

Traditional Individual Retirement Accounts

As **pension plans** shrink, or disappear, and **uncertainty** about the long-term viability of **Social Security** lingers, **personal savings** for retirement is **essential** to **financial well-being**.

The Employee Benefit Research Institute estimates that current retirees fund only 31 percent of retirement spending via personal savings. This is in stark contrast with the estimate that current workers will need to fund 66 percent of retirement expenses with personal savings.

For a retirement portfolio that requires \$1 million in savings today, you would need over \$2.4 million to fund retirement in 30 years (assuming a 3 percent inflation rate). Thus, it is increasingly important to save early for retirement. One of the most efficient and effective ways of doing this is by contributing to an IRA.

When Should I Contribute to an IRA?

While IRAs are an important piece of the retirement puzzle, contributions to 401(K) accounts with an employer match should be maximized first. Even when your employer only matches a portion of what you contribute to your account, this is an immediate return on your investment,

essentially free money. For example, if your employer contributes half of your contributions to a 401(k) (usually up to a certain percentage), your return is equivalent to a 50 percent return on investment in a non-matching retirement account. A 50 percent return, especially in difficult markets, can take a long time to generate.

On the other hand, 401(k) accounts have contribution limits, and not all individuals have plans with employer matching. In that case, traditional

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IRAs can be beneficial in saving for retirement and reducing taxes. With traditional IRAs, the account owner can defer taxes on both the principal and investment earnings, and use the taxes saved for other purposes.

If you haven't started saving for retirement, you'll first have to find room in your budget. It is important

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to cover all necessary living expenses before contributing to your retirement account, because it is difficult to withdraw IRA funds for emergencies. To prioritize how to save, determine what expenses are necessary and what expenses can be reduced or eliminated. Saving for retirement should be one of the top priorities after accounting for necessary living expenses.

How Should I Contribute?

Ideally, you should have a priority list of expenses and be able to account for future changes in income or expenses. With a budget this meticulous, you could set a recurring contribution to your IRA without worrying if you could afford it or not. Automatic contributions make it easy to save for retirement because you don't have to exercise willpower or remember to transfer money each month.

If your expenses and income aren't regular enough to support a set-it-and-forget-it system, you can still plan to make regular contributions at specific intervals. For instance, you can set a reminder in your calendar to make an IRA contribution on the 15th of each month. Depending on your expenses for the month, you may be able to contribute more one month than the next. This will allow you to pay for expenses that may come up unexpectedly. The downside to this system is that it still requires consistent effort, and you may be tempted to decrease contributions in favor of discretionary spending.

Many people also contribute to IRAs when completing their tax return. Based on your current tax situation, you may be able to contribute to your IRA and take a tax deduction for the prior tax year. This is a useful time to contribute to your IRA and is a way to defer taxes. It also serves as a useful and regular reminder to add funds to your retirement savings.

Differences Between Traditional and Roth IRAs

Both traditional and Roth IRAs can increase the likelihood that retirement expenses will be fully covered. Many people have questions about the difference between these two options and when to use one or the other. The main difference between the two plans is when principal contributions are taxed. With a traditional IRA, contributions are allowed to be made to the retirement plan pre-tax. The contributions are then taxed, along with the income generated by the investments, when the contributor takes distributions in retirement. Roth IRAs, on the other hand, make use of funds that have already been taxed. As a result, Roth contributions are not subject to tax upon distribution.

When choosing between a traditional and Roth IRA, your tax rate (both now and in the future) will be likely be the biggest factor to consider. Since traditional IRAs can be funded with pre-tax income that isn't taxed until distribution, they are especially useful when your retirement tax rate is lower than it is today. Conversely, since Roth accounts are funded with after-tax money but have tax-free distributions, they become more advantageous if you expect higher taxes in retirement than you have today.

Accurately forecasting the future of taxes is difficult to do, and the government officials who guide the direction of taxes even have a difficult time forecasting where rates will go in the next few years, much less decades. The most conservative approach to ensure that retirement funds are maximized for years to come is to contribute to both traditional and Roth accounts.

Withdrawal of Funds

When choosing between traditional and Roth accounts, make sure to consider differences in withdrawal limitations. With a traditional IRA,

you must take minimum distributions upon turning 70 ½ years of age, whereas Roth IRAs do not require these withdrawals. Similarly critical to assess is whether or not there may be cash flow needs that would necessitate the use of funds from these accounts. If you take a withdrawal from a traditional IRA before age 59 ½ there will be a penalty in addition to the normal taxes that would be due (unless there is an exception). In comparison, Roth IRAs generally are not subject to these constraints unless the account has been open less than five years. These rules can be very complicated and there are numerous exceptions. Talk to your financial or tax advisor with your particular circumstances in mind.

Working with Your Advisor

Both traditional and Roth IRAs have benefits and drawbacks; the main risk in selecting a retirement account is not knowing the differences among account options. To increase the likelihood that the investing options available match your needs and goals, it is important to work with your financial advisor, during both your working and retirement years. No matter the investment account chosen, saving and investing early in life is the most efficient way to meet retirement spending needs.

