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ROTH or Traditional IRA? Which is Right For You?

At this time of year, when most of us are preparing to file our annual income tax returns, we often get the question, "Should I contribute to an IRA?" "And if so, should I contribute to a ROTH or a traditional IRA?" In order to know which, if any, may be right for you, it is important to first understand the differences.

Both ROTH and Traditional IRAs are tax-qualified individual retirement plans, which means they receive preferential income tax treatment and are established by individuals for their own benefit. Contributions to these plans are limited and require you have earned income (generally wages or self-employment income).

While both ROTH and Traditional IRAs receive preferential income tax treatment, the treatment is quite different. Contributions made to a ROTH IRA are not tax deductible in the year of the contribution. In other words, there is no real preferential tax treatment in the year of the contribution. However, earnings grow tax-free and can be withdrawn tax-free, provided the withdrawals meet certain requirements.

On the other hand, contributions to Traditional IRAs may be tax deductible in the year made, depending upon the individual's income and whether they are eligible to participate in their employer's plan. Withdrawals from Traditional IRAs, however, are typically subject to ordinary income tax.

So, which is right for you? Is it better to get the current tax deduction and pay taxes on the withdrawals later? Or is it better to forego the tax deduction now and withdraw your gains later income tax free? If you expect to have less income during retirement than you have now while you are working, a Traditional IRA may be appropriate. However, if you expect to have as much or more income during retirement as you have now, a ROTH IRA may be more appropriate. These may be easier questions to ask than they are to answer.

There are other considerations as well. You must begin taking minimum distributions, based on your life expectancy, from Traditional IRAs beginning at age 70 ½. This means that income taxes cannot be deferred forever. You are not required to take any distributions from your ROTH IRA during your lifetime. This means the balance in the ROTH may continue to grow tax-free until it passes to your beneficiaries.

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It is important to keep in mind that both Traditional and ROTH IRAs are retirement accounts, and therefore you probably should not contribute amounts to these accounts if you expect to need the money prior to retirement. Although withdrawals may be made prior to retirement, all or a portion of the withdrawals taken prior to age 59 ½ are likely to be subject to a 10% penalty and income taxes.

Deciding which, if any, retirement plan is right for you requires understanding and defining your goals, developing a strategy to help you meet those goals and implementing that strategy throughout your lifetime. Only then, in our opinion, can you determine which is right for you.

We would love to help you start the process.

Consult your tax professional for advice.
Information provided as an incidental service to our business as financial planners.