How To Set Up A Roth IRA And Is It For Me?

Tips For Establishing And Funding A Roth IRA Of Your Own

Hey guys and girls - Ron Parks here, and welcome back to the channel!

The point of this episode is for me to give you the best advice to save and plan for retirement, as it is likely going to be the most expensive investment of your life.

While it may not always seem urgent, you typically want to start saving around 35, and preferably even earlier than that. We've established some strategies for you to work with, but we haven't really gotten into the finer details of what to do.

There are many options when choosing the retirement plan that's going to work for you; you've got 401(k)s, SEPs, profit-sharing plans, individual retirement accounts, and Roth IRAs.

Eventually, we're going to tackle every one of these so you can see which one is right for you. All of them have benefits beyond a normal savings account or brokerage account, it's just a matter of finding out which works best for your own goals and needs.

Today, we're going to start with Roth IRAs. No particular reason; they're just what's on the menu. We're going to define it, and go over the general rules of your account.

So, let's get down to brass tacks: What exactly is a Roth IRA?

Well, a Roth IRA is an individual retirement account that you open and fund yourself. Now - you might say that sounds like just an IRA, and you'd be right. The difference is in how and when you get a tax break.

That's about it, but a lot of people have some misconceptions when they hear the term. They think it's going to pay dividends, that it's some kind of investment.

Let me be clear, a Roth IRA is not an investment. You pay the taxes on the contributions initially going into the account, then your earnings are tax-free after that.

With traditional IRAs, your contributions to the account are tax-deductible for the year that you made them while your withdrawals are taxable. With a Roth IRA, your contributions are initially taxed, while your withdrawals are not.

So who should be in the market for a Roth account? That all depends on how much you expect to be taxed after you retire.

If your tax rates are likely to be higher, a Roth IRA is what you're going to be looking for. Another key benefit is that the contributions can be easily passed to heirs if need be.

But here's the trick - you're not always afforded the option of a Roth account. The IRS rules on eligibility are going to determine if you can even apply for one.

Let’s get into it, and a special thanks to Nerdwallet for breaking down the math here [ref1].

In 2020, the minimum modified adjusted gross income limit to apply as a single person is $124,000 to put in annual contributions up to $6,000. Those who earn between $124,000 and $139,000 a year can still make reduced contributions, and those earning over $139,000 are not allowed to contribute. As you can see, the more you make, the less you're able to contribute.

If you're married, the MAGI is obviously a lot more, extending to $196,000 for full contributions and up to $206,000 to make reduced contributions. Of course, this is unless you file separately. These are the current numbers on how much you have to make, and what you can put in.

If you are married and file jointly with only one partner earning income, there may be a better option for your situation. A spousal Roth IRA allows you to contribute for a non-working spouse. Of course, you have to be making enough to cover both of you. This is a great way to boost your retirement savings with only one income.

Now, say you make too much to contribute to a Roth IRA, but you're still trying to avoid the high taxes of other accounts. There are ways, completely legal, for you to open a backdoor Roth IRA.

We're going to walk you step-by-step through how to do that in a minute. But before we do that, we need to find out if you even want a Roth, right? Remember, the ultimate goal here is to cut the taxes you're expecting to get hit with when you retire.

So let's take you through the pros and cons of a Roth IRA.

First, the early withdrawal rules are much more flexible than a regular IRA. Usually, you're not going to want to make a lot of them early on in your retirement - it's just not advisable. This is, after all, there for AFTER you retire. But there are some circumstances that can't be avoided and you may need to, such as current world events and associated circumstances.

You've no doubt heard news stories in the past few months about people being forced to make early withdrawals due to the pandemic, but for the most part, people seem to understand the importance of continuing to contribute.

Still, hardships happen. With a Roth IRA, you're not going to have to pay income taxes or penalties on any early withdrawals you're forced to make.

However, the IRS can fine you up to 10% for early withdrawals otherwise.

