Retirement savings; Roth IRA or a traditional IRA?

Courtesy of B. Frank Voigt

Changes in the tax laws over the past few years have presented real opportunities for many people to capture significant tax savings. Among those changes was the creation of the Roth IRA, which is markedly different from the traditional IRA. If you are one of the millions of people who qualify for a Roth IRA, the tax advantages can be compelling.

What's different about the Roth IRA? Most notably, it reverses the taxation of the traditional deductible IRA, whose contributions are deductible but whose withdrawals are fully taxable at the investor's income tax rate. With a Roth IRA, contributions are not deductible, but all qualified withdrawals are totally tax-free.

Qualified withdrawals are those from a Roth account which is at least five years old AND are either: (1) made after the individual reaches age 59-1/2, becomes disabled, or dies; or (2) an amount up to $10,000 used within 120 days of withdrawal for a first-time home purchase. Investors may also withdraw their contributions tax-free. Any non-qualified distributions, to the extent they exceed contributions, would be taxed at taxpayer's regular income tax rate, plus an additional 10% penalty tax may apply. Also, distributions allocable to a qualified rollover contribution will be subject to premature distribution penalty if made within five years of the rollover.

Eligible individuals may contribute up to $2,000 annually to a Roth IRA. This $2,000 contribution limit gradually phases out for single taxpayers with adjusted gross income (AGI) levels between $95,000 and $110,000, and for joint filers with AGI between $150,000 and $160,000. Furthermore, participation in an employer-sponsored retirement plan does not prevent eligibility for a Roth IRA.

Earnings May Total Much More Than Contributions

At retirement age, a large proportion of the amount accumulated over the years in an IRA represents the earnings, not the contributions. For example, if a married couple each contributes $2,000 at the beginning of every year for 20 years to IRAs which earn 8% per year, the total accumulation is $197,692. Only $80,000 of that is the amount contributed, while the earnings equal $117,692. The considerable advantage offered by the Roth IRA is that there is no tax on qualified withdrawals.

In the above example owners who make a qualified withdrawal get the entire $197,692 accumulation with no subtraction for taxes it's all spendable. Had the same contributions been made to a 'traditional' IRA, all withdrawals would be fully taxable (assuming all the contributions were deductible). That would mean large sums lost to taxes. Even where the tax savings arising from deductions to a traditional IRA are invested every year and combined with the traditional IRA account proceeds, for many people the Roth IRA may produce more total after-tax dollars.

See the upcoming *Financial Services* special section in the April issue of *Inside Collin County Business*

Advantages For Older Participants

Unlike traditional IRAs, Roth IRAs permit contributions to continue even after age 70-1/2 if there is earned income. And, there are no minimum distribution requirements prior to death, thus allowing for continued tax-free accumulation.

Get Good Advice

The Roth IRA rules are complex, and many people will miss out on their full share of the tax savings unless they obtain good advice. Before choosing an IRA or making any changes to your investment strategy, you will want to discuss it with a qualified financial services professional, who should be able to work with you and your tax consultant to analyze your situation.

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