The ABCs of Traditional and Roth IRAs

Both Traditional and Roth IRAs (Individual Retirement Accounts) have tax advantages that can lead to enhanced asset growth. It may not seem like much in the beginning, but it adds up over time, and if you don't need the liquidity of the assets immediately it is something worth considering every year.

What are the benefits of each?

The traditional IRA offers the possibility of a tax deduction (depending upon one's income and tax filing status) and full deferral of taxes on investment earnings until withdrawal.

On the other hand, The Roth IRA does not give rise to a deduction, but all withdrawals are potentially tax free, including withdrawals of investment earnings. Withdrawals of contributions are always without tax consequence. So, if your tax bracket is currently low, putting the assets in a Roth IRA avoids the future taxes on the gains from those assets, which given a long growth period could be substantial.

Generally speaking, with all things being equal it should come out evenly whether the taxes are paid later with a Traditional IRA or immediately with a Roth IRA. The traditional IRA has a large base to grow off of, but then a larger base to tax later. However, if things are not equal and tax brackets are not the same, those dynamics may make one better than the other.

How should I decide which one is best for me?

Usually, one is considering the tax bracket one is currently in, the tax bracket one expects to be in at retirement, and trying to ensure the income is taxed at the lower brackets. The conventional wisdom has been that traditional IRAs are better if one's tax bracket will be going lower during retirement, and the deduction happens during the working years in the higher brackets. However, the highest tax brackets now apply at income levels much higher than the deduction thresholds, so this analysis has lost some of its pizazz.

Here are some additional factors that might be considered

The cost of the contribution. The pre-tax/after-tax amount of money left may affect the amount of contribution that can be made for some individuals, especially in a higher tax bracket. Given the tax bracket of 25%, the pre-tax full $6000 contribution for a traditional IRA would cost $7,500 pre-tax for a Roth IRA to arrive at the $6000 after tax funds. If the individual only has $6,000 in pre-tax money to contribute, then they could only place $4,800 into the Roth IRA that year after taxes, not taking advantage of the full contribution limit. The $6,000 in Traditional IRA funds could be converted to a Roth IRA in a future year if appropriate; however, assets that have been converted to a Roth need to go through a 5 year waiting period prior to receive some of the Roth IRA tax benefits.

The cost of withdrawing the funds. The Roth IRA is to be preferred if one hopes to preserve tax deferral for as long as possible. If one wants to take $10,000 out of a Roth IRA to cover certain retirement expenses, such as a family cruise, only $10,000 need be withdrawn. With a traditional IRA, one must withdraw enough to cover the income taxes as well as the retirement expense. That might mean, for example, that $13,000 would have to be taken so as to cover both the retirement expense and the federal and state taxes on the withdrawal. Roth IRAs also do not have Required Minimum Distributions (RMDs) kick in at 73, so those funds can be left to grow tax free while other funds are utilized for living expenses. Lastly, should the assets be needed prior to 59 ½, a tax penalty will be imposed on Traditional IRA withdrawal but the Roth withdrawal of contributions (but not investment earnings) can be distributed without incurring the penalty.

Effects of lowering your AGI (Adjusted Gross Income) other than on your tax bill

Health insurance through a state marketplace. Federal subsidies are available to those who purchase their health insurance from a state marketplace. The subsidies are tied to Modified Adjusted Gross Income (MAGI), and contributions to a traditional IRA will lower one's MAGI.

An income-based repayment plan for your federal student loans. Some programs link repayments to adjusted gross income. Contributing to a traditional IRA may generate both an income tax deduction and a reduction in loan payments. Some loans may be forgiven in 20 to 25 years, or in the case of some public service situations, as little as ten years.

Lowering the Medicare surcharge. Medicare looks back two years at your income to determine the surcharge on your monthly payments, which can range from $82.80 to $500.30 per month. Contributing to a deductible IRA may lower your income enough to reduce that surcharge. If you are working and can contribute to a 401(k) plan, the opportunity for reducing adjusted gross income is even greater. Anyone who is 63 or 64 and planning to enroll in Medicare at age 65 should take a careful look at this option.

A Roth IRA contribution may not be available to you

One additional reason for a traditional IRA is that you earn too much to contribute to a Roth IRA. If your 2024 MAGI is over $161,000 ($240,000 for marrieds filing jointly) you are not eligible to make a contribution to a Roth IRA. You are still eligible to make a nondeductible contribution to a traditional IRA, and the tax on investment earnings will be deferred for the deductible and nondeductible portions alike.

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