

Plan

Traditional or Roth IRA?

For people not covered by a retirement plan at work or for those who already contribute the maximum to their employer's plan, an individual retirement account (IRA) can be an attractive option. Interested individuals can choose between a traditional IRA and what's known as a Roth IRA.

The Basics

In 2009, you can contribute an amount equal to your total taxable compensation or \$5,000, whichever is less, to an IRA. If you're age 50 or older, you also may be able to make a "catch-up" contribution of \$1,000 over and above the \$5,000 regular contribution.

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What are the differences between a traditional and a Roth IRA? In a nutshell, you get tax advantages upfront with a traditional IRA and tax advantages at the back-end with a Roth IRA. Here are the specifics.

Traditional IRA = Tax-deductible Contributions

Your contributions to a traditional IRA may be tax-deductible. That's the upfront advantage. Contributions to a traditional

IRA are tax-deductible if you and your spouse are not active participants in an employer-sponsored retirement plan — regardless of how high your income is. With active plan participation by either you or your spouse, you can still contribute. However, your deduction will be limited or eliminated if your income exceeds certain levels.

As an active participant, your entire contribution for 2009 will be deductible if your adjusted gross income (AGI) is no more than \$55,000 (\$89,000 if married filing jointly and \$0 if married and filing separately). A married person filing a joint return who isn't an active participant, but whose spouse is, receives a full deduction if adjusted gross income is \$166,000 or less.

Any investment earnings on your IRA contributions also aren't taxed until you withdraw the money, presumably at retirement. So both contributions and earnings can grow tax-deferred until you retire. When you do begin making withdrawals, the money you take out of your IRA will be taxed at your ordinary income-tax rate.



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With certain exceptions, the tax law requires you to pay both income tax and a 10% early withdrawal penalty if you take funds from your traditional IRA before you reach age 59½. And you'll generally have to begin taking required minimum distributions (RMDs) once you reach age 70½ or face a 50% penalty on the amount not taken*.

Roth IRA = Tax-free Earnings

Unlike contributions to a traditional IRA, contributions to a Roth IRA are not tax-deductible. In addition, Roth contributions are phased out when adjusted gross income meets certain levels. For 2009, the phaseout ranges are

- \$166,000 to \$176,000 for married couples filing jointly
- \$105,000 to \$120,000 for unmarried persons
- \$0 to \$10,000 for married couples filing separately.

Once adjusted gross income reaches the top of the range, no Roth contributions can be made.

So what is the advantage of a Roth IRA? You won't pay tax or a penalty on withdrawals that meet the criteria for "qualified" distributions. This means that a Roth's investment earnings are tax-free if the tax law's requirements are met.

With both types of IRAs, there are exceptions to the early withdrawal penalty (for example, withdrawals for certain education expenses or up to \$10,000 of first-time home buying expenses).

Both IRAs = Enhanced Compounding

Compounding begins when a "return" (interest, for example) is earned on an amount invested (the principal). Instead of spending these earnings, they're invested. Then, the principal *and* the reinvested earnings produce more earnings. Over time, this process repeats itself so that returns are earned on a bigger and bigger pool of money.

With either type of IRA, no taxes are taken out of the account's current earnings. The full amount can stay in the IRA and be invested to produce additional earnings. This enhanced compounding boosts the IRA's potential growth.

*The Worker, Retiree and Employer Recovery Act waives the minimum distribution requirements for calendar year 2009 only.

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