Individual Retirement Strategies: Traditional vs. Roth IRA

Retirement is often one of the largest and longest financial goals for individuals, and there are many ways to save and prepare for that milestone. In the 1970s, Congress passed legislation to expand and encourage retirement savings, including the creation of employer-sponsored retirement plans and individual retirement accounts. The Individual Retirement Account (IRA) was first introduced in 1974 to encourage Americans to save for retirement and lower the dependency on Social Security and other programs. IRAs also gave income tax savings to people without access to an employer-sponsored retirement account. In 1997, the Roth IRA was created to complement the tax advantages of the original IRA, which is referred to as the Traditional IRA.

What Is an IRA?

An Individual Retirement Account (IRA) is an investment account set up at a financial institution with tax advantages that allows an individual to save for retirement on either a tax-free growth or tax-deferred basis.

You don't have to wait until you begin your full-time working career either; saving in an IRA can begin as soon as you have earned income. Investing in your early earning years helps you take advantage of an important factor when it comes to investing success: time. By giving your investments more time to grow and leveraging tools such as IRAs, you can potentially capture more compounded growth while also easing your tax burden. IRAs are a popular and powerful investment tool that can help you prepare for retirement. It is important to understand the characteristics of how they work and how to leverage them throughout your working years.

IRA Eligibility and Rules

Both Traditional and Roth IRAs have no age limit for contributions, but you must have earned income in the year you make the contribution to your account. Earned income is defined as wages, salaries, tips, or other taxable compensation you earn as an employee, even if you are self-employed. Non-working spouses can also contribute to an IRA based on the working spouse's income. Additionally, it is important to note that you can make contributions for a tax year until April 15 of the following year.

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In 2024, you can contribute up to $7,000 to your IRA account. If you are 50 years or older, you can contribute a total of $8,000. This is a cumulative limit, meaning if you have multiple IRAs, you cannot exceed $7,000 in total contributions across all IRAs.

One important distinction is that Roth IRA contribution limits are affected by your income. Your income doesn't affect your ability to make Traditional IRA contributions, however. In 2024, if you are single and earn over $161,000, you can no longer make a Roth IRA contribution. You can also only make a partial contribution if you earn over $146,000. Similarly, if you are married and your combined income is over $240,000, you cannot make a Roth IRA contribution. A partial contribution is allowed above $230,000.

Investment Options – What Can I Own?

IRAs allow a large selection of investment options and provide flexibility for your retirement savings. Most investors opt for a low-cost mutual fund or exchange-traded fund (ETF) that provides diversification in their investment portfolio. Investors who want to be hands-off will often opt for a target date fund that automatically invests funds based upon the specified date the money is needed. Other more hands-on options include individual stocks (ownership stakes in the company) or bonds (in which money is lent to a company in exchange for interest payments over time). You can also own money market funds (typically low risk and short-term investment vehicles with higher liquidity) as well as treasuries (debt securities issued by the U.S. government, considered to be the safest investments available with mostly lower returns on average).

Most custodians of IRAs (the financial institution they are held at) will only allow the ownership of traditional assets such as the ones listed above. However, if you wish to invest in assets like real estate, commodities, and precious metals, there may be additional steps to ensure your custodian allows for the ownership of alternative investments.

What Are the Tax Advantages to Using an IRA?

Investing in an IRA can have advantageous tax implications opposed to investing your retirement savings in a normal brokerage account. As an example, let's think back to the last time you drove on the highway and had to pay a toll for using the road. Investing for retirement in an IRA versus a taxable account is similar to using the express toll lane compared to stopping at the booth every 20 miles. Regular brokerage accounts make you stop at the "tax" tollbooth every year, whereas in an IRA, you can continue saving for retirement and pay the toll (tax) when you get off the highway or pull money out for retirement.

For a Traditional IRA in this context, you would pay the tolls for your time on the road when you get off the highway for retirement. This would include the money you initially entered the highway with as well as the money you've accumulated over time.

For a Roth IRA, you would pay the toll before entering the highway, and therefore you could exit the highway (take money out) whenever you want (as long as you're older than 59½). Roth IRAs are also unique in that after five years from your first contribution, you are allowed to take out money tax-free from the money you have already contributed. While you're on the highway, the money you accumulate over time can only be withdrawn after you turn 59½. However, because you already paid the toll, you can exit the highway with only the money you've already paid the toll for; the rest of your money must remain on cruise control until you're old enough to use it for retirement.

