The Great Debate "Traditional versus Roth"

The holidays are over! Our New Years resolutions have been set and probably broken. The cold weather has settled in. You know what that means don't you?

If you haven't figured it out yet, it is because nobody wants to mark the start of tax season. The race is on to file your taxes by April 15^{th}. Can you feel the excitement? Probably not, unless you are an accountant or are due for a big refund!

One of the questions that always spring's up at the last minute before filing that tax return is, "should I contribute to a Traditional or a Roth IRA?" People always want to know "which one is better?"

As a quick recap, contributions to a Traditional IRA typically are tax deductible (if you meet the requirements) and any growth is tax deferred until withdrawn after age 59 ½. If you have a retirement plan at work you are not eligible to contribute to a Traditional IRA unless your income is below the modified adjusted gross income level set by the government.

Contributions to a Roth IRA are not deductible. Any growth in the Roth IRA account is tax deferred and distributions are tax-free along as you meet the distribution requirements which begins with a 5 year waiting period. You can contribute to a Roth IRA if you have a retirement plan at work as long as your income is less than $107,000 if you are single tax payer and $169,000 if filing jointly.

In both cases the maximum contribution in 2011 is $5,000. If you are over 50 you can make an additional contribution of $1,000. In both cases there may be a 10% penalty for withdrawals before age 59 ½.

To answer the first question, it you have the money available and didn't contribute to retirement plan last year, then it is highly recommended that you contribute to either plan. If you did contribute to a retirement plan at work, then it still would be good idea to consider making an additional contribution into either option as long as it doesn't effect your daily obligations or insurance expenses. Ideally 10% of your income should go to savings but the world isn't always ideal.

As to which one is better, the choice is a function of your situation. Obviously, if you have contributed to a retirement plan at work, then the Roth IRA may be the only choice assuming your income is below the income thresh-hold. If you didn't contribute through your employer, then your current income, the contribution amount and time frame until retirement are the factors that you need to consider when deciding on which option to choose.

As an example, let's say a 40 year old was in the 28% tax bracket. If she contributed $5,000 to a Traditional IRA, she would save $1,400 in taxes. The government is helping us by allowing those tax dollars to grow tax deferred and compound over time.

To contribute a net of $5,000 to a Roth IRA at the 28% tax bracket, you would have paid $1,944 in taxes ($6,944 x 72% = $5,000). That is a lot of money that can be used for other purposes.

(Compliance Alert: The following calculations are hypothetical and are for comparison purposes only. Invest returns and tax rates will change over time.)

In both cases, if you contributed $5,000 per year for 20 years, in both accounts you would have approximately $194,964 if you averaged a 6% return. The funds in the Traditional account would be fully taxable when you take it for retirement. The funds in the Roth would be tax free when withdrawn.

The difference is, what would you do with the $1,944 in funds that didn't go to taxes each year? If the after tax amount of $1,400 per year was invested at a net return of 4.32 % (a gross return of 6% x 28% tax), that account could be worth approximately $44,963 which can be use for retirement.

That $1,400 difference may be needed for daily expenses. It may be needed to pay for life or health insurance. It could also be used to save for college for your children.

The truth is that neither plan has a true advantage over the other. Your current situation, goals, income, time frame and employment are the factors that need to be considered when making a decision. Where and how you invest your contributions may have any effect on you thinking as well.

If current income went into a higher tax bracket, then how would that effect the decision? Being in a lower tax bracket or only being able to contribute a small amount are important factors as well.

The question is, "how would each IRA fit into my current situation?" Whatever is recommended by the accountant or financial advisor should be taken into consideration. Ultimately, it is your money and you get to decide.

The important part is that you are setting aside funds for your future. Those that don't save for the future, how will they live when they want to stop or can't work any longer? Do what works best for you!