When to Use a Roth Account

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It's best practice to have a combination of retirement plans for tax planning purposes.

For example, qualified plans reduce your taxation now, but you will pay ordinary income tax on all withdrawals when you need to take money out of the account. On the other hand, a Roth IRA allows your money to grow tax-free forever, but you have to pay taxes on the money when you earn it. A good combination of these accounts and potentially brokerage accounts allow you to reap tax rewards now and in the future.

What's the difference between a traditional account and a Roth account?

When we talk about 401(k)s and IRAs, we often refer to them now as "traditional" accounts to distinguish them from their Roth cousins. Roth accounts are similar to traditional retirement accounts in many ways, but the taxation is essentially the opposite. So while a traditional 401(k) or IRA allows you to avoid paying taxes on earned income now, Roth equivalents will enable you to avoid paying income taxes in the future.

Say you open a Roth IRA and contribute $6,000 to it in October of 2021. There is no tax benefit for you in 2021 – the entire $6,000 you earned in that year is taxable as ordinary income. However, that money is now free to grow tax-free for as long as you live, and you will pay no income tax on either the contribution or the earnings when you take withdrawals from the account (subject to specific rules, please see below).

Not only do you not pay income tax on the withdrawals, but there are no Required Minimum Distributions (RMDs) at age 72 like there are with traditional IRAs. Therefore, Roth accounts are a great way to provide tax diversification to your retirement income stream and a fantastic estate planning tool. Since you don't have to take RMDs, if you don't need the Roth account to meet your living expenses, you can allow it to continue to grow for your heirs. When they inherit the account, your heirs will have ten years to withdraw the money, just as they would with a traditional account. Still, none of the withdrawals are taxable to them as income, so they can leave the money in the account for the entire 10 years, where it will continue to grow tax-free.

How to determine if a Roth account is right for you.

You will have to pay income taxes on your earnings at some point; the question is when you will pay them. So how do you know whether to use a Roth or a traditional account? It depends on your goals.

IF	THEN
You are in a lower tax bracket now but anticipate being in a higher one at retirement...	Invest in a Roth account.
You are in a higher tax bracket now but anticipate being in a lower one at retirement...	Invest in a Traditional account.
You have a sizable amount in traditional accounts, and the projected RMDs from those accounts will far outstrip your anticipated income need in retirement, causing you to pay income tax on withdrawals for the income you won't need...	Invest in a Roth account.
You want to be able to withdraw your contributions from an IRA without taxes or penalties before age 59 ½...	Invest in a Roth account.
You want assets that will grow tax-free throughout your life and can be withdrawn income tax-free by your heirs...	Invest in a Roth account.
You want a flexible way to save for your children's or grandchildren's college education as well as your retirement...**	Invest in a Roth account.
You make too much to contribute to a traditional IRA...	You may be able to invest in a Roth (see below)

***Once you reach 59 ½, all of your withdrawals (both earnings and contributions) are tax-free as long as it's been at least five years since you first contributed to a Roth. Before 59 ½, withdrawals of earnings will be subject to income taxes, but not an early withdrawal penalty, as long as the funds are used for qualified college expenses.*

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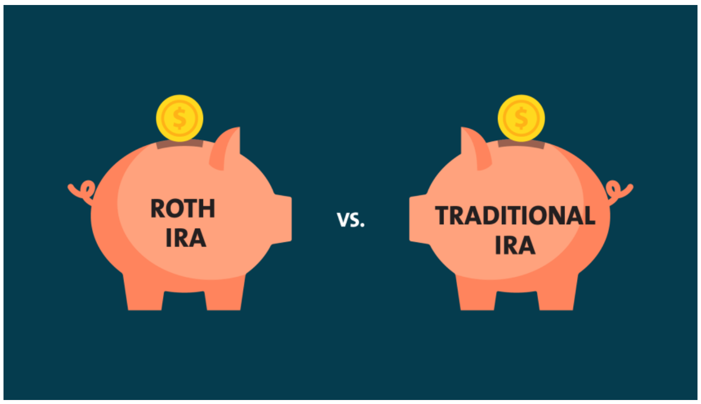
Roth IRA vs. Traditional IRA

Besides the obvious differences in taxation, there are two other differences between traditional and Roth IRAs. First, you can withdraw contributions you have made to a Roth IRA without paying taxes or penalties on the withdrawals. This means that a Roth can be both a retirement plan and a backup to your emergency fund if you invest some of the money in ultrashort-term bonds.

The second difference focuses on income phaseouts. The income phaseouts to qualify to contribute to a Roth are higher than for a traditional IRA, sometimes as much as twice as high. So, if you make too much to contribute to a traditional account, you may be eligible for contributions to a Roth. Don't assume that you make too much to contribute to a Roth IRA.If you make too much for a traditional IRA, talk to your CERTIFIED FINANCIAL PLANNER™ professional or check www.irs.gov to see if you can contribute to a Roth IRA instead.



Find out if you have a Roth option at work

Many employees now have the option of allocating part or all of their employer plan into a Roth 401(k) or 403(b). In addition, many people have access to Roth plans at work and don't know it. Contact your benefits office to see if you can contribute to a Roth plan through your employer.

Make sure you understand the account allocation between Roth and Traditional holdings. When you leave the job or retire, you'll probably want to roll the account over into IRAs, and it will need to split into two accounts: one Roth IRA and one traditional IRA.

Do not go blindly into the decision of how much to put into each type of plan. You are making a decision that will impact your retirement for decades. You should consult your tax advisor or your CERTIFIED FINANCIAL PLANNER™ professional for this complex analysis.

Diversification, Personalization, & Planning Are Key

Retirement planning changes as your family and priorities change. Tax laws will also change during that time. Regardless of what stage of life you are in, there are always opportunities to plan for your retirement, and tax diversification and your individual needs should be part of that process.

Ready to create a personalized plan? Contact Allegheny Financial Group to get started.