Traditional vs. Roth IRA: Which One is Right for You?

The tax season is an important time of the year, not only because we all need to file our tax returns but also because it forces us to make important personal financial decisions regarding our retirement. A common client question concerns personal IRAs. The two prominent plans are the traditional IRA and the Roth IRA. Deciding which one to use really depends on your specific situation and financial goals.

The traditional IRA offers plenty of tax advantages that should not be overlooked. It provides tax-deferred growth on your earnings inside the account, but most importantly, it allows you to deduct the IRA contributions you make on your personal tax return. For 2012, the IRS limits the amount of the deductible contribution to $5,000 for individuals with an additional catch-up contribution of $1,000 for those age 50 or older. The IRS does set limitations on the amount you can deduct, specifically if you make more than the annual income limit and you or your spouse are actively participating in a company retirement plan. If the limitation does not apply to you, the entire amount of your allowed contribution can be fully deductible.

One potential drawback to the traditional IRA relates to account distributions at retirement. Since your contributions during the accumulation phase were tax deductible, distributions at retirement are considered ordinary income and fully taxable. Additionally, if you withdraw the money in the account before the age of 59½, you may also face a 10 percent early-withdrawal penalty.

The Roth IRA shares some traits with the traditional IRA. The Roth IRA also provides tax-deferred growth on earnings inside the account and the contribution limits for 2012 are the same as the traditional IRA. Where it deviates is that Roth IRA contributions are never deductible on your personal tax return. Many people wonder why anyone would contribute to a Roth IRA if the contributions cannot be deducted for tax purposes. The answer lies in the fact that, unlike the traditional IRA, the Roth IRA distributions are generally not taxable when you withdraw the money at retirement. This basically provides you with tax-free withdrawals during your retirement years. This can be particularly beneficial if you anticipate being in a higher marginal tax bracket during retirement.

The IRS also places limitations on some aspects of the Roth IRA. There are annual income limits for taxpayers who want to contribute to a Roth IRA. Contributions can be phased out or eliminated when the taxpayer's income exceeds IRS limits. The annual income limits for the Roth IRA are generally higher than with the traditional IRA, which allows more taxpayers to participate in the Roth IRA. Also, the 10 percent early-withdrawal penalty can apply to Roth IRA distributions on earnings before the age of 59½ unless an exception is available.

It is important to analyze your current tax situation and your anticipated tax situation during your retirement to make a fully educated decision. A Roth IRA may be more suited for those who anticipate a higher marginal tax rate during their retirement years and want tax-free distributions during retirement. A traditional IRA may be more suited for those who need the tax deduction while they are working and foresee lower marginal tax rates during their retirement years. A common strategy for those who are unsure of their future tax status includes splitting the allowable annual contribution between traditional and Roth IRAs. The rules regulating IRAs can be cumbersome. Talk to your CPA and financial adviser to come up with a comprehensive strategy that fits your long-term tax and financial goals.

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