U.S. News & WORLD REPORT

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7 REASONS TO USE A ROTH IRA FOR EARLY RETIREMENT

Roth strategies for investing can make retiring early possible.

By: Rebecca Lake - October 18, 2019

Roth accounts offer advantages to early retirees. Early retirement is an achievable aim but it requires some smart thinking when it comes to taxes. Incorporating Roth strategies into the mix can help shape a tax-free retirement approach. A Roth 401(k) is one option, though it may not be available to every employee. A Roth individual retirement account, on the other hand, could be a more accessible way to plan for an early exit from the workforce. “By saving in a Roth IRA now, your money is growing tax-free and will be taken out tax-free, meaning you will only have to withdraw what you need to fund your retirement,” says Tony Drake, founder and CEO of Drake & Associates in Waukesha, Wisconsin. Here are seven benefits of using a Roth IRA for early retirement planning.

Contributions can be withdrawn at any time.

Traditional IRAs impose a 10% penalty for withdrawals of contributions and earnings made before age 59.5. Roth accounts are by nature better suited to early retirement withdrawal strategies. “A Roth IRA is the only tax-favored retirement vehicle in which a saver can access some of the funds without an IRS penalty prior to age 59.5,” says Marc Labadie, partner at The R.O.W. Group in Nashville, Tennessee. Original contributions can be withdrawn without triggering the early withdrawal penalty. That makes a Roth IRA more attractive for someone who may be planning to retire in their 40s or 50s and needs to have assets that are readily available to draw on as an income stream.

Growth accumulates tax-free.

One of the best features of a Roth IRA account for retirement is the ability to enjoy tax-free distributions starting at age 59.5. This can help with planning a withdrawal strategy when there are other retirement accounts in the mix. “The best strategy to make the most of a Roth IRA is to build it up while working, then actually leave it alone for the early retirement phase of life,” says Ben Barzideh, a wealth advisor at Piershale Financial Group in Barrington, Illinois. “During the early retirement phase, you want to live off of money in qualified retirement accounts, as you’ll be in a lower tax bracket usually than preretirement and you want to create taxable income in that phase of life.”

Greater tax predictability makes planning retirement budgets easier.

Retiring early poses some unique challenges to investors because the money in a portfolio may need to last three or four decades. A Roth IRA can be better equipped than a traditional 401(k) or IRA for meeting that challenge because tax uncertainty is eliminated. “All the contributions have already been taxed and you get to keep 100% of the growth,” says Matthew DeFelice, a partner at U.S. Financial Services. “Unless you can accurately predict what tax rates will be in the future when you take money out of your 401(k) or IRA, it’s difficult to know how much money you’ll actually have to spend after taxes are paid.” A Roth IRA makes it easier to gauge when to tap those assets in early retirement and how to space out withdrawals to stretch those dollars further.

Roth IRA conversions open the door for high-income earners.

The IRS excludes higher earners from making Roth IRA contributions directly but there is a work-around. “A strategy that can be employed if your income is too high to make an outright Roth contribution is the backdoor Roth, where you make a nondeductible traditional IRA contribution and immediately convert it to a Roth IRA,” says Delvin Joyce, a financial planner at Prudential in Charlotte. The trade-off is that the amount converted is taxable. Investors can spread the tax burden out by constructing a Roth conversion ladder, in which amounts are converted each year before retiring early. The key is to start a Roth IRA ladder conversion at least five years before the money is needed, experts say.

Roth assets offer spending flexibility.

Covering basic living expenses may be priority No. 1 when planning for early retirement but there are other ways a Roth IRA can prove useful. “Roth IRAs can also be used for your children’s college savings goals,” Joyce says. “Since your after-tax contributions can be withdrawn at any time without penalty or taxes, you could pull money out to pay for college expenses.” This assumes, of course, that a Roth IRA is just one part of a well-rounded retirement plan that includes other assets such as a traditional 401(k), taxable investments, cash savings or tax-advantaged funds held in a health savings account.

Stock market volatility may be more easily managed.

Stock market movements are unpredictable, to say the least, and for the early retiree, there may be less room for error when attempting to ride out waves of volatility. Roth accounts, when used in conjunction with other investment vehicles, can help offer some insulation against up and down movements. “The strategy of contributing to a Roth IRA, invested in a fixed index annuity, in the conservative to moderate part of a portfolio will help avoid future market losses and continue to accent the gains,” says Jim Merklinghaus, founder of JM Wealth Management in Vero Beach, Florida. “When the stock market is up, you use your gains to live on and when it’s down you move over to your Roth IRA.”

Fill the gap before Social Security kicks in.

Social Security represents one part of the three-legged retirement stool but it can end up being a phantom leg for early retirees. “The earliest you can claim Social Security is age 62, so until then you’ll need to have other sources of income,” DeFelice says. Additionally, there’s the cost of taking Social Security early to consider. Taking retirement benefits at age 62 results in a reduction of benefits, whereas waiting until age 70 to begin taking them can increase the monthly benefit amount paid out. Relying on Roth IRA withdrawals, along with funds from an employer-sponsored retirement plan and taxable investments can make taking Social Security early, and potentially short-changing benefits, a less urgent need.

Best reasons to use a Roth IRA for early retirement:

- Contributions can be withdrawn at any time.
- Growth accumulates tax-free.
- Greater tax predictability makes planning retirement budgets easier.
- Roth IRA conversions open the door for high-income earners.
- Roth assets offer spending flexibility.
- Stock market volatility may be more easily managed.
- Fill the gap before Social Security kicks in.

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