A ROTH IRA for Retirement Savings

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For many of us, we may have heard of a ROTH IRA, but sometimes there is confusion on its various uses. Traditionally speaking, a ROTH IRA is an account with special tax treatment that allows the investor to defer taxes on gains in the account, and if over age 59 ½, withdraw the gains tax free (there is a 5 year requirement on the account before withdrawing gains tax-free.) These traditional accounts are often used to support retirement savings goals. The retirement focus here being largely because of the early withdrawal penalties on the gains in the account if the owner is not yet over age 59 ½. Although these early withdrawal rules are the same as a Traditional IRA (another tax advantaged account where the owner gets a tax deduction on contributions in the year of contribution and then pays the tax later on withdrawals from the account). The difference is that with a ROTH IRA, you can withdraw your principal contributions early without penalty after the five year holding period has been satisfied.

Why is this little-talked-about feature so important? In the case of someone missing the yearly contribution in favor of keeping that would-be contribution in savings for a future emergency, they instead could fund the ROTH IRA and simply keep the money sitting in a cash account within the ROTH IRA.

It is often assumed that a ROTH IRA needs to use higher risk mutual funds containing stocks, bonds and other market investments typically earmarked for retirement, rather than more conservative options like a savings account or Money Market accounts. This spectrum of investment options allows for either conservative or more aggressive investments within the same ROTH IRA as the investor shifts their goals for the money over time.

To note, I am mainly addressing yearly contributions here. There are different rules on rollovers from retirement plans as well as ROTH IRA conversions from traditional IRAs and Non-deductible IRAs. These mechanisms for getting money into a ROTH IRA carry different rules that do not allow for immediate access, as a yearly contribution would allow.

A contribution to a ROTH IRA each year can be an effective strategy to not only have immediate access to your funds in case of emergency (principal only before retirement age 59 ½ or 5 years whichever is later from the date of when the ROTH was started,) but also capture the yearly contribution limit that would otherwise go unused which could hinder future tax and retirement planning efficiency and flexibility.