Summary 2006 VOLUME 12:2

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

Traditional Versus Roth IRAs

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Both Traditional and Roth IRAs are effective retirement saving vehicles for individuals. This article discusses their main characteristics, eligibility requirements, as well as what factors determine whether a Traditional or Roth IRA will be a better choice for you. Conversion of Traditional IRAs to Roth IRAs is a complicated topic that will be covered in a future article.

Contributions to a Traditional IRA can be made as long as you are under age 70 ½ and have taxable compensation income; they ***may*** be tax deductible (depending on several factors). After you reach age 70 ½, you cannot contribute any further and must begin withdrawing required minimum distributions ("RMDs") from the Traditional IRA. Assets in the account will grow tax-***deferred***, with any investment earnings and deductible contributions subject to ordinary income tax at eventual distribution. Distributions may also be subject to a 10% early-withdrawal penalty if they occur before you reach age 59 ½, unless one of the few exceptions applies.

Roth IRA contributions are not tax deductible and can be made only if your modified adjusted gross income ("AGI") does not exceed a certain amount. Assets in a Roth IRA will grow tax-free while in the account, and ***contributions*** can be withdrawn at any time without incurring income tax or penalties. Distributions of the investment earnings portion of the account will also be free from income tax and penalties if they occur after 1) the 5-year period starting with the tax year for which the first contribution was put into the Roth IRA, <u>and</u> 2) you have either reached age 59 ½, or become disabled or died, or are making a qualified first-time home purchase (up to $10,000). In this way, Roth IRAs offer tax-***exemption***, rather than simply tax-deferral.

<u>News About PDV Staff</u>

We are pleased to announce that Ms. Louisa Ho recently passed the Series 65, Uniform Investment Adviser Law Examination, which is administered by the National Association of Securities Dealers (NASD). She is now a registered adviser representative of PDV Financial Management in the State of California. Congratulations, Louisa!

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Roth IRAs offer additional benefits: you can contribute at any age so long as you have taxable compensation income, and you are not required to withdraw from the account even after you reach age 70 ½. The required minimum distribution rules for Traditional IRAs do not apply to Roth IRAs.

So which type of IRA is right for you? First, you need to make sure you are eligible to contribute to either one or both. As long as you are under 70 ½ and have taxable compensation income, you are eligible to contribute to a Traditional IRA; whether your contribution would be deductible, however, is a different issue that will be addressed below.

The eligibility requirements for contributing to a Roth IRA are more stringent in some ways, and more liberal in other ways, compared to those for Traditional IRAs. As long as you have taxable compensation income, you can contribute to a Roth IRA at any age, but only if your modified AGI falls within the limits described below.

Tax Filing Status	2006 Modified AGI	2006 Roth IRA Contribution Limit
Married filing jointly	< $150,000	Up to $4,000 (or $5,000 if you will be at least 50 years old by 12/31/2006)
	$150,000 ≤ X < $160,000	Less than the limit stated above
	≥ $160,000	$0
Single	< $95,000	Up to $4,000 (or $5,000 if you will be at least 50 years old by 12/31/2006)
	$95,000 ≤ X < $110,000	Less than the limit stated above
	≥ $110,000	$0

You can also contribute on behalf of a non-working spouse, as long as you file taxes jointly and your combined contributions do not exceed your combined taxable compensation for the year. Contributions to a spousal Traditional or Roth IRA are subject to the same limits discussed elsewhere in this article.

If you are not eligible to contribute to a Roth IRA, then a Traditional IRA will be your default option. Of course, making ***deductible*** contributions to a Traditional IRA under these circumstances would be preferable. However, contrary to popular belief, making non-deductible contributions to a Traditional IRA still yields tax benefits, because all investment earnings are tax-deferred, despite the inability to deduct the contribution upfront.

Assuming you are eligible to make a full contribution to either a Traditional or Roth IRA, which one is preferable depends on a whole host of factors. The most important issue is to determine at the outset whether your contributions to a Traditional IRA are fully deductible. This in turn depends on your filing status, modified AGI and whether you and your spouse are covered by a retirement plan at work.

The table below summarizes the 2006 tax rules for deducting Traditional IRA contributions based on these factors.

