Building Your Retirement Portfolio: Traditional vs. Roth IRA

- **$11.5 trillion is reportedly held in IRA accounts in the U.S. and 37% of U.S. households reported owning IRA accounts as of December 2022.**
- **The number of Americans with Traditional and Roth IRA accounts worth over $5 million tripled to more than 28,000 between 2011 and 2019.**
- **Over $15 billion in Roth IRA accounts is held by just 156 Americans!**

When you think of saving for retirement, what is the first thing that comes to mind? For many individuals, it is their employer-sponsored 401(k) plan. However, you cannot complete the conversation around retirement planning without addressing Individual Retirement Accounts (also known as IRAs). As noted above, over $15 trillion of the U.S.'s wealth is held in IRA accounts, and over 28,000 Americans have IRA accounts with balances over $5 million. When planning for retirement, contributing to an IRA can be a useful addition to your retirement portfolio – and you can make IRA contributions in conjunction with contributions to your employer-sponsored retirement account (such as a 401(k)) to maximize retirement savings. This makes the IRA a viable option for a wide range of individuals at various ages and income levels.

This article will review the different types of IRA accounts, the rules behind withdrawing from and making contributions to these accounts, how an IRA could fit into your overall retirement portfolio, and what an IRA account could potentially grow to if you contribute the maximum amount to it each year.

Types of IRAs

There are two main types of IRA accounts: Traditional IRAs and Roth IRAs.

	Traditional IRA	Roth IRA
Annual Contribution Limits	$7,000 (Under Age 50) $8,000 (Over Age 50)	$7,000 (Under Age 50) $8,000 (Over Age 50)
Who Can Contribute?	Anyone with earned income	Anyone with earned income, not a part of an employer retirement plan, and adjusted gross income "AGI" < $240,000
Primary Difference:	Pre-tax contributions; Withdrawals are Taxable	After-tax contributions; Withdrawals are Tax-Free
Tax Deductible?*	Yes, if AGI < $240,000 No, if AGI > $240,000	Not Tax Deductible
What if my "AGI" is > $250,000?	You can still contribute - Contributions are NOT tax deductible	"Backdoor Roth Contribution" Option - Traditional IRA contribution first then to a Roth
Best Suited For:	Individuals expecting to be in the same or lower tax bracket when taking withdrawals	Individuals expecting to be in a higher tax bracket when taking withdrawals
Withdrawal Rules:	Mandatory after Age 73; No penalties but taxed as current income after age 59.5	No Mandatory Withdrawals; No penalties and tax-free after 5 year holding period and age 59.5

*Assumes married filing jointly

Anyone with earned income can contribute to an IRA account – and the annual contribution limit between both accounts in any one year is $7,000 ($8,000 if you are over age 50). The primary difference between these two accounts is timing of when the tax is paid: for Roth IRAs, the contribution is made with after-tax dollars and withdrawals are tax-free after age 59.5; for Traditional IRAs, tax is NOT paid at the time of contribution and you can receive a tax deduction equal to your contribution amount – however, you will need to pay taxes when the funds are eventually pulled out.

If you are a high-income earner, married filing jointly with adjusted gross income ("AGI") over $240,000, there are two challenges you will face:

1. There is no tax deduction for Traditional IRA contributions (unlike the dollar-for-dollar tax deduction received if your AGI is < $240,000).
2. You cannot contribute directly to a Roth IRA – you need to contribute to a Traditional IRA first and subsequently transfer the funds from the Traditional to the Roth IRA (this is called a Backdoor Roth Conversion).

For individuals with AGI greater than $240,000, the Backdoor Roth Conversion is a great way to set aside funds each year that will be tax-free when you eventually pull them out. For individuals with AGI under $240,000, contributing directly to a Roth IRA and allowing those dollars to grow tax-free is a great option, while the one-for-one tax deduction for contributions to a Traditional IRA and tax-deferred growth is also appealing.

There is no one-size-fits-all answer when it comes to IRA contributions. Each year, you must take into consideration your current income while assessing what your future income will likely look like when you pull funds from the account. You could decide to make Roth contributions one year and Traditional IRA contributions the next year, or even a combination of contributions to both up to the $7,000 limit (or $8,000 if over the age of 50) in one year. Regardless of the direction you choose, you are setting aside funds for retirement each year that will grow tax-deferred.

How Could an IRA Fit Into Your Portfolio?

