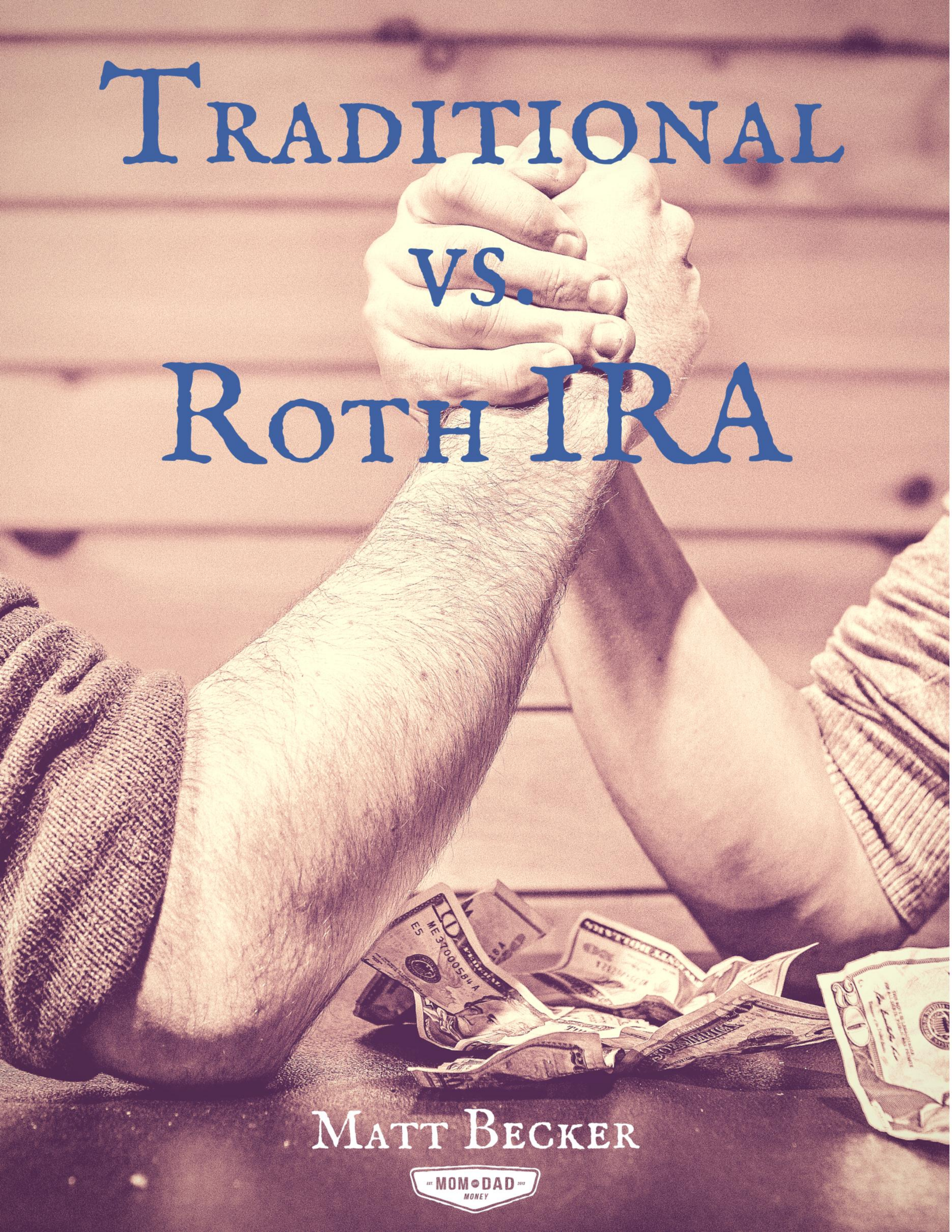
Traditional vs. Roth IRA



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MOM DAD MONEY

Table of Contents

Traditional vs. Roth IRA: Some Unconventional Wisdom for Young Investors 3
5 Reasons a Roth IRA Might be Right for You 8
3 More Unconventional Reasons to Contribute to a Traditional IRA..12
About the Author 16
Disclaimer 17

Traditional vs. Roth IRA: Some Unconventional Wisdom on Which is Better for Young Investors

When I was fresh out of college and starting my first job, my dad convinced me that I needed to start saving for retirement. Even if it was just a little bit, [getting started early was important](). Thanks dad!

