



Traditional IRA versus a Roth IRA

Currently, for Americans living on \$45,000 or more per year during retirement, 18% of that income is generated from personal savings and investments¹. For millions of Americans, that component of our income consists largely of Individual Retirement Accounts (IRAs). IRAs are tax deferred personal retirement funds that allow you to save up to \$5,000 per year (\$6,000 if you're age 50 or older). Tax deferral means you're not currently paying income taxes on dollars earned inside of these investment vehicles; instead, the tax is deferred until you withdraw your money. Consequently, your money is working harder for you during the accumulation phase.

Depending on your marital status, income, and participation in an employer sponsored retirement plan, the contributions may also be tax deductible. Beginning in 2009, the \$5,000 contribution limit adjusts annually for inflation in \$500 increments.

There are many types of IRAs but for the purposes of this article, let's review the differences between the Traditional IRA and the Roth IRA. The Roth IRA has essentially turned the Traditional IRA formula completely around. A Traditional IRA enables taxpayers to make tax-deductible contributions, but all contributions to Roth IRAs are after tax (non-deductible).

In addition, withdrawals are treated differently. With a Traditional IRA, contributions are growing tax-deferred and withdrawals are taxed at ordinary income tax rates. With a Roth IRA, investments grow tax-deferred but can be withdrawn after age 59½ tax-free. However, in order to receive

this tax-free treatment on a withdrawal, you also must have held the account for at least five years.

This ability to make contributions that can be withdrawn tax-free is a unique and powerful characteristic of the Roth IRA. Most taxpayers are eligible to make contributions to a Roth IRA. The ability to use this tool however, is phased out for Americans in higher income tax brackets. For example, if you're single, the \$5,000 (or \$6,000 if you're over the age of 50) that you can contribute begins to be phased out starting at \$105,000 and is completely phased out at \$120,000. For married filers, the phase out begins at \$166,000. Married couples earning \$176,000 or more can no longer contribute to a Roth IRA. Unlike the Traditional IRA however, contributions can still be made after age 70 ½ as long as you have earned income.

For investors who have existing Traditional IRAs, conversion to a Roth IRA is allowed for if they and their spouses earn less than \$100,000 per year. The biggest benefit to conversion is that all future earnings grow tax-free. This certainly sounds attractive, but investors should consider conversion with caution. Currently, all contributions and earnings moved to the Roth IRA from the Traditional IRA are taxable.

This conversion becomes a little more complex when you consider that you cannot use any of the dollars being converted to help pay the tax due without being subject to a 10% early withdrawal penalty if you're under the age of 59 ½. Many experts warn that if you do not have other money on hand to pay the taxes

due upon conversion, you're probably better off maintaining the Traditional IRA.

The decision to use either the Traditional IRA or the Roth IRA for new contributions, and the decision whether or not to convert from a Traditional to a Roth are driven in large part by your expected future tax rate. In the not too distant past, many retirees entered lower tax brackets during retirement. This is no longer the case for many, particularly as more people are working (at least part-time) during retirement to support the lifestyle to which they had become accustomed during their working years. Consequently, many taxpayers should take a hard look at conversion and making new contributions to the Roth IRA. Again, proceed with great caution. *A consultation with a Financial Advisor and your tax professional is highly recommended.*

To conclude, both the Traditional IRA and the Roth IRA are important tools to consider in the retirement planning process. Many will establish IRAs as a result of a rollover from an employer sponsored plan. As you explore which tool will work most effectively for you, consider these factors: your current income tax bracket, estimate for your future tax rates, your marital status, and your ability to pay the tax upon conversion. For most, these decisions are best made with the assistance of a professional advisor experienced in these matters. Once made, the decisions can be both irrevocable and taxing.



R. Dean Piccirillo, CFP®, CRPS®, AIFA®

Principal/Senior Financial Advisor

Office: 239-482-5522 Cell: 239-220-3793 dpiccirillo@hbksorce.com

Blog: www.deanpiccirillo.com LinkedIn: www.linkedin.com/in/piccirillo

8010 Summerlin Lakes Drive, Suite 200, Fort Myers, FL 33907

