

Comparing IRA Choices: Roth vs. Traditional

Which one is right for you?

With the decline of corporate pensions and the aging U.S. population putting stress on the Social Security system, the burden of saving and planning for retirement falls increasingly on individuals. This is especially true for younger Americans. Yet, navigating the retirement savings account options as well as investment choices can be a daunting task. But taking the time to understand these choices can go a long way toward paving the way for a more secure retirement down the road.

Most financial planning experts agree one of the most important retirement savings steps to take is to fully fund your 401(k) or other employer-sponsored retirement plan. If you're not able to contribute the maximum amount, consider contributing as least as much as the employer's matching amount, if available. Otherwise, you're leaving free money on the table.

If your employer doesn't offer a retirement savings plan or you're able to save more, consider contributing to an Individual Retirement Account (IRA). Many people don't realize you can contribute to an IRA even if you already partially or fully fund your 401(k) – you just may not be able to deduct your contribution.

There are two main types of IRAs – Traditional and Roth. One is not better than the other – each offers distinct features.

Traditional IRA

With a Traditional IRA, you must be under age 70 ½ to contribute and you or your spouse, if married filing jointly, has earned income.

Contributions may be tax deductible and earnings grow tax-deferred, meaning you pay taxes at the time the money is withdrawn or distributed, presumably in retirement. If you make non-deductible contributions, a portion of each distribution will not be taxable based on the percentage of before-tax and after-tax amounts in your Traditional IRA. Please note that distributions taken prior to age 59 ½ may be subject to a 10% IRA tax penalty.

There are no limits on income in order to be eligible to contribute, but account owners must begin taking required minimum distributions (RMDs) at age 70 ½.

Roth IRA

With a Roth IRA, there are no age restrictions for contributions. But you or your spouse, if married filing jointly, must have earned income. Contributions are not deductible.

However, earnings may be withdrawn tax and penalty-free provided: (1) the Roth account has been open for at least five years and you are age 59 ½ or older; or (2) the distribution is a result

of your death, disability, or using the first-time homebuyer exception. Unlike Traditional IRAs, Roth IRAs have no RMDs. Please note that distributions taken prior to age 59 ½ may be subject to a 10% IRA tax penalty and ordinary income tax.

There are, however, limits on income in order to be eligible to contribute. If your income is too high to contribute to a Roth IRA, you can always contribute to a Traditional IRA, assuming you are eligible. Even if you can't deduct your Traditional IRA contribution, you can take advantage of tax-deferred growth potential.

How taxes affect your decision

Now that you have an understanding of Traditional and Roth IRAs, you can decide which one works best for you. And, remember, you can contribute to both types of IRAs in any given year, as long as your total contributions don't exceed the annual maximum.

The primary driver of your decision is taxes. Assuming you're eligible to contribute to both a Traditional and a Roth IRA, you need to decide if you'd prefer to get a tax break now for contributing to a Traditional IRA or put after-tax dollars into a Roth IRA and take tax-free withdrawals later, assuming you have met conditions to do so.

If you believe you will be in a lower tax bracket in retirement or live in a state with no income tax, you may prefer to fund a Traditional IRA. If you expect your tax rate on withdrawals will be higher than or the same as your current tax rate, a Roth IRA may be the better choice.

Another potential advantage of a Roth IRA is that contributions (not earnings) can be withdrawn at any time for any purpose without tax or penalty. However, taking out contributions can carry a steep opportunity cost because you'll rob your retirement savings and give up the potential for that money to grow on a tax-advantaged basis over time.

Converting your Traditional IRA

One final note: You can convert your Traditional IRA to a Roth IRA at any time. After-tax dollars converted are not subject to tax or penalty. However, any pre-tax dollars converted will be included in your gross income for the year the conversion takes place, but there is no 10% IRS tax penalty.

It's important to know you cannot convert only your after-tax dollars – instead, a portion of each conversion will contain both before-tax and after-tax amounts. The benefits of tax-free income in retirement may justify the cost to convert.

Key factors to weigh in your decision to convert include your current income tax rate and expectations for future tax rates as well as availability of funds to pay the taxes associated with the conversion. Roth conversions can be complex. We recommend you consult with your tax professional and Financial Advisor before converting your Traditional IRA.

Evaluate your options

There are a number of factors to take into account when evaluating your IRA options. Some financial service providers offer online calculators that can help you choose. Or, you may want to enlist the help of your tax advisor and Financial Advisor to help you decide. Regardless of which IRA – or IRAs – you choose, starting early and saving consistently can help build your retirement savings and help ensure you can lead the retirement you envision.

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