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To Roth or Not To Roth – Which Is Better For You?

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To Roth or Not to Roth—Which IRA is better for you?*

Key points

- **Roth IRAs are likely to be better for people who**
  - Expect their tax bracket to be higher in retirement than now
  - Who expect not to need distributions from their retirement accounts to meet living expenses
  - Who expect to have an estate tax liability
- **Traditional IRAs are likely to be better for people who**
  - Expect their tax bracket in retirement to be lower than now.
  - Who want to save for retirement but also need the cash flow of a current tax deduction.

The government offers two choices for IRAs and 401(k) plans: traditional and Roth. With a traditional IRA or 401(k) you get a tax break now, but might have to pay for it later. Conversely, with a Roth IRA you pay taxes up front but can enjoy significant tax savings in the future. Whenever you face a choice, you have an opportunity but also a risk. Choose correctly and you can minimize income and estate taxes, but choosing wrongly can cause you to pay unnecessary taxes. Certainty about knowing whether a traditional or Roth IRA is better for you would depend on knowing the future, which of course is impossible. However, this article will show you how to make an optimal selection based on what you know now.

Comparison between Roth and traditional IRAs—basic rules

The table below summarizes the differences between Roth IRAs and traditional IRAs in their basic forms. Special situations where the generalizations in the table below do not apply include inherited IRAs, traditional IRAs where you do not take a tax deduction for contributions, and some circumstances when you can take distributions before age 59 ½ without paying penalty taxes.

When a Roth IRA is likely to be advantageous

The comparison between Roth and traditional IRAs suggests when Roth IRAs would be potentially better. Since you do not get a tax deduction for Roth IRA contributions, they are relatively more attractive when you are in a low tax bracket when you are making contributions. A prime example would be a worker early in her career.

Traditional IRA	Roth IRA
Take a tax deduction for the year in which you contribute	No tax deduction for contributions
Pay taxes on every distribution	No taxes due on distributions
Required distributions starting at age 70 ½	No required distributions
Contribution limits: $5,500 each year before age 50, $6,500 thereafter	Contribution limits: $5,500 each year before age 50, $6,500 thereafter
Income limits to take a tax deduction for your contribution (You can make a contribution without taking a deduction at any income level.[1])	Income limits to contribute to a Roth

In a similar vein, if you expect to be in a high tax bracket in retirement then a Roth IRA could be the better choice. This is particularly true if you expect not to need the required distributions to meet your living expenses. In that fortunate situation, required distributions create unnecessary tax liabilities that you can avoid with a Roth.

When a traditional IRA is likely to be advantageous

If you are in a high tax bracket while working, yet have difficulty meeting your expenses then the tax deduction of a traditional IRA contribution could make it easier for you to save for the future. An example would be a middle-aged parent who has to pay for his children's college expenses.

How your investment strategy should influence your IRA choice

Let's suppose you are fortunate enough not to need a tax deduction to help meet current expenses. Notice in the table that the contribution limits are the same for Roth IRAs and for traditional IRAs. So, for example, if you have $5,500 available to contribute to a Roth IRA, you could equally contribute the $5,500 to a traditional IRA and then invest the amount of tax savings in a separate account. That means that for someone in a 35% income tax bracket, a Roth IRA contribution of $5,500 has the same budget impact as a traditional IRA contribution of $5,500 plus an investment of $1,925 (35% of $5,500) in a taxable account.

Which of these options is better for you? In part, it depends on your investment preferences. If you are a tax-efficient investor then the traditional IRA might be better: The taxable investment of $1,925 could be in municipal bonds or in securities held for the rest of your life and never be taxed. Conversely, if you favor tax-inefficient strategies such as taxable bonds, REITs or shorter term trading, setting aside money in a taxable investment account could increase your tax liability

[1] Making contributions to a traditional IRA without taking a deduction is a way of getting around the income limits on contributing to a Roth IRA. It is an interesting, but complicated topic that we will address in the next issue of *Systems and Forecasts.*

as you would be paying taxes on your investment returns prior to retirement and also paying taxes on required IRA distributions during retirement.

From a financial planning perspective, if you do not have significant available cash then it is preferable to have a traditional IRA plus taxable savings as a liquidity reserve rather than tying up all available assets in a Roth IRA account that you should view as inaccessible until retirement.

Converting a traditional IRA to a Roth IRA

What if you decided to accumulate assets in traditional IRAs and then decided that a Roth IRA makes more sense for you? You can at any time convert your traditional IRA into a Roth, but doing so will incur an income tax liability for the amount converted. Converting a traditional to a Roth IRA basically amounts to pre-paying an income tax bill now in order to avoid one in retirement or upon death. When would this be a shrewd strategy?

As a general principle, you should not convert a traditional IRA into a Roth unless you have other, expendable taxable assets with which to pay the income tax that would result. But if you do have the available cash, there are two situations when a Roth IRA conversion can be profitable:

1. If you find yourself in a temporarily low tax bracket.
2. If you want to reduce the size of your estate.

The estate tax situation can be subtle, but not if you live in New York State. New York as an unusual estate tax where estates under $5.25 million do not owe any estate tax but estates above $5.25 million owe tax on the full amount, with no amount exempt from tax. (In contrast, the federal estate tax exempts the first $5.49 million, so taxes are owed only on the amount of the estate that is above $5.49 million. Most other states with estate taxes are similar, although Massachusetts has a similar "estate tax cliff" that kicks in for estates of more than $1 million.)

The bottom line is that converting from a traditional to a Roth IRA and paying the resultant income tax will reduce the size of your estate. If you live in New York or Massachusetts and are able to nudge your estate below the estate tax thresholds by converting to a Roth IRA, the savings could be substantial.

Implications

The decision to contribute to a traditional IRA or a Roth IRA, or the decision to convert from a traditional to a Roth IRA, depends on your individual situation. One size does not fit all, and as always, I am available to advise our investment management clients on this decision. If you are not a client of ours and would like financial planning services, give me a call.

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