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To Roth Or Not To Roth?

As we close in on the end of summer and enter the month of fall, I find myself astonished with how fast the year has gone. It seems like just a few weeks ago we were talking about spring clean-up and summer planning but now football is back (with fans) and kids are starting school. Having kids head back to in-class learning is great to see. In the spirit of a new school year, I figured I would discuss a topic that has been coming up recently in regards to one's financial life.

Lately, I have fielded a number of questions around Roth IRA's and more specifically, how they compare to traditional IRA's. At their core both options serve as a means to save money for retirement. The biggest difference lies in the fundamental tax treatment of either option (be sure to consult your tax advisor before making any decisions). With a traditional IRA money grows on a "pre-tax" or tax deferred basis. When you make a contribution, that money may be tax deductible to you which potentially lowers the income you have to claim and pay taxes on. As a very simplistic example, if you reported an income of $50,000 in a given year and made a $6,000 contribution to your traditional IRA, that $6,000 would likely be deducted from your income of $50,000 leaving you with $44,000 that must be claimed as income (not accounting for other deductions or credits that may apply). When it comes to withdrawing money, all pre-tax distributions from the account would be taxed as ordinary income to you.

This is in comparison to a Roth IRA where money is contributed "after-tax". In this situation, money contributed is not deducted and should be claimed as income. The benefit to a Roth is that contributions and future growth are potentially tax free upon qualified withdrawal. Both accounts have their benefits and it's not a "one size fits all" approach. Given your specific situation a traditional IRA, Roth IRA, or a combination of both may make sense.

The ability to possibly take advantage of Roth Conversions is also brought up often. As it stands now, at the age of 72, most individuals have to start taking required minimum distributions (RMD's) from their traditional IRA or other pre-tax accounts (think 401(k)'s, 403(b)'s, etc.). This required withdrawal percentage increases with age and the corresponding distribution is generally treated as ordinary income. A potential financial planning strategy can be found in the ability to systematically convert money over time from a traditional IRA to a Roth IRA, pay income taxes upon conversion, and allow all future Roth IRA growth and withdrawals to potentially be tax free with no RMD. The appropriateness of such strategy depends on a number of factors including potential current and future income and various changes to the tax law.

One of the beauties of financial planning, as in life, is that we are constantly learning and evolving. When it comes to our financial lives, too often I see inaction from a lack of communication or misinformation. I hope this article provides value as it relates to some retirement options that may be available to you.

—Rob Swarts, AWMA®

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