Traditional Vs. Roth IRA

Do you know the difference?

Traditional Individual Retirement Accounts (IRA), which were created in 1974, are owned by roughly 33.2 million U.S. households. Roth IRAs, however, were created as part of the Taxpayer Relief Act in 1997, are owned by nearly 22.5 million households.[1]

Both are IRAs. And yet, each is quite different.

Know the limits. Up to certain limits, traditional IRAs allow individuals to make tax-deductible contributions into the account. Distributions from traditional IRAs are taxed as ordinary income, and if taken before age 59½, may be subject to a 10-percent federal income tax penalty. Remember, under the SECURE Act, in most circumstances, once you reach age 72, you must begin taking required minimum distributions from a Traditional Individual Retirement Account (IRA). Additionally, you may continue to contribute to a Traditional IRA past age 70½, under the SECURE Act, as long as you meet the earned-income requirement.

Filing single. For singles, the maximum tax-deductible contribution starts shrinking once your modified adjusted gross income (MAGI) reaches $65,000. Singles with adjusted incomes of $75,000 and above are not eligible for a tax deduction.[2]

Filing jointly. For those who are married and filing jointly, things are a bit more complicated. If you or your spouse makes an IRA contribution that is covered by a workplace retirement plan, the deduction begins phasing out when your adjusted gross income is at $104,000, and it disappears at $124,000. However, if you do not have a workplace plan, but your spouse does (or vice versa), the 2020 limit starts at $196,000, and no tax deduction is allowed once the contributor's income reaches $206,000.

Also, within certain limits, individuals can make contributions to a Roth IRA with after-tax dollars. To qualify for a tax-free and penalty-free withdrawal of earnings, Roth IRA distributions must meet a five-year holding requirement and occur after age 59½.[3]

Income impacts total contributions. Like a traditional IRA, contributions to a Roth IRA are limited based on income. For 2019, contributions to a Roth IRA are phased out between $193,000 and $203,000 for married couples filing jointly and between $122,000 and $137,000 for single filers.

Contribution limits. In addition to distribution rules, there are limits on how much can be contributed each year to either IRA. In fact, these limits apply to any combination of IRAs; that is, workers cannot put more than $6,000 per year into their Roth and traditional IRAs, combined. So, if a worker contributed $3,500 in a given year into a traditional IRA, their contributions to a Roth IRA would be limited to $2,500 during that same year.[4]

Catch-up contributions. Individuals who reach age 50 or older by the end of the tax year can qualify for "catch-up" contributions. The combined limit for these is $7,000.[5]

Let's chat. When it comes to picking an IRA, both traditional and Roth IRAs may play an important role in your retirement strategy. If you have any questions, let's chat soon about how these products may be a good fit for your goals.

Citations.

1 - irs.gov/retirement-plans/individual-retirement-arrangements-iras, [01/09/2020]
2 - irs.gov/retirement-plans/ira-deduction-limits, [12/20/2019]
3 - irs.gov/retirement-plans/are-you-covered-by-an-employers-retirement-plan [01/08/2020]
4 - irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits [02/07/2020]
5 - Internal Revenue Service, 2019. The Tax Cuts and Jobs Act of 2017 eliminated the ability to "undo" a Roth conversion.