At the time I was working for a small start-up without an employer-provided retirement plan, so I needed to figure things out on my own and quickly found my way to the IRA. What an ingenious little device! A retirement account you can set up on your own and invest pretty much however you want? Pretty cool!

So I went about setting one up and quickly found that I needed to make a choice. Did I want to open a Traditional IRA or a Roth IRA? I went out in search of advice and found the response to be pretty much unanimous: a Roth IRA was the way to go. The logic was the same no matter where I looked and went like this:

1. I was young and in a low tax bracket.
2. Someday I would be older and in a higher tax bracket.
3. Given that, I should pay the taxes now to get tax-free income later.

Makes sense right? It did to me. So I opened up a Roth IRA and happily stuffed it with money for years without so much as a second thought.

But over the years I continued to learn, and in that time I've discovered that the logic that leads people like myself to a Roth IRA is flawed. In fact, the Traditional vs. Roth IRA debate looks a lot different when you actually run some numbers and see the results.

So today I want to show you the truth behind the Traditional vs. Roth IRA debate in the hopes that you can make a more informed decision than I did when I started out.

Why the conventional wisdom is harmful

Let me get this out of the way. As long as you're saving for retirement you're doing a great job. As I said in my series on how to start investing from scratch, the most important decision you can make is to get started, not which IRA you choose. That has not changed.

With that said, the end goal of investing is to have saved as much money as you need within the timeframe you need it. If there are easy ways to make that more likely, you should take advantage of them.

The problem with the conventional wisdom in the Traditional vs. Roth IRA debate is that it's mathematically incorrect, and it therefore leads a lot of people down an inefficient path. It's not a bad path, it's just that for many people there is a better one that will help them reach their goals more easily.

In order to explain where the conventional wisdom goes wrong and how we should be thinking about it instead, I'm going to have to back up a little bit and make sure we all understand some of the basic definitions first. For that reason, this post will be a little longer than normal, but I hope you stick with me because the conclusion can make a big difference in your retirement planning.

What's the difference between a Traditional IRA and a Roth IRA?

There are several ways in which a Traditional IRA differs from a Roth IRA, but today I'm only going to focus on the biggest difference. If you'd like a more comprehensive list, including guidelines for whether you are actually eligible to contribute to either one, you can check out this resource: Which IRA is right for you?

The biggest difference between a Roth IRA and a Traditional IRA has to do with how they are taxed.

Traditional IRA taxation

Any money contributed to a Traditional IRA is treated as a tax deduction in the year of the contribution. This lowers your taxable income for the year, giving you an immediate benefit.

As an example, if you're a married couple in the 15% tax bracket and you contribute the maximum $11,000 to a Traditional IRA for 2013, you will save yourself $1,650 in taxes for 2013 (0.15*11,000).

The flip side is that when you actually reach retirement and start taking money out of the account, those withdrawals will all be taxable.

Roth IRA taxation

The tax treatment for a Roth IRA is exactly the opposite.

Your contributions to a Roth IRA are not deductible and therefore do not save you any money on this year's taxes.

On the other hand, your withdrawals in retirement are 100% tax-free. In other words, you pay your taxes now in order to be tax-free later.

Understanding different kinds of tax rates

The last thing I want to talk about before I get into the real meat of the comparison is the difference between a **marginal tax rate** and an **effective tax rate**.

Don't worry, I'm not going to get too technical here. But understanding this difference is crucial to making a true comparison between a Traditional or Roth IRA.

Marginal tax rate

A **marginal tax rate** is the tax you will pay on your last dollar of income. If you're in the 15% tax bracket, your marginal tax rate is 15%. Your last dollar earned was taxed at 15%, and if you earn another dollar it will be taxed at 15%.