Traditional IRA

Traditional IRA contributions are tax-deductible on both state and federal tax returns for the year you make the contribution. This means that whenever you pay money into your account, you can receive a deduction on your taxes in that year from the state you live in as well as the federal government. As a result, withdrawals (when you take the money out), officially known as distributions, are taxed at your income tax rate when you make them, presumably in retirement. This means that when you take the money out, a certain percentage of it will be paid towards taxes at a rate that is based off how much income you have for that point in time.

Contributions to Traditional IRAs generally lower your taxable income in the contribution year. This means that when you contribute to a Traditional IRA, you get to pay taxes on less income than you actually earned for the year. This could help you qualify for other tax incentives you wouldn't otherwise get, such as the child tax credit or the student loan interest deduction.

If you withdraw money from a Traditional IRA before age 59½, you will pay taxes and a 10% early withdrawal penalty. You can avoid the penalty (but not the taxes) in some specialized circumstances, such as when you use the money to pay for qualified first-time homebuyer expenses (up to $10,000) or qualified higher education expenses.

Roth IRA

When you contribute to a Roth IRA, you don't get a tax deduction. This means it doesn't lower your Adjusted Gross Income (AGI) that year, but your withdrawals from your Roth IRA during retirement are tax-free. That's because you paid the tax bill upfront, so you don't owe anything on the back end.

Roth IRAs have income-eligibility restrictions. In 2024, single filers must have a Modified Adjusted Gross Income (MAGI), which is AGI plus exempt or excluded income and certain deductions, of less than $161,000.

Roth IRAs carry no required minimum distributions (RMDs), meaning you're not required to withdraw any money at any age or during your lifetime at all. This feature makes them ideal wealth-transfer vehicles. Beneficiaries of Roth IRAs don't owe income tax on withdrawals either. However, they are required to take distributions or roll the account into an IRA of their own.

Roth IRAs allow you to withdraw a sum equal to your contributions in the account without suffering a penalty or taxes for any reason before the age of 59½.

What Is the Difference Between Traditional and Roth?

Both Traditional and Roth IRAs provide generous tax breaks, but it's a matter of timing when you can claim them. Anyone with earned income can contribute to a Traditional IRA. Whether the contribution is fully tax-deductible depends on your income and whether you (or your spouse, if you're married) are covered by an employer-sponsored retirement plan, such as a 401(k).

Another difference between Traditional and Roth IRAs lies in withdrawals. With Traditional IRAs, you must start taking RMDs. RMDs are mandatory, taxable withdrawals of a percentage of your funds (even if you don't need the money) at the age of 73 for account owners born between 1951 and 1959, and 75 for those born in 1960 or later. The IRS offers worksheets to calculate your annual RMD, which is based on your age and the size of your account.

Roth IRAs involve after-tax contributions and tax-free withdrawals; conversely, a Traditional IRA allows you to deduct contribution amounts and lower your taxable income (but withdrawals are taxed).

> *Example: For a Traditional IRA, if you earn $100k but contribute $5k to the IRA, you therefore only "made" and pay taxes on $95k. If that $5k contribution turns into $30k by the time you take a withdrawal, you'll pay the taxes on the $5k and the $25k in growth.*
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> *For a Roth IRA, if you earn $100k and make a $5k contribution, you pay taxes on the $100k and therefore aren't obligated to pay taxes on the growth at retirement. If that $5k turns into $30k, you then have $30k to withdraw without a tax obligation.*

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Should I Use a Traditional or Roth IRA?

A Roth IRA or 401(k) makes the most sense if you are confident of having a higher income in retirement than you do now. If you expect your income (and tax rate) to be higher at present and lower in retirement, a Traditional IRA or 401(k) is likely the better option. A Traditional IRA allows you to devote less income now to making the maximum contribution to the account, giving you more available cash.

	Traditional IRA	Roth IRA
Funded With	Pre-Tax $	After-Tax $
Contribution Limits (2024)	$7,000 ($8,000 if age 50+)	$7,000 ($8,000 if age 50+)
Taxes	• Contributions are tax-deductible • Taxes paid upon withdrawal	• Contributions not tax-deductible • Tax-free withdrawals
Timing	Higher tax bracket pre-retirement	Lower tax bracket pre-retirement
Income Limits for Full Contribution (2024)	None	• Under $146k (Single) • Under $230k (Married)
Required Minimum Distributions (RMDs)	Age 73	None
Withdrawals Pre-Retirement (Age 59½)	• 10% penalty + taxes	• Contributions tax/penalty free • Earnings 10% penalty + taxes

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If you have any questions, please reach out to your D.A. Davidson financial professional.