The Wall Street Journal

Is a Roth Account Right for You?

More People Now Have Access to What Can Be the Best of All Retirement Accounts

By Laura Saunders

Dec. 19, 2014

Roth accounts can be a great way to save for retirement—and it is getting easier to use them.

Roths include both tax-sheltered individual retirement accounts and company-sponsored 401(k) savings plans, and, as with traditional versions of these accounts, assets grow tax-free.

In many other important ways, though, Roths and traditional plans vary considerably.

The biggest difference: With traditional IRAs and 401(k) plans, savers typically contribute pretax dollars and then owe tax at ordinary income rates on withdrawals made after age 59½. But savers using Roth IRAs and Roth 401(k)s put after-tax dollars instead of pretax ones into their accounts.

Roth owners thus forgo a valuable upfront tax break, but they can get a better one in return: tax-free withdrawals of assets after age 59½. Roth accounts have a host of other benefits as well, such as more flexibility.

Jared Guyer, a 38-year-old meteorologist in Norman, Okla., likes the fact that, unlike with a traditional IRA, he and his wife can withdraw contributions to their Roth IRAs without penalty—making them a de facto emergency fund.

"Fortunately, we haven't had to take money out," says Mr. Guyer, whose wife just had the couple's first child. "But it's nice to know we could, if push came to shove."

To be sure, Roth savings aren't always best. "Roth accounts are wonderful to have, but not if the price of admission—taxes—is too high," says Natalie Choate, a lawyer specializing in retirement benefits at Nutter McClennen & Fish in Boston.

Making the right choice depends on multiple factors, including income, future tax rates and changes Congress could make in the law. Here's what you need to know.

Easier Access

Until recently, many affluent savers didn't have access to Roth accounts. Income limits set by Congress kept many people from contributing to Roth IRAs, and Roth 401(k)s weren't widely available.

Now that is changing. According to benefits firm Aon Hewitt, millions of workers have the option of putting some or all of their 401(k) dollars into a Roth 401(k). Out of nearly 400 large and midsize firms surveyed, more than half now offer such an option, compared with only 11% in 2007—and Aon Hewitt expects the number to grow.

In addition, the Internal Revenue Service recently issued a ruling making it easier for workers to move after-tax dollars in a 401(k) plan into a Roth IRA. And in 2010, Congress removed an income cap so that all taxpayers can convert part or all of a traditional IRA to a Roth IRA.

These expanded options are likely to boost the trend toward Roth accounts. Although traditional IRAs hold about $6 trillion—more than 10 times the assets that Roth IRAs do—Roths are growing much faster.

According to the Investment Company Institute, a fund-industry trade group, the number of households with one or more traditional IRAs has held steady at about 27 million over the past decade, while the number with Roth IRAs has grown 47%, to about 13 million.

A spokesman for brokerage firm Charles Schwab says it now has nearly 1.2 million Roth IRAs, up 32% in the past five years alone—more than double the growth of its traditional IRAs.

Tax Breaks

In essence, savers have to decide whether it's better to get a tax break now for putting dollars into a traditional IRA or 401(k) plan, or to put after-tax dollars into a Roth account and take tax-free withdrawals later—perhaps in several decades.

The short answer: If you expect your tax rate on withdrawals will be higher than or the same as your current tax rate, a Roth account is often the better choice, experts say.

"The tax comparison is often the main driver," says Maria Bruno, a retirement specialist at financial-services firm Vanguard Group.

In general, many young savers should opt for Roth accounts, as Mr. Guyer and his wife have done. But for savers in their peak earning years, it often makes sense to grab the upfront break a traditional IRA or 401(k) plan offers.

Many savers appear to understand this rule of thumb. At Vanguard, says Ms. Bruno, people under 30 are putting 92% of their IRA contributions into Roth accounts.

At the same time, conversions of traditional IRAs into Roth IRAs, which are fully taxable, peak between age 65 and 70 at Vanguard. Many of the converters are probably retirees whose tax rate has recently dropped.

There may be other savers who should avoid Roth accounts—those who lose tax benefits when their income is too high.