Effective tax rate

But you didn't pay 15% in taxes on your entire income. In fact, with the standard deduction and personal exemptions, there's a good chunk of your income that you didn't pay any tax on at all. And because of our progressive tax code, there's another chunk of it that was only taxed at 10%. So your **effective tax rate** is the percent of your total taxes paid over your total income, and will be significantly lower than 15%.

An example

Let's look at a simple example of a married couple with 1 child earning $53,000 per year. Their marginal tax rate is 15%. But what's their effective tax rate?

You can look at my worksheet here to see the calculations, but the end result is that **the couple's effective tax rate is only 6.5%**.

So what's the real Traditional vs. Roth IRA Comparison?

Okay, now that we've gotten all of those definitions out of the way, it's time for the real meat of the article: how you should really be making the decision about contributing to a Traditional IRA vs. a Roth IRA.

Please keep in mind that this conversation applies in the same way if you have the choice between a Traditional 401(k) and a Roth 401(k).

The conventional wisdom behind the Traditional vs. Roth IRA comparison looks at your marginal tax rate today against your marginal tax rate in the future. This is wrong.

What you need to do instead is compare your MARGINAL tax rate TODAY with your EFFECTIVE tax rate in the FUTURE.

That's because any contributions to a Traditional IRA save you money at your marginal rate today, but any future withdrawals are taxed at your effective rate.

Let's look at an example. You can follow my calculations and change some of the variables in this workbook here: Traditional IRA vs. Roth IRA.

For this example, I'm going to assume that all of our tax policies will stay the same over the years. This clearly won't happen, but since we have no idea what WILL happen it doesn't really make sense to speculate. I'm also going to ignore inflation, which just makes things more complicated and doesn't materially affect the end result.

Finally, I'm ignoring the possibility that you have a pension or that you will receive Social Security income, since most young people don't have a pension and Social Security is so variable from person to person. The existence of either of those would change the calculations below in favor of a Roth, though not necessarily fully in favor of it.

In this example we're using the same married couple we used above making $53,000 with one child, which puts them in the 15% tax bracket. We're assuming they could contribute the maximum $11,000 per year allowed for a married couple to a Traditional IRA. With a Roth they would have to pay taxes on that $11,000, so their annual contribution is only $9,350 ($11,000 * (1 - 0.15)).

The conventional wisdom says that the 15% tax bracket is low and they should therefore contribute to a Roth.

So how does it actually play out? Well, when we actually run the numbers, as you can see in the spreadsheet linked above, we discover a few things that really challenge the conventional wisdom.

First of all, after 30 years of saving for retirement the balance in the Roth IRA is $1,143,934. Using the standard 4% withdrawal rule to determine how much they can take out each year in retirement, that would give them a $45,757 annual income in retirement. That is 100% tax-free.

With the Traditional IRA, their balance after 30 years is $1,345,805. It's about $200,000 higher because they were able to contribute more because of the tax-break. But the withdrawals are taxable, so that's not the full comparison.

To get the final comparison, we have to first calculate the 4% withdrawal for the Traditional IRA, which comes out to $53,832 per year before taxes. Notice that this is almost the same as their $53,000 in income during their working years. (These numbers were not chosen by accident).

The conventional wisdom would argue that because your income is essentially the same, and therefore your marginal tax rate is the same, it shouldn't make a difference whether you contributed to a Roth or a Traditional IRA. Does that hold up?

When we take taxes out of that $53,832 per year, we find out that our withdrawal ends up being $49,650 after-tax. So let's do a quick comparison of the results:

Type	After-Tax Withdrawal	Difference
Roth	$45,757	
Traditional	$49,650	$3,893

I don't know about you, but I would rather have that extra $3,893 of income every year.

What's the reason for this difference?

The big reason why the Traditional IRA comes out ahead has to do with the difference between marginal and effective tax rates that we talked about above.

In this particular example, the Roth IRA contributions would be taxed at the MARGINAL rate of 15%, while Traditional IRA contributions would be tax-free.

