IRA VS. ROTH IRA

By Steven W. Shirley

Money you put in a traditional IRA is generally tax deductible no matter how high your adjusted gross income (AGI) might be—unless you're an active participant in a qualified employer plan such as a 401(k), 403(b) or 457.

In that case, a traditional IRA contribution is fully deductible for single filers with an AGI of $50,000 or below (partially deductible between $50,000-$60,000). For married filing jointly, the phase-out range for deductibility is between $75,000-$85,000 ($150,000 limit for the non-participant spouse of an active participant in a qualified employer plan, when filing jointly).

Contributions to a Roth IRA are never tax deductible, but qualified withdrawals are tax-free (unlike withdrawals from traditional IRAs, which are taxed as ordinary income). You can contribute the maximum $4,000 to a Roth IRA if your AGI is below $95,000 for single filers and $150,000 for married filing jointly. You can make a partial contribution if your AGI is between $95,000-$110,000 for singles and $150,000-$160,000 for married filing jointly.

If you're still able to save more after taking advantage of your employer's 401(k) match limit, here's what you should do next:

- **If you're eligible to make a deductible contribution to a traditional IRA,** consider putting your next $4,000 there—especially if you expect to be in the same or lower income tax bracket in retirement when you take withdrawals. You're still getting a pre-tax deduction as you do with your 401(k), but you'll likely have more investment choices. If you can afford to save more after contributing $4,000 to a traditional IRA ($5,000 if you're 50 or older in 2006), then continue with your 401(k) up to the maximum allowed.

- **If you're not eligible to make a deductible contribution to a traditional IRA but you're eligible for a Roth IRA**, consider putting your next $4,000 into a Roth ($5,000 if you're 50 or older in 2006). Your contribution won't be deductible, but qualified withdrawals will be tax free down the road. If you're in a higher tax bracket when you make your withdrawals, the Roth would be especially attractive. Ending up in the same bracket would mean a wash for income tax purposes—but a Roth IRA has other advantages.

  A Roth IRA doesn't force you to take required minimum distributions at age 70½, as you'd have to do with a qualified employer plan or traditional IRA. That's an advantage in terms of letting your Roth IRA continue to grow tax deferred in your later years. It could also benefit your heirs, who'd be able take money out income tax free after you're gone.

  Again, if you're able to save more after you put $4,000 in a Roth, continue with your 401(k) until you max it out.

- **If you're eligible for neither a deductible contribution to a traditional IRA nor a Roth IRA contribution**, then just continue with your 401(k) until you've contributed the maximum allowed.

New in 2006: The Roth 401(k)

In January 2006, the "Roth 401(k)" account (403(b) plans are also eligible) went into effect. It works much like a regular Roth—contributions come from after-tax dollars and qualified withdrawals are income tax- free. But there is no income limit to participate!

Eligible employees can contribute to either the traditional 401(k) or the Roth 401(k), up to the 2006 contribution limit of $15,000 per individual, plus an additional $5,000 catch-up contribution for those 50 or older. Also, the balance from a Roth 401(k) could be rolled over directly into a regular Roth IRA when you leave the employer. An employer match, if any, would automatically go into the traditional 401(k) option, regardless of where the employee contributions are directed.

Assuming your employer offers the option, the choice of a Roth 401(k) could make sense if you think your tax bracket will be the same or higher in retirement—not a bad guess given today's relatively low tax brackets and the potential to generate significant portfolio income and retirement distributions from other deferred accounts. If that's the case, then maxing out on a Roth 401(k) and then contributing to a Roth IRA, if eligible, might be the way to go.

On the other hand, if you're in a lower bracket when you retire (or, even worse for the Roth, if the current income tax is replaced by a flat tax or consumption tax), then a traditional 401(k) would have been a better bet. One way to "hedge" against the unknown is to split your contributions between the traditional option and the Roth option, assuming your employer makes both available.

Example using 2006 limits

Your salary is $95,000. Your goal is to save 20%, or $19,000. Your employer matches your 401(k) contributions, up to the first 6% of your salary ($5,700).

1. First $5,700 to 401(k)
2. Next $4,000 to a Roth IRA (not eligible for a deductible contribution to a traditional IRA)
3. Next $9,300 to 401(k)

In this case, you're able to contribute the full $15,000 limit to your 401(k) and the full $4,000 limit to a Roth IRA.

If the amount you're able to contribute to an IRA and 401(k) each year is less than the maximum allowed, you would follow the order above until you reached your personal savings limit (assuming the employer match). Keep in mind your 401(k) has a distinct advantage: Once you set your saving percentage, you're on "pay yourself first" autopilot. Since you have a greater opportunity to spend money earmarked for your IRA, you need to be more disciplined about saving it.

Mr. Steven Shirley is a Registered Representative of IMS Securities, Inc. Member FINRA/SIPC and Investment Advisor Representative of IMS Financial Advisors, Inc. 10205 Westheimer, Suite 500, Houston, TX 77042 *713 266 2993. IMS Securities, Inc., IMS Financial Advisors, Inc., and Steven Shirley are not engaged in rendering legal, accounting or tax advice. If these services are required, utilize the services of a CPA, attorney, accountant, or other consultant as may be required. Mr. Shirley can be reached at 713 751-3163 or sshirley@ims-securities.com