You Are Covered By a Retirement Plan at Work	Tax Filing Status	2006 Modified AGI	2006 Traditional IRA Contribution Deductibility
Yes	Married filing jointly	≤ $75,000	Full
		$75,000 < X < $85,000	Partial
		≥ $85,000	None
	Single	≤ $50,000	Full
		$50,000 < X < $60,000	Partial
		≥ $60,000	None
No	Married filing jointly (spouse **is** covered by a plan at work)	≤ $150,000	Full
		$150,000 < X < $160,000	Partial
		≥ $160,000	None
	Married filing jointly (spouse **is not** covered by a plan at work)	Any	Full
	Single	Any	Full

If you cannot deduct your Traditional IRA contribution at all, then you will not receive any upfront tax benefits from contributing to a Traditional IRA. In this case, contributing to a Roth IRA will be a better choice for you, as it will allow you to benefit from tax-free distributions at retirement. The following hypothetical, which relates to someone who is saving for retirement in 15 years, illustrates this point.

Type of IRA	Balance at end of Year 15 (b)	After-tax withdrawal amount at end of Year 15 (c)	Total return (d)
Traditional (a)	$8,315.71	$5,821.00	**$1,821.00**
Roth	$8,315.71	$8,315.71	**$4,315.71**

a. Your Traditional IRA contribution is assumed to be non-deductible.

b. You make a $4,000 contribution at the beginning of Year 1, with an assumed compounded annualized investment return of 5%.

c. Your assumed combined state and federal income tax rate is 30% throughout the entire period

d. Total return = After-tax withdrawal minus $4,000.

If you can fully deduct your Traditional IRA contribution and your income tax rate is projected to be roughly stable or lower at retirement, you will be better off making the entire contribution to a Traditional IRA, because the immediate positive impact of the tax deduction plus the benefits from investing these tax savings over time would in most cases outweigh the back-end benefits of tax-exemption from a Roth IRA.

However, if your income tax rate at retirement can be projected with reasonable certainty to be much higher than it is today, then the back-end, tax-exempt benefits of a Roth IRA would likely outweigh the immediate benefit of a tax deduction and any related investment gains on such tax savings. This is because the value of the Roth IRA tax exemption increases proportionally to rising tax rates.

In addition to trying to project tax rates many years from now, another area that is tricky to analyze is if your contribution to a Traditional IRA is only ***partially*** deductible. The fact that you can make contributions to both a Traditional and a Roth IRA in the same tax year, subject to overall limits, offers you some planning tools to address this situation.

For 2006, the ***aggregate*** contribution limit for all your Traditional and Roth IRAs is the lower of 1) 100% of your taxable compensation, or 2) $4,000 (or $5,000 if you will be at least 50 years old by December 31, 2006). For example, if you are qualified to contribute to both types of IRA and your aggregate contribution limit is $4,000, then you may contribute all $4,000 to either a Traditional or Roth IRA, or split the $4,000 between the two types of IRA. Contributions to a Traditional or Roth IRA can be made up to the tax filing deadline (not including extensions) for the tax year to which such contributions relate. You therefore have until April 16, 2007 (Monday) to make IRA contributions for 2006.

If your contribution to a Traditional IRA is only partially deductible, it is helpful to apply the general rules described above to both the deductible and non-deductible portions. This means contributing the maximum permitted deductible amount to a Traditional IRA (assuming projected stable or declining income tax rates at retirement) and contributing the remaining allowable amount to a Roth IRA. However, you need to be aware that this arrangement will likely result in higher administrative and brokerage costs than if you invest all your contributions in a single type of IRA.

If the situation is too close to call, there are reasons to favor the Roth IRA over a Traditional IRA. First, the Roth IRA does not require mandatory distributions at 70 ½, permitting the assets to continue growing in a tax-exempt way. Second, you can continue contributing to a Roth IRA to build up tax-free investment earnings past 70 ½. Third, your contributions (i.e. your principal) in a Roth IRA can be withdrawn at any time without income tax or penalty. However, balanced against these advantages is the reality that Congress can always limit or eliminate the back-end tax-exempt status of the Roth IRA in the future, though adverse political ramifications would discourage any such change.

Choosing between a Traditional and a Roth IRA is a difficult decision. Be sure to think through the situation thoroughly in deciding which IRA is more suitable to meet your financial goals.