At the other end, the Roth IRA withdrawals would be tax-free while the Traditional IRA withdrawals would be taxed at an EFFECTIVE rate of 7.8%.

So by going with a Traditional IRA in this example, the couple would essentially be choosing to pay 7.2% less in taxes, **even though their marginal rate would be the same at each point in time**. Over 30 years of saving that adds up to a significant difference.

Conclusions

Now let me be clear. This doesn't mean that a Traditional IRA is always better than a Roth IRA. There are many variables that might make your specific situation different from the example shown here. Some of those variables will tilt the scales in favor of a Roth IRA. Others will tilt them in favor of a Traditional IRA. A true personal evaluation will be more nuanced than what's presented here.

But what should be clear is that the conventional wisdom behind the Traditional vs. Roth IRA debate is wrong. You cannot simply compare your tax rate now to your expected tax rate in the future. Doing so drastically underestimates the value of a Traditional IRA.

One of the biggest financial decisions you will make is how to save for retirement. My hope is that this helps you make a more informed decision.

5 Reasons a Roth IRA Might be Right for You

Last week I wrote an article debunking some of the conventional wisdom around the Traditional vs. Roth IRA comparison. Today's post will refer to that one frequently, so if you haven't read it yet you might want to before continuing on (link: Traditional vs. Roth IRA: Some Unconventional Wisdom on Which is Better for Young Investors).

In that post, we came to the conclusion that a Traditional IRA can often be much more favorable than it's often considered to be, even for young investors and even for people currently in low tax brackets (people for whom the Roth is almost universally recommended).

It would be easy to walk away from that article and feel like the Traditional IRA is now the definite way to go, but as is true with most things it's almost never that simple.

There are plenty of situations where a Roth IRA can be a good idea and I'd like to run through some of them today.

We aren't robots. You'll probably contribute more to a Roth IRA.

To fairly compare a contribution to a Traditional IRA with one to a Roth IRA, you can't compare contributions of the same amount. In other words, a contribution of $X to a Traditional IRA is really not the same as a contribution of that same $X to a Roth IRA because a Traditional contribution is tax-deductible (but will be taxed later) while a Roth contribution is after-tax (but will not be taxed later). The current tax savings you get from a Traditional contribution means you can fit a bigger contribution in your budget.

This was illustrated in my previous article comparing a Traditional with a Roth IRA with the example in which a married couple was deciding between either maxing out their Traditional IRA ($11,000), or contributing the equivalent after-tax amount to a Roth IRA ($9,350 in the example with a 15% tax bracket). An alternative way to compare equivalent after-tax contributions would be to compare an $11,000 Roth IRA contribution with an $11,000 Traditional IRA contribution PLUS an investment of the tax savings offered by that Traditional contribution.

But the reality is that while this is a mathematically correct comparison, people aren't robots and don't often think like this. A lot of people will simply consider that they have $X to contribute. In other words, they'll be deciding something like whether to put $5,000 into a Traditional IRA or $5,000 into a Roth IRA.

If those are the choices, then a Roth IRA wins because you're contributing more after-tax dollars. $5,000 that will never be taxed is more than $5,000 that will eventually be taxed. Simple as that.

So while we can certainly debate ideologically about which is better based on the technically correct math, in terms of actual behavior many people will end up contributing more after-tax dollars to a Roth IRA than a Traditional IRA simply because the mental accounting is easier.

If you're willing to put in some extra effort and add that extra investment on top of your Traditional IRA contribution, then great! But if not, then the simplicity of maxing out the Roth IRA is likely to be your best bet. It may not be mathematically perfect, but we're not robots and we shouldn't expect ourselves to be.

You expect to have other income in retirement

I mentioned this a couple of times in the previous article, but only in passing. The example in that article assumed that your IRA was your only source of retirement income and that simply may not be true for a lot of people.

