



## Learn the Main Differences Between a Roth IRA and a Traditional IRA

### Description

An IRA is one of the most prominent forms of retirement savings accounts. You must pick between two options when you start one: Roth or traditional.



## How to Choose Between Roth IRAs and Traditional IRAs

The primary distinction between a Roth IRA and a standard IRA is how and when you receive a tax advantage. Traditional IRA contributions are tax-deductible, but withdrawals in retirement are not. On the other hand, contributions to Roth IRAs are not tax-deductible, but withdrawals in retirement are tax-free.

The following are the primary distinctions between standard and Roth IRAs:

ROTH IRA	TRADITIONAL IRA
Key differences	

## **ROTH IRA**

No immediate tax benefit for contributing. Contributions can be withdrawn at any time without taxes or penalties. Ability to contribute is phased out at higher incomes. Qualified withdrawals in retirement are tax-free.

### **Contribution limit**

\$6,000 in 2020 and 2021 (\$7,000 if age 50 or older)

### **Early withdrawal rules**

Unless you meet an exception, early withdrawals of earnings may be subject to a 10% penalty and income taxes. (Roths allow contributions to be withdrawn at any time).

## **TRADITIONAL IRA**

If deductible, contributions reduce taxable income in the year they are made. Deductions can be phased out depending on income. Distributions in retirement are taxed as ordinary income. At age 72, there are required minimum distributions (RMDs).

Most Roth IRA vs. regular IRA advice begins with a question: Do you believe your tax rate will be higher or lower in the future?

If you can firmly answer that question, you may theoretically choose the form of IRA that will provide you with the greatest tax savings: Choose a Roth IRA and its delayed tax benefit if you expect to be in a higher tax rate in retirement. Suppose you anticipate reduced rates of return in retirement. In that case, a regular IRA with its upfront tax advantage is the way to go.

It's difficult to predict what your tax rate will be in retirement, especially if you're decades away from retiring. Fortunately, there are other factors to consider when deciding whether a Roth or regular IRA is right for you.

## **First and Foremost: Check Your IRA Eligibility**

The IRS limits on IRA eligibility may force you to choose between Roth and standard IRAs. Your earnings will determine:

- If you are eligible to make a Roth contribution.
- How much of your conventional IRA contribution you can deduct from your taxes this year. Deductibility of traditional IRAs is limited only if you or your spouse have access to an employee savings plan, such as a 401(k) (k).

It's worth noting that you can contribute to both a regular and a Roth IRA in the same year, as long as the total amount does not exceed the maximum permissible contribution limit, which is \$6,000 in 2021 and 2022 (\$7,000 if you're 50 or older).

## **Why the Roth IRA Works for Most Savers**

Here are several reasons why a Roth IRA may be preferable to a standard IRA for individuals who qualify.

1. **With a Roth, early withdrawal requirements are significantly more flexible.** Although early withdrawals from retirement accounts are typically discouraged, the Roth permits you to withdraw contributions — money you put into the account, not earnings — at any time without having to pay income taxes or an early withdrawal penalty.

Suppose you withdraw from a regular IRA before retirement. In that case, the IRS isn't as forgiving: You'll almost certainly be hit with a hefty 10% early withdrawal penalty, as well as taxes at your current income tax rate on the money you withdraw. There are a few exceptions to this rule — for more information, visit our page on traditional IRA withdrawal requirements — but you'll need to approach with considerably more caution than you would with a Roth.

2. **For retirees, the Roth has fewer restrictions.** Traditional IRAs require you to begin taking required minimum distributions (RMDs) when you reach the age of 72.

The Roth IRA has no mandated minimum distribution rules unless you inherit it: You are free to leave your money in the account to grow tax-free for as long as you live.

3. **Unless you're an exceptionally disciplined saver, a Roth IRA will provide you with more after-tax money.** Yes, both kinds of IRAs offer a tax reduction. However, there is an often-overlooked advantage to the Roth's tax treatment. Because your tax break won't arrive until retirement (via tax-free withdrawals), you won't be tempted to spend it before then. The tax benefit from a typical IRA is provided annually when you file your taxes, making it easy to squander the money on a variety of items.

To break even in terms of after-tax savings, you must be disciplined enough to reinvest your traditional IRA tax savings each year into your retirement savings. If that seems doubtful, you'd be better off saving in a Roth, where you'll have more significant after-tax savings when you retire.

4. **Investing in a Roth in addition to your 401(k) provides tax diversity.** Most companies' regular 401(k) plans give the same tax advantages as a traditional IRA. Although some employers offer a Roth 401(k) option for employees, if yours does not, putting some of your retirement assets into a Roth IRA will give you more alternatives for managing your tax burden in retirement.

## Making the Call

The only advantage of a regular IRA is the tax break for most people. And we're not ignoring this benefit: it may be a substantial benefit for high-income earners and a terrific incentive for folks who might otherwise avoid saving for retirement. In the short term, it effectively makes saving for retirement "cheaper" because the tax savings each year reduce the cost of your contributions.

However, you will have to pay that tax burden in retirement, so unless you absolutely need that upfront tax reduction, it's difficult to go wrong with a Roth IRA.

### Category

1. Finance

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