rule Your Retirement* Newsletter

Now Is a Great Time to Consider Tax-Free Roth Retirement Accounts

Robert Brokamp, CFP December 14, 2018 Taxes , Accounts , Saving

I know a woman named Rebecca, and when she benefits today from something she did a while back, she says to herself, "Thanks, Past Rebecca." It might be a simple as waking up to a fridge with milk because she stopped for a gallon on the way home the night before, even though she didn't feel like it. Or it might be the freedom to leave her job and start a business (as she has) because she saved so much money while she was other-employed.

Retirees with Roth retirement accounts can also thank their past selves because they decided to bite the tax bullet when they contributed to the account years ago (such contributions are not tax-deductible) but now enjoy tax-free withdrawals. It's the same for retirees who converted a traditional account to a Roth, and their heirs will also appreciate that foresight if they inherit the tax-free accounts.

Now is a particularly good time to consider a Roth account. With tax rates at their lowest points in decades, the tax break you give up by contributing to a Roth isn't as valuable.

So should you take a tax hit now to win your future self's gratitude and affection? The answer depends on whether you're working or retired and whether you have a Roth option at work. Fortunately, we have details, so read on, Fool!

Roth IRA vs. Roth 401(k)

Let's start with some basics as well as important differences between the IRA and employer-sponsored flavors of the Roth. The table below is a handy summary, but make sure you know all the nitty-gritty before you take money out, especially if you're not yet age 59 ½.

	Roth IRA	Roth 401(k)/403(b)
2018 Contribution Limit	$5,500	$18,500
2019 Contribution Limit	$6,000	$19,000
Additional "Catch-Up" for Workers age 50 and Up	$1,000	$6,000
Income Limits on Eligibility	For 2018, the amount that can be contributed gradually declines to zero from modified AGIs of $120,000 to $135,000 (single) and $189,000 to $199,000 (married). For 2019, the limits increase by $2,000 for singles and $4,000 for married.	None
Five-Year Rule for Withdrawals to Be Tax-free	The clock starts when you make a contribution to *any* Roth IRA.	Each account has its own clock, unless assets in an old plan are rolled into a new plan.
Required Minimum Distributions at Age 70 1/2?	No	Yes, unless you're still working for the company.
Withdrawals Before Age 59 1/2	Previous contributions come out first, which are tax- and penalty-free. Withdrawals of growth are taxed and penalized 10%, though the penalty may be avoided in some cases, such as a first-time home purchase, qualified higher-education expenses, or substantially equal periodic payments (SEPP).	Withdrawals are a combination of contributions and growth, with the latt portion being taxed and penalized, though the penalty may be avoided in such cases as withdrawals from the pla with an employer you left at age 55 or older, "hardship," or SEPP.
Loans?	No	Yes, up to $50,000 or half of vested interest (whichever is less), if allowed b employer.

Why Roth?

To Roth or not to Roth is a question of when you want a tax break. Contributing a Roth account means you're going to pay more taxes today in exchange for lower taxes in retirement. The same if you choose to convert a traditional retirement account to a Roth, as the converted amount gets added to your taxable income.

The prospect of a future smaller tax bill can certainly add some extra sheen to your golden years. However, from a pure numbers perspective, a Roth mostly makes sense if you'll be in a higher tax bracket in retirement; after all, you want to take your tax breaks for when you'll face the biggest tax bills.

So the decision of whether to Roth starts with comparing your tax rate today to what it could be in the future. That last one might be hard to predict, given all the variables (your future income, what current and future politicians will do, unpredictable and expensive events such as wars that could affect tax rates). But here are some guidelines:

- If you're single and have $38,700 or less in *taxable* (not gross) income or are married and have $77,400 or less in taxable income, you're in the 12% tax bracket in 2018. The Roth is probably your better bet.
- Younger workers tend to benefit more from the Roth since most people reach their peak earning years in their late 40s or early 50s.
- The closer you are to retirement, the more you can use an online tax calculator to estimate your current and in-retirement tax liabilities and feel comfortable with the accuracy of the projections. You can use the online tax estimators from TurboTaxand TaxAct.
- Keep in mind that most people drop into a lower tax bracket once they retire.
- Given large government deficits and underfunded entitlements, tax rates will have to go up eventually. That burden is more likely to fall on younger and higher-income Americans.

Contemplating your current and future tax rate will get you pretty far in make the "Roth or Not" decision. But here are some other factors to consider.

An extra underappreciated tax benefit! The more income you receive in retirement, the more your Social Security benefit will be taxed. Withdrawals from *traditional* retirement accounts are included in the income that can lead to higher Social Security taxation. However, withdrawals from Roths are not. So not only are the withdrawals tax-free, but they might also shield more of your Social Security from taxation.

But choosing a Roth can lead to underappreciated tax costs! Contributing to a traditional retirement plan or deductible traditional IRA reduces your adjusted gross income (AGI), whereas contributions to a Roth account do not. Your AGI is important because it can affect many other aspects of your tax bill, including your eligibility for, and the size of, various deductions and credits. Thus, it's important to appreciate the total impact that choosing the Roth over the traditional account (or converting to a Roth) has on your tax bill. Use an online tax calculator or speak with your account to understand all the moving parts.

You can make 70 ½ meaningless. You must begin taking required minimum distributions (RMDs) from traditional retirement accounts at age 70 ½ (or wait a year and take two distributions). Also, you can't contribute to a traditional IRA beyond that age. However, you don't have to worry about RMDs with Roth IRAs, and you can contribute as long as you have earned income. Roth 401(k)s and 403(b)s are subject to RMDs if you're no longer working for the company, but all you have to do is transfer those assets to a Roth IRA to make them RMD-free. Keeping money in tax-advantaged accounts for as long as possible is particularly beneficial for people who don't need the money (perhaps because of other large accounts or a generous pension) and/or who want to leave a large (income-tax-free!) inheritance to their heirs.

