Traditional versus Roth tax-advantaged plan contributions

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Summary: Many taxpayers puzzle over whether to contribute to traditional versus Roth tax-advantaged retirement plans. For most people, contributions to traditional tax-advantaged plans will probably provide a higher net present value over their lifetimes. We have just finished three years of development on a fully automated, lifecycle personal financial planning tools toolkit, VeriPlan. The most challenging part of the development was to design and program a general tax model, which incorporates all aspects of U.S. personal taxation at the federal, state, and local levels including income, asset, and property taxes. This was done while simultaneously modeling the incredible complexity of the numerous favors of available tax-advantaged individual and employer retirement programs. The automated tax-advantaged plan tool within VeriPlan is summarized here.**Click here to learn more about VeriPlan or to buy it -- >> Retirement Financial Planning Software**Given our tax-related software modeling capabilities, *The Skilled Investor* has some observations regarding contributions to traditional versus Roth tax-advantaged retirement accounts.1) When all significant personal financial factors are modeled, most individuals would find that contributions to "traditional" IRAs and 401Ks have a higher personal net present value, when compared to the alternative of contributing to a Roth IRA or to the relatively new "designated" Roth 401k plans. This statement is based on an analysis of typical pre-retirement and post retirement income levels, tax rates, asset returns, and a myriad of other factors. As a simplification of an excessively complex issue, traditional wins over Roth for the average taxpayer most of the time. The net present value comparison tends not to be very close.2) The financial advantage of traditional versus Roth accounts can vary over a lifetime depending upon one's asset allocation and the assumptions used for the asset class risk premiums that future markets might pay. All of this is unpredictable. However, statement #1 above is based upon 70-year average asset class returns and still holds true with variance modeling above and below these long-term historical returns averages.3) Statement #1 above also assumes that tax rates and limits will remain constant over time. This is not likely to be true. However, our present tax structure would need to change very significantly to alter the current economic preference for contributions to traditional over Roth accounts for the typical person.

The confounding problem that Americans face is that our government has significantly over-promised Social Security, Medicare, and government employee retirement program benefits. These over-promises will probably hit hardest those who currently are a long way from retirement. Benefits will be reduced and/or taxes with increase. Politics will determine who pays more taxes or receives fewer benefits. Either way, there will be no free money available. More taxes would mean less personal net income from which to save for those are subject to increased taxation. This would make it harder to make retirement contributions. Lower future benefits would mean needing to save more before retirement and/or having to consume less in retirement.4) There are some unusual situations where Roth contributions might become more advantageous during one's working years. For example, in the circumstance where there is a temporary loss of current income due to extended unemployment or disability, then the traditional versus Roth equation can change. Job loss means lower cash flow and probably means that current living expenses would exceed remaining current income and new contributions would be much harder to make.However, for people who have already contributed in the past to traditional retirement plans, in this circumstance, it could be advantageous to convert some of already owned traditional account assets into Roth account assets. Whether this would make sense to do would depend upon a person's then current (and probably much lower) federal, state, and local total marginal tax rates and the amount of unused itemized deductions he or she might have. For example, a mortgage still needs to be paid whether or not one has current income, and mortgage payments and real estate taxes can provide a significant tax shelter via itemized deductions. In such a circumstance, if this person does not convert some of his or her traditional tax-advantaged plan assets into Roth assets, then the value of the tax shelter provided by these unused deductions and by much lower marginal tax rates would be wasted.5) Roth assets also have another very significant characteristic, which is not valued in the statements above, that makes them valuable particularly to more wealthy persons. Traditional retirement accounts must begin to take mandatory taxable distributions at age 70 and 1/2 and withdrawals are geared to actuarial tables. The objective of these mandatory withdrawals tied to actuarial tables is force all assets in traditional tax-deferred retirement accounts to be distributed and taxed at ordinary income tax rates over one's remaining years of life. In contrast, Roth accounts are taxed initially when contributions are made and no further taxes are due on any future appreciation.Because of a recent change in the tax law, a Roth account can also be inherited without tax on the appreciated assets. Then, these inherited Roth assets can also continue to grow without taxation for the person who inherits the Roth account. There are some limitations. In addition, the rules require mandatory withdrawals in relationship to actuarial tables for the person who inherits the Roth IRA account. These mandatory withdrawals gradually force distribution of the Roth assets into accounts that are taxable. The Roth distribution of appreciated assets is not taxable to the person who inherits the Roth account, but subsequent asset appreciation in the taxable account would be taxable. Therefore, inheritability of Roth accounts could be very advantageous and would tend to close the valuation gap between traditional and Roth contributions for some people. Nevertheless, only a relatively narrow, wealthier segment of the population would tend to benefit. Most other people are not likely to benefit. They would have a tough enough time maintaining their retirement living standard in retirement and would probably will not have substantial estate assets left to be inherited.

Finally, our government representatives should be ashamed of themselves for developing such an incredibly complex system of retirement tax incentives. While this is largely due to political compromise policymaking, having the public be so confused about retirement investment alternatives inhibits retirement planning and investing. When our current national personal savings rate is zero/negative, when private employer pensions are in rapid retreat, and when the Social Security, Medicare, and government employee retirement programs all have huge looming deficits, then millions of people are heading for personal retirement train wrecks. We should keep the pressure on our political representatives to streamline and fix these ridiculously complex tax-advantaged retirement savings programs and to improve retirement savings incentives.**Click here to learn more about VeriPlan or to buy it -- >> [Retirement Planning Software]**

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