

# IRA TRADITIONAL OR ROTH?

*If you elect to contribute to an IRA, you must decide if you want utilize a Traditional or Roth IRA. Both are good options to save additional funds for retirement, and both offer tax saving advantages – but is one a better choice than the other? The contribution limits for both options are the same. In order to determine which is the better choice, you need to consider differences in taxation and ask yourself... which option will provide you with the most after tax income during retirement?*

A Traditional IRA provides tax savings in the form of “pre-tax” contributions. Money you contribute can be taken as a deduction, which lowers your Adjusted Gross Income and reduces your taxes for that year. The account grows tax-free and when you take distributions, all withdrawals, including contributions and earnings, are subject to state and federal income taxes.

Contributions to a Roth account are made on a “post-tax” basis. You pay taxes up-front and contributions cannot be deducted from your yearly income, but when you reach retirement age both the earnings and contributions can be withdrawn tax-free.

## THE GOAL OF “MORE MONEY” – IT’S COMPLICATED...

One of the common assumptions often made is a Roth will provide more money at retirement. This may or may not be true. Let’s compare a Roth vs. a Traditional IRA using an average income tax of 25% and 5% rate of return for each account. When the tax rates and the rates of return are identical, would one option put more dollars in your pocket during retirement?

For this example, both of our savers have reviewed their budgets and determined they can afford to contribute about \$75 each month.

The Roth saver will pay taxes first, and then make the monthly post-tax contribution to the IRA. At a 25% tax rate, in order to contribute \$75 they must earn \$100. \$25 will be paid in taxes and the remaining \$75 contributed to the Roth IRA. At retirement, the distributions will be tax-free.

The Traditional IRA saver will pay taxes when they take distributions, but because they are not paying taxes up front, the \$25 dollars that would have gone to taxes can instead go into the IRA. *Their \$100 contribution will result in the same \$75 reduction as the Roth saver.*

Now let’s apply the 5% rate of return over a 20-year time-frame\* and then deduct the 25% in taxes the Traditional IRA saver would pay on distributions during retirement.

ROTH
Post-Tax Monthly Contribution = \$75
After 20 years & 5% return = \$30,827.53*
Account is tax free = \$30,827.53

TRADITIONAL
Pre-Tax Monthly Contribution = \$100
After 20 years & 5% return = \$41,103.37*
After 25% tax = \$30,827.53

In both examples our savers have earned \$100 in income but the Roth saver gives up 25% of this to taxes which reduces the amount they can contribute each month. Our Traditional IRA saver must pay taxes when they take distributions, but if they are taxed at the same 25% rate, they end up with the same \$30,827.53. The argument can be made that the Roth saver essentially paid less overall in taxes but what tangible financial benefit did they gain? If both savers contribute an equal amount, say \$100, then the Roth does provide more funds at retirement – *but failure to increase the contribution rate when participating in a Traditional IRA diminishes the tax benefit it provides.*

## TAXES – A BIG PART OF THE EQUATION.

So all things being equal, which option is going to provide you the most income for retirement? It all revolves around what percentage you end up paying in taxes. As your Adjusted Gross Income (AGI) increases, so do your tax rates.

FILING STATUS SINGLE	
2020 AGI BRACKETS	TAX RATE
\$0 – \$9,875	Taxed at 10%
\$9,876 – \$40,125	Taxed at 12%
\$40,126 – \$85,525	Taxed at 22%
\$85,526 - \$163,300	Taxed at 24%
\$163,301 - \$207,350	Taxed at 32%
\$207,351 - \$518,400	Taxed at 35%
\$518,401 - above	Taxed at 37%

MARRIED FILING JOINTLY	
2020 AGI BRACKETS	TAX RATE
\$0 – \$19,750	Taxed at 10%
\$19,751 - \$80,250	Taxed at 12%
\$80,251 - \$171,050	Taxed at 22%
\$171,051 - \$326,600	Taxed at 24%
\$326,601 - \$414,700	Taxed at 32%
\$414,701 - \$622,050	Taxed at 35%
\$622,051 - above	Taxed at 37%

Can you manage your income to pay taxes at a lower rate? If you assume your taxable income during retirement will be lower, it may make sense to take the tax break now by contributing to a Traditional IRA, then pay taxes on the distributions during retirement – at the lower rate. If you believe your taxable income/rate will be higher during retirement, then the tax-free distributions of the Roth may be a better option.

