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Roth vs Traditional IRA

How to choose between accounts

IRAs (individual retirement accounts) are tax-preferred investment accounts intended for retirement savings. Roth and Traditional IRAs both benefit from not paying taxes on gains when realized, but they differ in *when* they are taxed. **Roth IRAs are taxed before funding** while **traditional IRAs are taxed at withdrawal**[1]. There are also restrictions on who can contribute and how much. The purpose of this document is to outline the requirements and provide guidance on when to use each type of account.

Strategy

Since Roth and traditional IRAs differ in when they are taxed, this suggests a strategy of paying the tax when in a low tax bracket. This means funding Roth IRAs in low tax bracket years and funding traditional IRAs in high tax bracket years. A typical strategy might be:

- Contribute to a Roth IRA in early years when earnings and tax bracket are low
- Contribute to a traditional IRA in mature working years when earnings and tax bracket are high
- Complete Roth conversions after retirement but before RMDs and Social Security, when income and tax bracket are low (See Roth Conversion synopsis)

Requirements and Limits

Earned Income:

The taxpayer or their spouse must have earned income in order to contribute to an IRA.

Contribution Limits:

The most a taxpayer can contribute to an IRA is $6,500. This amount is indexed for inflation. In addition, a taxpayer who will be 50 years or older by the end of the year may make a catch-up contribution of $1,000.

Income Cap:

For 2023, the cap for making a deductible contribution to a traditional IRA starts at $73,000 for a single taxpayer or $116,000 for a married taxpayer filing jointly. The cap for contributing to a Roth IRA starts at $138,000 for a single taxpayer or $218,000 for a married taxpayer filing jointly.

Required Distributions:

Traditional IRAs have required minimum distributions (RMDs) starting the year the owner turns 73. There are no RMDs for Roth IRAs.

Penalties:

There are restrictions on withdrawing funds before age 59 ½. Also, Roth IRAs have a five year holding period requirement. Penalties may apply if exemptions are not met.

[1] This article deals with deductible contributions to a traditional IRA. Taxpayers also have the ability to contribute after-tax dollars (a non-deductible contribution) to a traditional IRA. While this can be part of a backdoor Roth strategy, this type of contribution works differently than the deductible contribution to a Traditional IRA and is not considered here.

Growth of Roth vs. Traditional IRA

	A Roth IRA (24% tax)	B Traditional (24% tax)	C Traditional (32% tax)	D Traditional (12% tax)
Earnings	$6,500	$6,500	$6,500	$6,500
Tax at contribution	*$1,560*	*$0*	*$0*	*$0*
Net contribution	$4,940	$6,500	$6,500	$6,500
Value after 5 years	$7,258	$9,551	$9,551	$9,551
Tax at withdrawal	*$0*	*$2,292*	*$3,056*	*$1,146*
Net Withdrawal	**$7,258**	**$7,258**	**$6,494**	**$8,405**

Columns A and **B** show outcomes for Roth and traditional IRAs after five years of 8% growth. Given a constant tax rate of 24% the after-tax results are equal. However, if tax rates change, then the after-tax value of his traditional IRA will be different. **Column C** shows that the net withdrawal is lower if taxes are higher in retirement (32% in the example) while **column D** shows that the net withdrawal is higher if taxes are lower in retirement (12% in this case).

Considerations

- ✓ RMDs are not required for Roth IRAs: Roth IRAs can continue to avoid tax on portfolio earnings longer than Traditional IRAs. For individuals who do not spend their full RMD, this enhances the tax benefits of IRA accounts.
- ✓ Roth IRAs allow for greater contributions on an after-tax basis: Traditional IRAs and Roth IRAs have the same contribution limits (currently $6,500 per year). However, on an after-tax basis, this means more money can be saved to a Roth IRA.
- ✓ Owning multiple account types (Roth IRA, traditional IRA, taxable accounts) provides flexibility: A taxpayer who has multiple account types can manage her taxable income in retirement by withdrawing spending needs from different accounts.

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T (732) 450 0147

infowwm@withumwealth.com

withumwealth.com