IRA VS ROTH IRA

It's a tough balance between the tax-now/tax-later conundrum that is among the biggest differences between socking retirement money away in a traditional IRA versus a Roth IRA. Which should you choose, and should you stick with that choice until you retire?

Funds going into a traditional IRA are pre-tax. Money earmarked toward a Roth IRA is after-tax. Earnings on traditional IRAs are tax deferred. Roth IRA earnings are not taxed, with some early withdrawal exceptions.

As you wade into the decision-making process, look first at your income and what you can afford, both from an out-of-pocket perspective and in taxes. You must pay taxes either way. The question is when, and the answer should be when it costs you the least.

A briefing on Traditional versus Roth IRAs

First, a primer on both: You need to have an income, or be married to someone who earns an income, to open either type of IRA. Both have contribution limits of $6,000 a year until you turn 50. After that, you can add an extra $1,000 annually as a "catch-up" in your final years of working. Once you turn 70½ in the calendar year, you are no longer eligible to contribute to a traditional IRA. The government wants you to start withdrawing from it instead, through required minimum distributions (RMDs), and pay taxes on it. A Roth IRA, on the other hand, does not have RMDs and can be passed on to your heirs without a tax penalty.

There are no income limits on traditional IRAs, but there are on Roth IRAs. These limits start at $122,000, with phase-outs on the contribution amounts up to $137,000 in income, when ineligibility kicks in. The limits are $193,000 to $203,000 for married couples.

Withdrawals on the two differ as well. With a Roth IRA, you can withdraw your contributions at any time for any reason without being penalized. However, if you want to withdraw any earnings or interest on those contributions, you must be over 59½ and your initial contribution must have been made at least five years prior to avoid paying a 10% withdrawal penalty.

You’ll pay that 10% penalty on any funds you take out of a traditional IRA, with some exceptions, before turning 59½.

The real upfront costs

Because there are no upfront tax breaks with a Roth IRA, your $6,000 contribution will cost you, yes, a full $6,000. With a traditional IRA, you may be eligible for a tax break that will mean your $6,000 contribution might only really cost you, say, $3,960 out of pocket today. But remember that you will pay taxes on it after you turn 70½ and start withdrawing.

Of course, your tax bracket is a major decision driver on which route to take. And not just the bracket you’re in now, but where you expect to be in retirement. If you’re in the 28% to 39% range now, contributing to a Roth IRA could cost you plenty more up front than it might in your golden years, when your income may be lower and your tax bracket may be, too. But if you think your income will be substantially higher in retirement, the Roth could offer financial solace then and won’t cost as much in taxes now. And then there’s preference: Do you want to pay fewer taxes now or later?

But do you have a crystal ball? Of course you don’t, and not knowing what kind of income you’ll be generating once you’re in retirement can make the Roth versus traditional IRA choice a daunting one.

If you choose the traditional IRA path, some retirement planners encourage you to also set aside roughly $1,500 in estimated tax per annual contribution to help cover the taxes in those retirement years.

A couple other things to consider: You can have both a traditional IRA and a Roth IRA, but your annual collective contributions cannot exceed $6,000 if you’re under 50. You can convert a traditional IRA into a Roth IRA at any time by paying the taxes owed. A combination of both might also offer you tax relief in retirement.