The reason this matters is that any other income you're counting on will fill up at least some of those lower tax brackets that served to make the effective rate on the Traditional IRA withdrawals so low. If you have enough other income, then your IRA withdrawals will end up being fully taxed at your marginal rate in retirement.

The most likely source of income for most people is Social Security. For all of the death knells that seem to pop up in the media, Social Security is alive and kicking and many people are collecting steady paychecks from the government in their retirement. An article from Michael Kitces also informs us that even if NOTHING is done to address the current Social Security shortfall, we should still be able to receive 70% of our estimated benefits. So it seems like counting on some amount of Social Security is certainly prudent.

If you'd like to know your current estimated Social Security benefits, you can follow the instructions here: How to Check Your Social Security Benefits.

But there are other potential sources of income as well. Some people still have a pension (lucky dogs!). Others plan on doing part-time work well into their retirement years. Others will have investments in regular old taxable accounts pumping out interest and dividends each year.

The point is that wherever it's coming from, any income in addition to withdrawals from a Traditional retirement account can increase the effective tax rate on those Traditional withdrawals. Depending on what tax bracket that other income takes you into, it could be beneficial to have some tax-free Roth money to avoid extra taxes.

Now to be clear, this doesn't mean that having other income automatically makes a Traditional IRA a bad choice. Far from it. It just means that that other income sources need to be considered when making the Traditional vs. Roth evaluation for yourself.

Tax diversification

Just like I talk about the value of diversifying your investments, there can be value in diversifying the tax benefits offered by a Traditional account vs. those offered by a Roth account

In my previous article, I presented the Traditional vs. Roth IRA debate as an either/or decision. The reality is that you don't have to choose one or the other. You can choose to do a little of each and there are certainly arguments for doing so.

Having some money in a Traditional IRA will give you the opportunity to fill up at least some of those lower tax brackets in retirement. This will let you save more in taxes today that you will have to pay back later.

Having some money in a Roth IRA will protect you from some of the risk that either tax rates will rise or that you'll have enough income in retirement to push you into a higher tax bracket (lucky you!).

Keep in mind that diversification doesn't have to mean a 50-50 split between the two. It can be any proportion you want. But there is certainly some merit to this type of approach.

You want to pay now for certainty later

At its core, a Roth IRA is simply a way for you to pay now for certainty later. The reality is that we don't know what the tax laws will be years down the road, and it can be comforting to know that you have some money that you'll be able to access tax-free.

We can run all of the illustrations and do all the math in the world to try and determine when doing so is the "optimal" decision, but in the end some people just want the assurance of a Roth IRA.

Flexibility

The Roth IRA has some flexibility built into it that a Traditional IRA doesn't. We'll run through some of those features here.

Availability of contributions – Any contributions you make to a Roth IRA are available for you to withdraw at any time without tax or penalty. In most cases this probably isn't advisable, but it's an option that can be useful and isn't available with a Traditional IRA. If you'd like to read more about this, see here: Roth IRA as an Emergency Fund – Is it a Good Idea?

Continue contributing for longer – Roth IRAs allow you to continue to make contributions past the age of 70.5. Traditional IRAs do not. This means that if you have earned income later in life, the Roth can be a good way to continue getting some tax benefits.

Required minimum distributions – With a Traditional IRA the government will eventually force you to start taking withdrawals, typically at age 70.5. This has the potential to limit your options in retirement, and a Roth IRA does not have this requirement.

Estate planning – There are various reasons a Roth IRA can be useful for estate planning, particularly if you have money that you want to pass on to children. You can find a good overview of those reasons here: Estate planning opportunities with Roth IRA conversions.

Conclusions

Unfortunately, there is no one-size-fits-all answer to the Traditional vs. Roth IRA debate. Both have their merits and as with almost anything else, it requires a personal evaluation of your own circumstances to determine the right approach for you.

3 More Unconventional Reasons to Contribute to a Traditional IRA

In the past couple of weeks, we've talked about some unconventional wisdom in the Traditional vs. Roth IRA debate showing a big potential benefit of a Traditional IRA that isn't often discussed. We then countered that with an article looking at 5 reasons a Roth IRA might be right for you.

