Some Insights On:
Retirement Planning

Understanding Roth IRAs and Traditional IRAs

With a traditional IRA, you may be able to take an income tax deduction for money you contribute, depending on your income and on whether you have a 401(k) account or a pension at work. If you qualify for the deduction, you'll be taxed on withdrawals.

With a Roth IRA, deposits are taxed, but withdrawals are not. But again, you can only contribute to a Roth IRA if your income is below a certain threshold. For 2014, the thresholds are $120,000 for single people and $191,000 for married couples.

Both IRA types have a maximum contribution of $5,500 per year for people under 50 and $6,500 for people over 50. So, should you choose one, the other, or both? Let's look at each type and weigh the pros and cons.

Traditional IRAs
Putting money in: You can contribute as much as $5,500 per year, or $6,500 per year if you're age 50 or older. That money is tax-deferred, meaning that you can deduct it from your income taxes, if you meet the income qualifications, but you'll be taxed on it when you withdraw it.

You can wait until April 15 of the next tax year to make a contribution and deduct it from your taxes for the current year.

Taking money out: You can start withdrawing money from your IRA when you turn 59 ½. Withdrawals are taxed as standard income.

You can withdraw money from a traditional IRA before you're 59½, but the IRS will hit you with a 10 percent penalty *and* make you pay regular income tax on the amount you withdraw. You may qualify for an exception if:

- You have unreimbursed medical expenses that are more than 10% (or 7.5% if you or your spouse was born before January 2, 1949) of your adjusted gross income.
- The distributions are not more than the cost of your medical insurance due to a period of unemployment.
- You are totally and permanently disabled.
- You are the beneficiary of a deceased IRA owner.
- You are receiving distributions qualified as substantial equal periodic payments
- The distributions are not more than your qualified higher education expenses.
- You use the distributions to buy, build, or rebuild a first home.
- The distribution is a qualified reservist distribution.

If none of these circumstances apply to you, you should avoid early withdrawals. (Another reason to make sure you have a solid emergency fund.)

You must start taking withdrawals by April 1 of the year following the year you turn 70½. The IRS calls these required minimum distributions. The penalties for not taking them far exceed the tax on taking them.

Roth IRAs
Putting money in: The contribution limits and deadline are the same as for traditional IRAs. What's different is that contributions are taxed.

Taking money out: Withdrawals are tax-free and you can start making them at 59½.

With a Roth IRA, you can make early withdrawals with no tax or penalty as long as they don't exceed the amount you've contributed. For example, say you've contributed $20,000 and your earnings have increased your account balance to $30,000. If you withdraw $22,000, you'll pay tax and a 10 percent penalty on the $2,000 in earnings.

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The IRS doesn't require Roth IRA-holders to take minimum required distributions at 70½.

So, which is right for you?
One thing to consider is whether your income tax bracket will stay the same or go down when you retire.

- If it will stay the same, you're probably better off in a Roth IRA, assuming you meet the income requirements. It may be easier for you to pay the taxes now rather when you retire.
- If you expect to be in a lower income tax bracket at retirement, you're may be better off in a traditional IRA, because the taxes you pay after retirement will be lower than those you would pay now.

The equation changes somewhat if you have an employer-sponsored 401(k). These are tax-deferred, like traditional IRAs, so you might want to invest in a Roth to avoid back-loading all your taxes.

Please note that (1) any discussion of U.S. tax matters contained in this communication cannot be used by you for the purpose of avoiding tax penalties; (ii) this communication was written to support the promotion of marketing of the matters addressed herein; and (iii) you should seek advice based on your particular circumstances from an independent tax advisor.