Second, a Roth IRA is much easier on retirees. Regular IRAs require you to start making withdrawals by 72. You don't have a choice, and with people staying at work longer and longer, that's becoming a bigger problem. With a Roth IRA, there are no set rules for when you have to start making withdrawals.

So you're free to let your savings keep growing as long as you live, which is ideal for those hard-workers who just insist they're never going to slow down. Personally, I don't mind a little break at the end of… you know, life, but some people just have more drive than I.

Third, and this is going to depend on what kind of person you are- but unless you are one diligent penny-pincher who saves the first nickel they ever made, you're going to end up with more money after-taxes for retirement with a Roth account. Both IRAs and Roths offer tax breaks, but traditional IRAs offer tax breaks only once a year.

Everyone remembers National Lampoon’s Christmas Vacation – Chevy Chase is banking everything on his Christmas bonus, when it turns out he's got a free Jello-of-the-month membership, then the next thing you know, he's got a chainsaw. But what good is an annual bonus when you're settling down?

With a Roth account, you know you're going to arrive at retirement age with more after-tax savings.

Lastly, say you have a 401(k) offered at the company you work. In this situation a lot of people consider skipping a Roth IRA, figuring their organization is going to take care of things - but this can be a mistake.

The original reason IRAs exist at all is for those who don't work for companies that provide them to be able to save for their retirement. But nothing is stopping you from opening both, and you'd be wise to do so.

Some companies offer a Roth 401(k), and that's great, but this option isn’t always available. But if you have the choice, get both. Having a Roth IRA alongside your 401(k) means you can diversify your retirement funds, and moving money between the two can mean huge savings in taxes later on.

So those are probably the best reasons for getting a Roth IRA, but now we need to address those who might not need or want one. It sounds ideal, I know, but it's not for everyone.

Let's go through some of the more obvious reasons you might have already figured out first.

You're not going to want a Roth if you can't afford it. If the only way you can pay the taxes on your account is by making withdrawals from your IRA, it's not for you. Remember, a Roth account's purpose is to keep more money in it longer, not keep making early withdrawals on contributions.

If you need money within five years or less of retirement, you're probably not going to want one either. Same reason, the longer you keep it in, the better.

Also, if you make too MUCH money. First of all, congratulations. Second, as you saw in Nerdwallet's chart, you can't contribute to an account if your income is too high.

And finally, if this will push you into a higher tax bracket, it's not advisable. Usually, the best strategy is to convert just enough to keep you in the same tax bracket.

So you've probably worked that much out for yourself - you know how much you make, you know how much you can save. Now let's talk about some of the other drawbacks that are a little less apparent.

First, it's not great for those that are starting late. The longer you have money in a Roth account, the more you stand to have when you retire. But what good is that going to be when you're only saving later in life? The time horizon to get one is short, so you'll need to make some decisive decisions early on.

Second, and this is strictly for the very generous. I commend you for leaving so much of your estate to charity, but it doesn't make sense to do it with a Roth. Charities are already tax-free, so there's no point leaving it in a tax-free account you have to pre-qualify to apply for. If you're planning on leaving it to heirs, that's great, but for charities, this is not what they're made for.

And here's a psychological factor you may not have considered: ever have fun writing a gigantic check to the IRS? I didn't think so. There's a mental leap you have to take when you're considering putting your money into a tax-free account, and if you're converting money, which we'll talk about in a moment, you're inevitably going to have to pay the piper.

In this case, that's the big, unpleasant IRS. They're not all like Ben Affleck in The Accountant, but they make sure writing that check is a potentially psychologically damaging experience. But we're talking big money here, so you have to have a little bit of courage.

So, those are the most significant drawbacks to a Roth IRA, but if you still think you're in the market for one, let's get you there. You may be concerned about making too much to contribute, and that's understandable. However, now it's time to walk you through how to open that backdoor Roth IRA.

First, you open up a traditional IRA account. This is something anyone can do. If you're under 70 and you're making taxable income, you're eligible. You might have an open account already, or you might have to create one.

