



ROTH VS. TRADITIONAL IRA: RETIREMENT AND ESTATE-PLANNING ADVANTAGES

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It would be nice if the Roth IRA had been around long as the traditional IRA. Imagine the long-term benefits of tax-free growth throughout a 40-year career. Annual contribution limits for IRAs are relatively low (\$6,000; \$7,000 for 50-plus), but the Roth is a good complement for investors who also contribute to an employer-based retirement plan. While 401(k) contributions are made from tax-deferred income, Roth contributions are derived from previously taxed income. Both vehicles are permitted to grow without taxes on earnings; however, in retirement, you don't have to pay any taxes on Roth distributions, whereas all 401(k) distributions are taxed at your then-regular income tax rate.¹

That tax bite during retirement can feel pretty punishing when you're on a fixed income. It's one reason why the Roth has an edge over the traditional IRA—which also taxes distributions in retirement. One of the key strategies that has emerged in the Roth IRA era is tax diversification in retirement: Try to invest in such a way that not all your income is taxable. This can help avoid taxes on Social Security benefits and keep you from having to pay higher Medicare premiums.²

Everyone has different circumstances, and you should build your financial portfolio to reflect your needs and objectives. Since the total amount you can contribute to an IRA each year—traditional, Roth or a combination—is limited, it's typically a good idea to pick one that best meets your needs. Another viable strategy for reducing taxes in retirement is later converting a traditional or rollover IRA to a Roth. Investors also should consider the advantages of both versions for estate planning purposes. If you have any questions, or would like help developing a long-term IRA strategy, please contact us.

Distributions from a Roth IRA can increase your income during retirement since qualified withdrawals are not taxed. Moreover, if an investor doesn't need to use his Roth funds during retirement, those assets and all potential tax-free earnings they generate can be left tax-free to heirs. Whatever amount he passes on can continue growing tax-deferred and eventually be withdrawn tax free. Note that non-spouse beneficiaries of a Roth will need to take full distribution within ten years of inheriting the money. However, when beneficiaries have the discipline to leave that money in the inherited Roth for the full ten years, it can continue to grow for an even larger inheritance with no tax consequences.³

By contrast, traditional IRA distributions to heirs are considered taxable income in the year(s) withdrawn.⁴ So don't just think about reducing your own taxes with a Roth; consider its tax-free advantage for your heirs. Be aware that you can contribute only earned income to an IRA. That precludes Social Security and pension income, dividends, etc. You may continue to

contribute throughout retirement as long as you're earning some income—and may only contribute up to amounts earned, subject to the contribution limits. Also bear in mind that there are income limits for making Roth IRA contributions. Single tax filers must earn less than \$140,000 (in 2021); the married and file jointly income limit is 208,000.⁵

In a Roth conversion, you can move money from a 401(k) into a Roth IRA, converting all or a portion of assets throughout time, but there are considerations. For example, you'll have to pay taxes on the money you move in the year it's converted. That's a good reason to only move a portion at a time; try not to tip your reported income into a higher tax bracket each year. If you conduct the conversion once you're retired, your taxable rate will be lower.

However, Roth funds are subject to a five-year rule. If you convert 401(k) funds to a Roth you've already owned for five years or more, you can go ahead and use that money.

¹ Dayana Yochim and Andrea Coombes. NerdWallet. April 28, 2021. "Roth IRA vs. Traditional IRA." <https://www.nerdwallet.com/article/investing/roth-or-traditional-ira-account>. Accessed July 21, 2021.

² Phil Lubinski. ThinkAdvisor. June 10, 2021. "6 Ways to Help Clients Avoid Medicare's IRMAA Surcharges in Retirement." <https://www.thinkadvisor.com/2021/06/10/6-ways-to-help-clients-avoid-medicare-irmaa-surcharges-in-retirement/>. June 23, 2021

³ T. Rowe Price. Summer 2021. "The Simple Move That Has Significant Advantages." <https://www.troweprice.com/content/dam/iinvestor/planning-and-research/Insights/investor-magazine.pdf>. Accessed June 23, 2021.

⁴ Dayana Yochim and Andrea Coombes. NerdWallet. March 17, 2021. "Inherited IRA: How It Works & Distribution Rules for Beneficiaries." <https://www.nerdwallet.com/article/investing/roth-or-traditional-ira-account>. Accessed July 21, 2021.

⁵ Charles Schwab. 2021. "2020-2021 Roth IRA Contribution Limits." <https://www.schwab.com/ira/roth-ira/contribution-limits>. Accessed June 23, 2021.

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