Life changes are tax changes. Many of life's big milestones — marriage, divorce, birth, death, job change, onetime boosts or reductions to income — probably affect your tax bill. That also may mean that it's time to reevaluate the "Roth or not" decision.

What would you do with the deduction or taxes owed after a conversion? If you use an online calculator to decide between a traditional or Roth account, the calculation assumes you will invest the money you saved by choosing the traditional account and getting a tax deduction. However, if you instead want to use that money for other purposes — especially for not-particularly productive things (a ginormous TV in every room!) — then the Roth might make sense even though an online tool tells you otherwise. Similarly, if you're analyzing whether you should convert assets in a traditional account to a Roth, the calculator will probably assume that the taxes due as a result will have come from other investments. But if the money would have come from no-yielding cash or money that would have been spent in ways that don't provide long-term value, paying taxes today in exchange for paying no taxes in the future may be a good "investment."

Scaling Mt. Roth-more, Even If You're "Ineligible"

As described above, there are limits to how much you can contribute to Roth accounts, and higher-income Americans may not be able to contribute to a Roth IRA at all. However, there are three ways you might be able to get more assets into Roth accounts despite these restrictions.

1. Convert

Anyone of any age can do a Roth conversion. (There used to be an income restriction, but that's no longer the case.) You don't have to convert an entire traditional account, so consider converting just portions over time to smooth out the tax consequences. Also, you don't have to wait until you leave your employer to convert money you have in a traditional 401(k) to a Roth account; you can do a so-called "in-plan conversion" if your employer allows it, regardless of your income. The only money you can't convert is any non-vested employer matches. Just keep in mind that you'll still owe taxes on the amount converted.

Until recently, you had until Oct. 15 of the following year to change your mind about a conversion and undo it via a process known as "recharacterization." However, the Tax Cuts and Jobs Act of 2017 eliminated the ability to recharacterize after 2018, so don't do a Roth conversion unless you're sure it's the right move.

Finally, because the conversion results in higher taxes, you should adjust any withholdings or quarterly payments so you don't pay underpayment penalties when you file your return.

2. The Backdoor Roth

If you're unable to contribute to a Roth IRA because of income limits, you still might have an option: You can contribute to a non-deductible traditional IRA (which anyone younger than 70 ½ can do as long as he or she has earned income) and soon thereafter convert it to a Roth. If you don't have any pre-tax money in any other traditional IRA accounts, including SEPs, SIMPLEs, and rollovers from previous employers' plans, you can immediately convert that traditional IRA to a Roth IRA. (And by "you," we mean that you can ignore what your spouse has.) Here's the real bonus: Because you couldn't deduct the contribution and because the account didn't have an opportunity to grow, you won't owe any taxes on the conversion. This little trick is known as the "backdoor Roth."

It gets complicated if you have pre-tax money in a traditional IRA because, for tax purposes, the amount is prorated across all your accounts. For example, if you have $50,000 of pre-tax money in an IRA and then make a $5,000 non-deductible contribution to the IRA and immediately convert that account to a Roth, only 10% ($50,000 divided by $5,000) will be tax-free. However, there's one possible way around this. You can transfer those pre-tax assets to your existing 401(k), if your employer allows it. The downside: 401(k)s have limited and often pricier investments, and most don't allow individual stocks and bonds.

3. After-Tax 401(k) Contributions

You probably knew about the contribution limits to 401(k)s listed in the chart at the beginning of this article, but you might be able to contribute even more. There's another, all-in limit of $55,000 in 2018 ($56,000 in 2019) or 100% of compensation, whichever is higher. This includes employee *and* employer contributions. If your account hasn't reached that annual limit, you can make additional after-tax contributions.

Don't confuse those after-tax contributions with Roth contributions, which are also after-tax and grow tax-free. The growth attributed to these after-tax contributions is tax-*deferred* — that is, you don't pay taxes until you make withdrawals, which are taxed as ordinary income.

Furthermore, as of this year, when you leave your employer, you can segregate these after-tax contributions from the growth and transfer the former assets into a Roth IRA and the latter into a traditional IRA. Technically, you're converting those after-tax contributions to a Roth. However, because the converted amount doesn't involve any *pre-tax* money or growth, the conversion won't cost you anything.

An example: Let's say you make a $25,000 after-tax contribution to your 401(k), and it grows to $100,000 over the years. When you leave your employer, you transfer the $75,000 worth of growth to a traditional IRA and convert the $25,000 contribution to a Roth IRA (which then grows tax-free like Roths everywhere). Had you not made that $25,000 after-tax contribution and kept it in a regular, taxable brokerage account, you'd be paying taxes on the annual gains, dividends, and interest attributable to those investments each and every year.

Not every plan allows this; it's up to your employer. But if it's available to you, it's a great way to add more tax-advantaged assets to your portfolio if you can save more money beyond the $18,000/$24,000 annual limits and your income makes you ineligible for a Roth IRA. Just remember that the same early penalty withdrawals apply to this money, so only contribute money you don't need until age 59 ½.

The Foolish Bottom Line

If you're feeling a bit mixed up, that's understandable; the rules governing retirement accounts send even experts' heads spinning. A good bit of caution is warranted whenever making decisions about your accounts, especially when it comes to pre-59 ½ withdrawals and account rollovers. So triple-check your understanding of the all the ins and outs before doing anything. A competent CPA is a good source of information and confirmation. The customer-service folks at your account providers can help explain the logistics specific to that company, though they may not be experts on the more complicated tax topics. But putting in the time to learn all the details, getting help if you need it, and making the moves that are right for you can result in thousands of dollars of after-tax wealth. Your future self will love you for it.