If those two weren't enough to make your head swim, today I'm going to give you **3 more reasons to consider contributing to a Traditional IRA**.

My goal with this mini-series is simply to help you make a more informed decision by pushing past some of the conventional wisdom floating around out there. Retirement planning is an important part of your family's future and I think you deserve to know all the facts, not just the 5-second sound bites many financial "gurus" like to spit out.

So without further ado, here are 3 more unconventional reasons to contribute to a Traditional IRA.

You can convert to a Roth IRA when it makes sense

One point that's often lost in the Traditional vs. Roth IRA debate is that as the law stands currently, you don't have to contribute to a Roth IRA right now in order to take advantage of the Roth IRA later. That is, you can contribute to a Traditional IRA today to take advantage of the tax deduction, and then later, *at a time of your choosing*, CONVERT some or all of that money to a Roth IRA. You will pay taxes on any amount you convert, but this can be a HUGE benefit if done correctly.

Here's an example:

Jack and Jill are a married couple making $75,000 per year, putting them squarely in the 15% tax bracket. Their state also has a 5% income tax, so their total income tax rate is 20%.

They could choose to contribute to a Roth IRA this year and lock in that 20% rate on the contribution. Or they could choose to contribute to a Traditional IRA, save the 20% in taxes, and give themselves some flexibility.

A couple years down the road, let's say that Jack and Jill have saved some money and decide that they want to take a big risk. They're going to quit their jobs and start the business they've always dreamed of running together. Exciting, right?

Very exciting! But the reality is that they'll probably have little to no income for the first year, and maybe even the second year as well. If they have some money in a Traditional IRA (money that they saved 20% in taxes on when contributing), they could use those low-income years to convert some or all of it to a Roth IRA. Yes, there are tax consequences. But because they don't have other income they could potentially convert at least some of it at a 0% rate (because of the standard deduction and personal exemptions). They could also do some at the 10% rate. State taxes would be in addition to both of those.

So they would end up being able to put their money into a Roth IRA, money that will never be taxed again, and save EVEN MORE in taxes because they did it on their own schedule through a conversion rather than locking themselves in with a contribution.

This opportunity doesn't only come up when you start a business. There are many reasons why you might be in a lower tax bracket in the future and could potentially take advantage of this. Maybe you go through a period of unemployment. Maybe you change careers and temporarily take a lower salary. Maybe you have a child and one parent decides to stay home. Maybe you retire early.

The point here is that the conversion option gives you flexibility and choices, but only if you start with a Traditional contribution. A Roth contribution locks you into your current tax bracket.

As of 2014, there are no income limits and no limit to the amount you are allowed to convert. So this option is open to everyone.

Update: *I actually did this myself in 2014. You can get the details here: Finding the Silver Linings in a Lower Income.*

Potentially avoid or reduce state income tax

When discussing taxes, people often only talk about Federal income tax rates. That is, someone will say they're in the 15% tax bracket, meaning they pay 15% in taxes to the Federal government.

But there are many states that have an additional income tax, and Traditional IRA contributions give you a break on that tax too. Here in Massachusetts the income tax rate is a flat 5.2%, so any Traditional contributions I make save me 5.2% in current taxes in addition to the savings on Federal taxes.

Depending on where you live now and what your plans are for later in life, it's possible that you'll one day live in a state that either has a smaller income tax or no income tax at all (Florida anyone?). If that's the case, you could save some real money with a Traditional contribution by getting the benefit of the deduction in the higher tax bracket today AND the benefit of withdrawing in a smaller tax bracket later.

As a quick example, as I said above I could save 5.2% in state income taxes by contributing to a Traditional IRA today. If we someday move to Florida (very possible given that my wife is from Pensacola), my Traditional IRA withdrawals would never be subject to state income tax. I would have completely avoided it!

It all depends on the personal situation of course, but this is worth considering especially if you currently live in a state with high income taxes. Two resources where you can look up income tax rates by state are here and here, though neither was updated for 2015 as of the time of this writing.