When looking at most individuals' portfolios, their assets can be broken down into three main buckets:

1. Cash – includes checking/savings accounts (used for living expenses and holds emergency fund)
2. Taxable Investment Accounts – includes brokerage accounts that holds stocks and bonds
3. Retirement Accounts – includes employer-sponsored 401(k)s/403(b)s, and IRA accounts

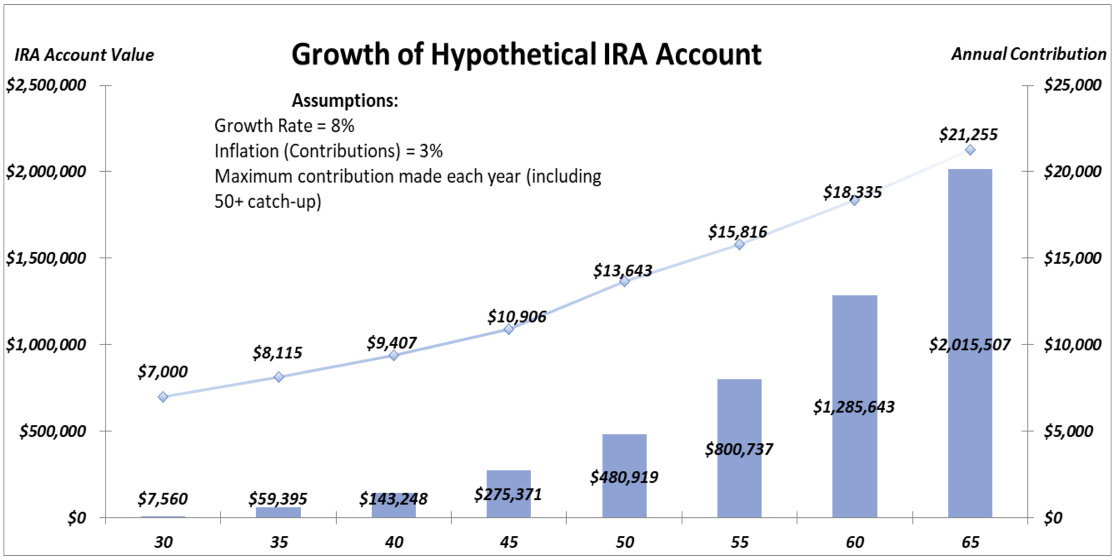
When saving for retirement, the challenge for many is determining how much they need to allocate each year across these buckets. To maximize contributions to the retirement bucket each year, most individuals would need to contribute the max amount to their 401(k) and IRA – which could either be $29,500 or $38,000 depending on if you are over the age of 50. For high-income earners, maxing out both accounts is an after-thought and can be done automatically each year with funds leftover to allocate appropriately to the other buckets. Other individuals may not be able to contribute the max to their IRA/401(k) accounts each year and must allocate funds across the various buckets based on their income and living expenses. Regardless of the individual, understanding the maximum amount you can contribute to the retirement bucket is the first step in determining which type of IRA you could contribute to during the year and at what amount.

	Cash & Savings Accounts	Tax Investment Accounts	Retirement Accounts
Holds:	Cash (living expenses & emergency fund)	Stocks/Bonds	Stocks/Bonds
Account Type:	Checking/Savings	Brokerage	401(k)/403(b)s & IRAs
Annual Contribution Limit:	Unlimited	Unlimited	401(k)/403(b): $23,000 ($7,500 catch-up if 50+) IRA: $6,500 ($1,000 catch-up if 50+)
Target Annual Return	1-3%	7-9%	7-9%
Is Income Taxable?	Yes	Yes	No (tax-deferred)

What Could Your IRA Balance Grow To?

At this point you may be asking the question: "If I make the maximum annual contributions to an IRA account each year, what can the account potentially grow to by retirement?". Although there are many factors that contribute to this, the chart below shows what your IRA account could *potentially* grow to based on the following assumptions:

- Age IRA contributions begin: 30
- Maximum annual contribution made each year
- Inflation growth rate of contributions = 3%
- Annual investment return = 8%



As you can see, this individual's IRA account could grow to $2,000,000 by age 65, with cumulative contributions of $463,000 over the span of 35 years. Depending on if the individual decided to contribute to a Roth or Traditional IRA account, the funds could potentially be accessed without paying any taxes if all contributions were made towards a Roth! If a Traditional IRA, the account would grow without needing to pay taxes on the income each year, and only withdrawals are taxable when the individual eventually pulls money from the account.

Both Roth and Traditional IRAs can be valuable savings vehicles for retirement. These accounts share key similarities such as their contribution limits but have significant tax differences. It is important to consider your financial situation, goals, and potential future income when determining if and how to contribute to a Roth and/or Traditional IRA.

Please feel free to contact us at any time to discuss changes to your financial situation or to review your portfolio. We appreciate the confidence you have placed in Wellspring to be your trusted advisor.

Sources:

The Number of People With IRAs Worth $5 Million or More Has Tripled, Congress Says — ProPublica

The Role of IRAs in US Households' Saving for Retirement, 2021 (ici.org)

U.S. Retirement Assets: Data in Brief (congress.gov)

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