For example, the American Opportunity Credit is a valuable tax offset for people paying college tuition that's worth up to $2,500 per student each year. But it phases out beginning at $160,000 of adjusted gross income for most married couples in 2014.

As a result, savers who want to claim the credit and who earn close to that threshold should probably opt for traditional savings accounts. That is because pretax contributions reduce income, while after-tax contributions to a Roth account don't.

Tax Diversification

Many savers will find it hard to guess what their tax rates will be in a decade or two, or to predict how Congress will revise the rules on tax-sheltered retirement accounts.

In that case, Marina Edwards, a senior consultant with the benefits firm Towers Watson , offers this advice: First, make sure to reap whatever matching funds an employer offers for retirement savings. Then, with tax consequences in mind, apportion contributions over time among different buckets: one with savings in Roth IRAs and 401(k)s, another with pretax savings in traditional IRAs and 401(k)s, and perhaps a third with after-tax cash or investments.

Each bucket has different tax characteristics, and having money spread among them can enable taxpayers to make tax-efficient withdrawals in retirement, says Ms. Edwards.

"Each year people can see which bucket it makes sense to pull from and then vary their withdrawals," she adds.

Getting In

More people now have ways into a Roth account than just a few years ago. Here is a rundown of the options:

Some people can contribute directly to a Roth IRA, which are named for former Sen. William Roth (R., Del.). (He persuaded Congress to create the accounts in 1997. The Roth 401(k) followed in 2006.)

For 2014, savers can put in up to $5,500 (plus $1,000 if they are 50 or older). As with many tax breaks, including traditional IRAs, there are income limits. Roth IRA eligibility phases out for most married joint filers with adjusted gross income above $181,000 and singles above $114,000.

Unlike with traditional IRAs, the ability to contribute to a Roth doesn't end when a worker reaches 70½, Ms. Choate says.

Savers also can convert all or part of their traditional IRAs into Roth IRAs. As the transfer is fully taxable, experts recommend that people do Roth conversions in years they will owe at lower rates and in amounts that won't push them into higher brackets—say, after the account owner's retirement, or when he is between jobs.

The good news with Roth conversions is that if circumstances change, the taxpayer can undo them, up to a point.

Savers who earn too much to contribute directly to a Roth IRA can sometimes choose a "backdoor" Roth IRA. To do this, the saver contributes after-tax dollars to a "nondeductible" IRA and then converts it right away to a Roth IRA—so that there will be little or no tax on the conversion.

One hitch: If the saver has other IRAs holding pretax money, the conversion amount could be partly or mostly taxable because the conversion is prorated among all the taxpayer's IRAs.

One way to avoid this problem is to move pretax IRAs into a company 401(k) plan—assuming it is a good one—so that the backdoor Roth conversion can be tax-free.

According to benefits firms and retirement-plan sponsors, more employers now offer Roth 401(k)s that allow workers to put in all or a portion of their retirement savings, up to $17,500 for 2014 (plus $5,500 for those 50 and older). Contributions are made in after-tax dollars, while any company matching is in pretax dollars.

When the worker leaves and wants to do a tax-free rollover, Ms. Choate says, the Roth contribution and its earnings go into a Roth IRA, while the company match and its earnings move into a traditional IRA.

Recently the IRS issued a ruling benefiting employees who contribute after-tax dollars to a traditional 401(k) plan. When the worker leaves and wants to do a tax-free rollover, the after-tax contribution goes to a Roth IRA, but the company match, its earnings and earnings on the worker's after-tax contribution go into a traditional IRA.

According to Rob Austin, head of retirement research at Aon Hewitt, workers usually don't have to max out pretax contributions to put after-tax dollars into 401(k)s. Some 42% of firms surveyed offer this option, he says.

Contributing after-tax dollars to a traditional 401(k) plan could affect the plan's "discrimination testing"—rules that prevent highly paid employees from receiving disproportionate benefits, says Ms. Edwards of Towers Watson. But correcting any discrimination isn't difficult, she adds.

The deadline for putting money into 401(k) plans is generally Dec. 31, but savers can contribute to traditional and Roth IRAs for 2014 through April 15, 2015.