Your contribution helps you qualify for tax credits and deductions

Just recently I talked about the saver's credit, which allows certain people to get a tax break (up to $2,000 per year) when they contribute to their retirement accounts. The saver's credit is just one of many tax credits and tax deductions that relies on a number called AGI (adjusted gross income) to determine whether you're eligible to take it.

Your AGI is simply your full income with certain things taken out, like contributions to a tax-deductible retirement account (such as a Traditional IRA or 401(k), not a Roth), contributions to a health savings account, moving expenses, etc. You can see a more complete list here.

One of the reasons a Traditional IRA contribution can be so valuable is that it lowers your AGI. And the lower your AGI, the more likely you are to qualify for some really valuable tax credits and deductions.

Here's a short list of tax breaks that are either reduced or completely eliminated once you reach a certain level of AGI:

- **Saver's credit:** Up to a $2,000 tax credit. Completely eliminated for married couples once AGI exceeds $60,000.
- **Child & dependent care credit:** Up to $1,050 for one child, $2,100 for two or more. The amount you can claim decreases with AGI but is never completely eliminated.
- **Medical expense deduction:** You can only deduct the amount that exceeds 10% of your AGI (7.5% if you or your spouse are 65 or older). Obviously, the lower your AGI, the lower the threshold.
- **Dividends and capital gains:** This isn't actually a credit or deduction, but taxpayers in the 15% tax bracket or lower don't have to pay taxes on these. So lowering your taxable income with a Traditional contribution can definitely help here.

There's another number, called Modified AGI (MAGI), that adds certain things back to AGI and is used to determine eligibility for other credits and deductions. One of the things that gets added back are any IRA deductions, which slightly lessens the value of the Traditional IRA. But Traditional 401(k) contributions still help you qualify, so if your Traditional vs. Roth decision is in a 401(k) you should keep these additional tax breaks in mind:

- **Child tax credit:** Up to $1,000 per child. Starts phasing out for married couples at MAGI of $110,000.
- **American opportunity tax credit:** Up to $2,500 per student for qualifying education expenses. Completely eliminated for married couples once MAGI exceeds $180,000.
- **Lifetime learning credit:** Up to $2,000 per family for qualified education expenses. Completely eliminated for married couples once MAGI exceeds $128,000.

There are plenty more, and you should talk to a tax professional if you want to understand which might specifically apply to your personal situation.

Conclusions

As we've said many times by now, the final decision in the Traditional vs. Roth debate depends very much on your own personal financial situation. My goal in this mini-series was simply to give you some things to think about when making the decision that maybe you hadn't considered before.

About the Author

Hi, I'm Matt Becker. I'm a fee-only financial planner and the founder of Mom and Dad Money, where my mission is to help new parents build a better financial future for their families.

I have two young boys myself, so I know first-hand how hard it can be to handle all the new financial responsibilities that come with starting a family. It's not easy to figure out what you're supposed to be doing, how to prioritize everything, and how to fit it all within a limited budget. And when you add all that on top of the challenge of caring for your children, it can create a lot of stress, anxiety and maybe even some tension between you and your partner.

I created my practice to make all of that easier and less stressful for you. Every day I help new parents just like you to set financial goals, create a spending plan that actually works, get the right protections in place, and start saving for the future. I know how confusing it can be to navigate all of that yourself (my wife and I had plenty of trouble ourselves), so my role is to act as an objective advisor who can help you see the big picture and figure out how all the pieces fit together. With the right plan in place, my clients spend less time worrying about money and more time enjoying their growing families.

If you would like someone to talk to about your money questions, I invite you to schedule a free, no-obligation phone call so that you can tell me a little more about your situation. Even the simple act of talking about your struggles and concerns can bring you a lot of relief, so please click the button below to schedule your call.

CLICK TO SCHEDULE

You can also go directly to this URL, http://momanddadmoney.com/consult, or just shoot me an email at matt@momanddadmoney.com and we'll work it out.

I'm looking forward to talking to you soon!

Matt

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