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## IRA vs. Roth IRA: Which is Appropriate and When?

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In a tax code rife with acronyms, even savvy investors are confused by popular retirement vehicles like traditional Individual Retirement Accounts (IRAs) and Roth IRAs. Understanding these subtle differences can help you strategically plan for retirement.

IRA stands for "individual retirement account." Unlike a regular investment account that is taxed annually, assets that have been added to an IRA are allowed to grow without paying taxes on growth. That is, until distributions begin. As you withdraw money from an IRA, the distributions are fully taxable as ordinary income, just as if you were drawing a paycheck. Contrast this with a Roth IRA. Funds added to a Roth IRA also grow untaxed but when you take distributions, the income is tax-free. If the choice is between taxed income and tax-free income, why would anyone want a regular IRA?

"It comes down to the taxes," says FPA member Karen Brelsford, CFP®, a financial planner with Klima & Associates in Columbia, Md. Contributing to a Roth IRA is never a deduction and is always made with after-tax dollars while traditional IRA contributions are deductible in some instances. "You have to decide if you want to pay the taxes now, on a smaller contribution going into a Roth IRA, or if you want to pay taxes on a larger amount coming out of your traditional IRA after several years of growth," Brelsford said.

When Roth IRAs were created, restrictions were established to keep investors from putting as much money as possible into an account that would never be taxed. First, annual contributions are limited to \$5,000 if under age 50 and \$6,000 if over age 50. Second, while many investors will be able to put the maximum into their Roth IRA, your contribution may be limited or not allowed if you are in a higher income tax bracket. [Learn more](#) from the Internal Revenue Service (IRS) about the contribution limits.

Traditional IRA contributions have their own limitations. While anyone can annually contribute \$5,000 if under age 50, or \$6,000 if over age 50, the contributions are only deductible in certain instances. Income levels and a work retirement plan covering you or your spouse determine if your contribution is deductible. Because traditional IRA contributions are always allowed but only sometimes deductible and Roth IRA contributions are sometimes allowed but never deductible, the decision of which type of IRA should receive your annual contribution can be complicated.

"The bottom line is this: do you want to be taxed now or later?" says Brelsford. "We generally assume we will be in a lower income tax bracket once we retire, but that has to be judged on a case-by-case basis." FPA member Dennis A. Suckstorf, ChFC, CFP®, AFC, a senior financial planner with Financial Advantage Inc. in Columbia, Md. elaborates, "You need to take into account not only the money being paid in taxes, but the opportunity cost of that tax money." Current and expected income tax rates and estate taxes all factor into which type of IRA will save the most money in the long run. Suckstorf believes, "Generally, the younger you are when you contribute to a Roth IRA, the better. But even if you are not young, a Roth IRA can be an estate planning tool that provides tax-free income to heirs."

Once an investor is ineligible for contributing to a Roth IRA, it may be in his or her best interest to contribute to a traditional IRA, even if they won't receive a deduction. At the very least, the funds will grow untaxed until distributions are taken. If you are making non-deductible contributions to a traditional IRA, Brelsford recommends, "Open up a separate account; the math is really hairy when it comes to calculating taxes on distributions from combined deductible and non-deductible contributions." Suckstorf agrees, "Custodians will allow you to have as many IRAs as you like. Separating deductible and non-deductible contributions helps simplify a complicated process."

The IRS requires traditional IRA contributions to be reported as they are made. Deductible contributions are reported when you file your taxes on Form 1040 and non-deductible contributions are reported on Form 8606. Suckstorf cautions, "Once you make a non-deductible contribution to a traditional IRA, Form 8606 must be filed each year, even in years when you do not add to the account." Self-filers often overlook filing these forms — a mistake that can result in a \$50 penalty each year the form was not filed.

"It is a common mistake," says Brelsford. Perhaps because it is common, the IRS is not always vigilant about enforcing penalties. For investors who need to correct unfiled Forms 8606, Suckstorf recommends, "File Form 8606 at the same time that you file your taxes for the year; penalties tend to slip through the cracks this way."

If you are uncertain which of your contributions are deductible and which are non-deductible, start by contacting your IRA custodian. "Have the custodian search and see when your contributions were made," says Suckstorf. "Match those contributions to your tax returns. If you made a contribution to an IRA that was deductible, it will show up on your tax return for that year. If the contribution isn't listed on your tax return as a deduction, then you know it was a non-deductible contribution." Once you have sorted contributions Suckstorf says, "You can file Form 8606 at any time with the total amount of non-deductible contributions." After providing the IRS with the correct information, annually filing Form 8606 is relatively simple.



Even once you develop a plan for dealing with deductible vs. non-deductible and traditional IRA vs. Roth IRA contributions, be sure to evaluate your plan annually. "Tax laws change," says Brelsford. "Unfortunately, we don't have a crystal ball to see where taxes are going. I encourage my clients to plan for multiple eventualities." If this level of planning is more complicated than what you wish to do on your own, find a planner who specializes in retirement and taxes.

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