Next, talk to your IRA administrator. They will instruct you and provide the paperwork to convert that account into a Roth.

Now, since only after-tax money goes into a Roth, you're going to have to pay that deduction. When you pay your income tax that year, make sure you pay it on the money you're converting.

There are different types of transfers you can do to convert the money. You can roll it over, which means just transferring the money into the Roth within 60 days.

Then there's the trustee-to-trustee option, where your IRA advisor will transfer the money between accounts.

And finally there's the same-trustee transfer, which means you move the money from your IRA to the Roth using the same institution.

Now, this is important to remember. If you do roll the money over, the IRS expects you to do it while operating under something called the Pro-Rata Rule. We're going to get into some light math here. The IRS will look at your traditional IRAs, combined if you've got more than one.

Now, let's say all your IRAs are composed of 70% pre-tax money and 30% after-tax. That 70/30 ratio will determine just how much of the money you convert into the Roth is taxed. So in this instance, no matter how much you wind up converting, 70% of that is taxable.

If you intend to leave any of your retirement to heirs, you must name your beneficiaries. Otherwise, this money is going to go through the probate process. That means delays, expensive attorneys, and a whole host of other problems you don’t want to stick your loved ones with.

So, now that you're ready to open a Roth IRA, you might be asking what you can with the money once it's deposited. Is it just going to sit there and remain tax-free? Yes! However, you can buy stocks and purchase mutual funds, and place them inside your Roth account.

Though just because you could, doesn't mean you should. Here are some things you're never going to want to put into a Roth account.

You're going to want to avoid penny stocks. If you've seen The Wolf of Wall Street, you have a pretty good idea what these are. These are stocks that show up one the pink sheets, and they're never sure things.

You hear about some brothers in Utah inventing the new television, and someone is cold calling you asking to invest, but you gotta realize the likelihood of another Philo T. Farnsworth turning up in the pink sheets is next to nil.

So if you're buying 1,000 shares of a 10 cent stock, you think you're gonna get big, but there's a 99 percent chance you're not. So if you put a penny stock into a Roth IRA and it isn't the sure thing you think it is, you're going to wind up losing a lot of money, and you won't be able to make an annual contribution.

The second is a short-term bond. Bonds are usually thought of as safe, long-term investments. But you're not going to want to stake your retirement on something short-term. Generally, avoid the word "short-term". It's not worth it, and it's kind of contradictory if you're planning on saving for the long haul.

The next thing you don't want to mess with in a Roth is an annuity. If you don't understand annuities, that's already a bad thing. Annuities already offer you tax referrals. It's not like you're going to get double or triple tax-protection. It seems just wasteful, and annuities tend to have pretty high fees.

Essentially, what we're looking at are any stocks that aren't a sure thing or at least very promising or anything that's already offering a tax break. That's just redundant.

So, what did we learn?

To recap, we've determined just how much you need to make to qualify for a Roth IRA and what you can expect to get out of it. Remember the most critical aspect of a Roth account – it's tax-free for you and your heirs.

Obviously, if you don't think you can afford one, then it's probably not the right option for you. Especially if you're going to be making a lot of early withdrawals.

If you have considered the potential drawbacks and find they don't really apply to you, I couldn't advise getting a Roth IRA more. You're going to wind up saving a lot more, and you're going to pay a lot less in taxes.

Even if you don't qualify, if you still think it's the right option, there are ways you can legally open a backdoor Roth IRA.

But once you get a Roth IRA, know what you're putting in it, and don't place things in it that are already tax-free.

Okay, well, that just about does it. I hope you found this video informative. If you did, smash that like button, subscribe, and be sure to click that notification bell so you can watch the latest uploads as they come out. I try to post every week, if not more, and I look forward to seeing you on the next one!

ref1: Graph under "Roth IRA income limits for 2019/2020": https://www.nerdwallet.com/article/investing/roth-or-traditional-ira-account