Traditional vs. Roth IRA

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Traditional vs. Roth IRA: Running the Numbers

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? 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 at the time, so I opened up a Roth IRA and happily contributed to it for years without so much as a second thought.

But over the years I continued to learn, and in that time I 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 in this mini-guide 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 wrong

Let me get this out of the way. As long as you're saving for retirement you're doing a great job. The most important decision you can make, by far, is to start saving money, not which IRA you choose.

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 you should be thinking about it instead, I'm going to have to back up a little bit and make sure we're on the same page with the basic definitions first. Let's get that out of the way now.

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 for now I'm only going to focus on the biggest difference. We'll get into some of the other pros and cons in a bit.

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 your Traditional IRAs in 2017, you will save yourself $1,650 in taxes that year (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 as regular income.

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 access the money tax-free later on.

Understanding different kinds of tax rates

The last thing we need to talk about before we 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

Your **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 calculated by dividing your total taxes paid by 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%**.

While they pay 15% tax on any additional dollar they earn, their total tax bill only comes out to 6.5% of their income.

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 this comparison: how you should really be making the decision about contributing to a Traditional IRA vs. a Roth IRA.

Please keep in mind that these numbers work 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 I'm using the same married couple I used above making $53,000 with one child, which puts them in the 15% tax bracket. I'm assuming they could combine to contribute the maximum $11,000 per year allowed 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, that would give them an annual income in retirement of $45,757. 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.

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?

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

Type	After-Tax Income	Difference
Roth IRA	$45,757	
Traditional IRA	$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.

Make a smarter decision

To 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 the example 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.

So, now let's look at some of the other factors that should play into your decision.

5 Reasons a Roth IRA Might be Right for You

Clearly, a Traditional IRA is often a better deal than it's 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).

But there are plenty of reasons why a Roth IRA still might be a better choice. Here are five of the biggest.

1. You aren't a robot. You'll probably contribute more to a Roth IRA.

To fairly compare Traditional IRA contributions to Roth IRA contributions, you have to make adjustments for taxes. 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 IRA contribution means you can fit a bigger contribution in your budget.

That difference was illustrated in the chapter above 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 IRA contribution to a different account (like a 401(k)).

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 decide that they have $X to contribute. For example, they may want to max out their IRA the choice is whether to put that $5,500 in a Traditional IRA or a Roth IRA.

If that's the choice, then a Roth IRA is better because you end up contributing more after-tax dollars. $5,500 that will never be taxed is more than $5,500 that will eventually be taxed. Simple as that.

So while we can certainly debate about which is better based on the technically correct math, and while you certainly CAN use that information as part of your decision making process, 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 you're not a robot and you don't have to act like one.

2. You expect to have other income in retirement

The example in that first chapter assumed that your IRA was your only source of retirement income, and that likely won't be the case.

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.

In fact, according to the 2013 Trustees Report on Social Security, it should still be able to pay out about 70% of the current estimated benefits for the rest of the century even if no changes to the program are made. So you will likely have at least SOME retirement income in addition to whatever you're withdrawing from retirement account.

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 the amount of that income, 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.

3. Tax diversification

Just like it's a good idea to diversify your investments, there can be value in diversifying the tax benefits offered by a Traditional IRA vs. those offered by a Roth IRA.

See, framing this as a battle between different types of IRAs is a little misleading. Because 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.

And having some money in a Roth IRA will protect you from the risk of higher tax rates in the future, either because of changes to the law or because of increase in your income.

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.

4. 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 you may just want the assurance of a Roth IRA.

5. Flexibility

The Roth IRA has some flexibility built into it that a Traditional IRA doesn't. Here are some of the main features.

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 in certain situations and isn't available with a Traditional IRA.

College savings – A Roth IRA can actually be a good place to put your college savings. You can withdraw up to the amount you've contributed tax-free and penalty-free at any time and for any reason, and you can withdraw amounts above that penalty-free if the money is used for higher education expenses (though you will be taxed). Plus, if you don't end up needing the money for college, you can simply keep it in your account for retirement.

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. Roth IRAs do not have this requirement as of now, though there have been proposals in Congress to add it.

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.

Roth IRAs are great!

The bottom line is that Roth IRAs are fantastic accounts and there are many situations in which using one is absolutely the right decision.

But now let's look at a few more reasons why you might consider a Traditional IRA instead.

3 More Unconventional Reasons to Contribute to a Traditional IRA

If all of the above wasn't enough to make your head swim, now I'm going to give you 3 more reasons to consider contributing to a Traditional IRA.

These three things aren't talked about much when people debate this topic, but in the right situations they could save you a lot of money.

1. You can convert to a Roth IRA when it makes sense

As the law stands right now, everyone has the ability to convert as much Traditional IRA money to Roth IRA money as they want at any time, without limit.

What that means is that 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'll pay taxes on the money 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. Not great, but it does give them an interesting opportunity.

If they have 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. They would be taxed on the conversion, but because of their lack of 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 would 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 2017, there are no income limits and no limit to the amount you are allowed to convert. So this option is open to everyone.

2. 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 many states have their own income tax on top of the Federal income tax, and in some states the tax rate is fairly high. And Traditional IRA contributions are deductible for state tax purposes as well.

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 by contributing to a Traditional IRA, getting the benefit of the tax deduction today, and later on getting the benefit of withdrawing it while in a lower tax bracket.

As a quick example, let's say you live in a state with a 5% income tax. If you contribute to a Traditional IRA today and then eventually move to Florida, you can avoid ever paying that 5% tax on the money you contribute.

It all depends on your personal situation of course, but this is worth considering especially if you currently live in a state with high income taxes. You can find details on your state income tax rate here: http://www.bankrate.com/finance/taxes/check-taxes-in-your-state.aspx.

3. Qualify for tax credits and deductions

There are a number of tax credits and tax deductions that rely 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 $62,000.

- **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 $131,000.

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.

Roth or Traditional? No Wrong Answer.

Unfortunately, there’s no way to know for sure whether you’ll be better off contributing to a Traditional IRA or a Roth IRA. A definitive answer would require knowing both your future income and future tax rates, and there’s no way to be sure about either of those.

Hopefully though, everything above puts you in a position to make a better, more informed decision for yourself.

And no matter what, remember that both the Traditional IRA and the Roth IRA are fantastic accounts. As long as you’re contributing to one of them, you’re in good shape.

Want More Guidance?

I know how hard it can be to balance all the financial responsibilities that come with starting a family. From paying your bills, to saving for the future, to trying to enjoy yourself in the meantime, it's not easy figuring out what to prioritize and how to find room for everything.

As a fee-only CERTIFIED FINANCIAL PLANNER™ who specializes in working with new parents, I work every day with other parents who want to make the right financial decisions for their families. And as a dad with two young boys myself, my wife and I are going through many of the same things you are.

It's not easy. And that's why I offer a range of options for you to get more guidance.

If you'd like more help with your financial questions, here are a few different ways you can get it:

- The **Jump Start Session** allows us to work together to craft a personalized financial plan for your specific goals and situation. And it's pay-what-you-can so that you can get the advice you need at a price you can afford.
- If you're more of a DIYer, I offer a variety of **financial guides** designed to walk you step-by-step through the most important parts of your financial plan..
- Please feel free to email me any time with any questions that are on your mind. I'd love to hear from you and I'm always happy to help. My email address is matt@momanddadmoney.com.