Unfortunately, trying to determine what your income and tax rate will be during retirement is at best, a guess. Your sources/amount of income, deductions, expenses, and future changes to the tax codes will all work for or against you.

### SO MANY THINGS TO CONSIDER...

How much of your retirement income will come from taxable sources? Will distributions from these accounts push you into a higher tax bracket? During retirement there will be times when you may take a larger than usual distribution to replace an aging automobile or go on that dream vacation. Having funds in a Roth account allows you to cover all or part of those major expenses with tax-free distributions, thereby keeping your taxes in a lower bracket/rate.

You may have fewer items to deduct during retirement. For example, getting the house paid off is a wonderful thing, but how will losing that deduction impact your taxes? On the flip-side, not having monthly mortgage payments may enable you to maintain the same standard of living with less income – potentially maintaining the same (or even a lower) tax rate. Review your current deductions and expenses and consider how they will impact your tax rates and income needs during retirement.

Will Social Security affect your income and tax rates? Under current law, Social Security benefits are subject to income tax at certain income thresholds determined by adding your AGI, plus any nontaxable interest, plus ½ of your annual Social Security benefit. Once you exceed these income limits, either 50% or 85% of your Social Security benefit will be subject to income taxes. The tax rate is determined by the applicable tax bracket IE: 10%, 12%, 22% etc. If taxable distributions and earnings are not reduced, adding Social Security benefits to the mix could result in increased taxable income and push you into a higher tax bracket. For some retirees, their Social Security benefits may reduce the need for taxable distributions or earnings, and result in lower taxes.

Roth IRAs do not force a required minimum distribution (RMD) be taken each year but they must be taken from a Traditional IRA. How will these distributions impact your tax rate during retirement? The distribution percentage when the retiree must begin taking the RMD's (either age 70 1/2 or 72) from a Traditional IRA is approximately 3.65% (age 70 1/2) or 3.91% (age 72). Will these withdrawals push a portion of your income into a higher tax bracket?

Under the current Nebraska tax code, earned income and distributions from a Traditional IRA are subject to state income tax. What if you plan on moving to a state with no state income tax during retirement? If the answer is yes, distributions from a Traditional IRA would be subject to federal but not state income taxes. If that is the case, would you be better off contributing to a Traditional IRA now?

What is your current tax rate? Are you just starting out your career and anticipate earning more as you advance beyond entry level positions? If you fall into the lowest tax bracket now but expect to earn more in the future, then contributing to a Roth may make more sense at this stage of your life. If your income increases to the point where you fall into a higher tax bracket, then switching contributions to a Traditional IRA may become the better option.

What about Medicare premiums? Premiums are based on income, and a large distribution from a Traditional IRA can result in higher premiums. Under current law, distributions taken from a Roth IRA will not count toward these income thresholds.

Do you want to pass an inheritance to your spouse or children? One of the benefits of a Roth IRA is the ability to bequeath those dollars on a tax-free basis. If your heirs' income tax rates fall into the lower brackets, they may be better off inheriting a Traditional IRA rather than a Roth. Remember the example above – the larger account balance in the Traditional IRA has the potential to provide a greater overall benefit if taxed at a lower rate. Be aware the tax implications of inheriting any IRA can be complicated. Beneficiaries may need professional assistance to limit their tax liability.

### SO WHAT IS THE ANSWER? TRY A BLEND OF BOTH?

Each individual situation is different and this article only covers a few of the circumstances you may encounter. For many individuals, the best choice might be to employ both a Traditional and Roth IRA. Even if you think your tax rates during retirement will be lower, having a portion of your nest egg in a Roth IRA provides additional flexibility to manage your taxable income during retirement. In the end, there really is no wrong choice! Both Traditional and Roth IRA's are excellent options to save for your future.

**\*Calculations made using the U.S. Dept of the Treasury "Savings Planner" calculator.**