Should you be making Roth contributions?

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Isn't it exciting when you finally become eligible to contribute to your 401(k) at work? It provides that feeling of having a financial future. However, those feelings are usually abruptly interrupted by the extensive list of options to choose from.

One option that stood out to me when signing up for my company's 401(k) plan was the Roth IRA option. This is something commonly overlooked by employees because they simply do not know what it means or the benefits a Roth account can offer.

A Roth IRA contribution is a contribution that is included in your gross income now but is tax-free when taken out at retirement. This is an attractive option since the earnings in the account are tax-free as well. Also, for younger investors who are earning a lower income than they expect to earn in the future, one benefit of the Roth account is that they will pay less income tax on the money now than they would when they withdraw it in retirement. They also have longer for the earnings to grow and thus more money will be available tax-free in retirement. The employer's matching contributions will be placed in a traditional 401(k). This helps diversify taxable income in retirement.

A traditional 401(k) contribution is made in pre-tax dollars and those funds, including earnings, are taxed at the time they are withdrawn from the account. This could be beneficial if you are in a high tax bracket and expect to be in a lower one during retirement.

You do not have to have a 401(k) through your employer to make Roth contributions. Most people, if they meet the requirements, can open a Roth IRA in their own name and make contributions themselves. An individual who has an income of at least $5,500 in 2017 but not over $118,000 for a single filer, or $186,000 for joint filers, would qualify to contribute the full $5,500 to their Roth IRA. Consult with an advisor and your accountant to see if you are eligible.

Tax benefits to a Roth IRAs

Roth IRA contributions are made with after-tax dollars and the contributions and earnings in the account can be withdrawn tax-free once the account is held for five years and you attain age 59½. Withdrawals can also be made

under a few other special circumstances such as disability, first time homebuyer expenses, or if it is withdrawn by the beneficiary or estate after your death. These qualified distributions do not incur a 10% early withdrawal penalty.

If nonqualified distributions are made, they will incur the 10% penalty and be taxed only on the earnings portion of the funds if the distribution exceeds the contributions you have made. This means that if you are under 59½ you can withdraw the amount of your contributions with no penalty as long as you have held the account for at least 5 years.

For example, Sally opened a Roth IRA in 2010 at age 30 with a contribution of $3,000. Her account at the end of 2016 had a balance of $5,300. She would be able to withdraw $3,000 without paying a penalty or tax. But, if she withdraws $4,000, she would pay a 10% early withdrawal penalty plus tax at her current tax rate on the $1,000 beyond her contribution.

Another notable advantage to Roth IRA accounts is that there are no required distributions when you reach age 70½ or at any time thereafter. If the funds are not needed in retirement they can continue to grow in the account and be left to your beneficiary. Also, as long as you have an income, you can continue to make contributions to your Roth account even after you attain age 70½.

If you do take withdrawals from your Roth IRA in retirement they do not count towards taxable income. Your income used for programs such as marketplace health insurance and social security is based on your Modified Adjusted

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Gross Income (MAGI). Roth distributions do not count toward MAGI, but taxable IRA withdrawals do. This could be very beneficial in getting a lower healthcare rate or paying less tax on social security benefits in retirement.

It's a good idea to consult with your financial advisor about which investment vehicles should be used to take distributions and the tax implications of your choices.

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