Factors that tend to favor Roth tax-advantaged plan contributions (Part 1 of 2)

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Summary: In a recent article, "Traditional versus Roth tax-advantaged plan contributions," The Skilled Investor discussed why the average taxpayer would tend to benefit more by contributing to traditional rather than to Roth tax-advantaged IRA and 401k retirement plans. This follow-up article in two-parts discusses eight personal financial planning factors, which could flip one's preference toward making current contributions into Roth tax-advantaged plans instead. Many people struggle with the "traditional versus Roth" contribution decision for their personal financial and investment planning. The tradeoffs over a lifetime are very complex. Rules-of-thumb, back-of-the-envelope calculations, and simple spreadsheets cannot model all the important personal financial factors. The decision is not simply about present versus future tax rates. Instead, the decision requires a personalized and comprehensive projection and valuation of your lifetime income, expenses, debts, net assets, and taxes. Because *The Skilled Investor* has developed a comprehensive and automated financial lifecycle planner, we are in a relatively unique position to comment on this complex topic using the results of our model. We can rapidly model and project personal financial tradeoffs across anyone's lifecycle, while taking into account personal taxes across one's lifetime in eight federal, state, and local tax categories.**Click here to learn more about VeriPlan -- >>**
Often the "traditional versus Roth" decision conversation involves sometimes heated debates over current versus future marginal tax rates. Many people have speculated recently that marginal U.S. personal ordinary income tax rates are likely to increase in the medium-term to long-term future. They reason that raising future tax brackets is one of the possible measures that would help to close the three huge funding gaps for the Social Security, Medicare, and federal employee retirement programs. While these predictions might become reality, once you start speculating about changing tax rules across a lifetime, an already complex lifecycle modeling problem becomes far more complex.

For purposes of this article, we will assume that the current tax rules will stay the same over one's lifetime. There is just no way to tell when, how, and by how much marginal tax rates on ordinary income and/or capital gains taxes might change. In addition, if changes do occur, would they affect all accounts or only new accounts? When tax laws are changed, one way that politicians get interest groups off their backs is to "grandfather in" or continue some or all of the old rules for existing accounts. Nevertheless, if marginal ordinary income tax rates do increase in the future, then obviously this would aid the case for Roth contributions.Also, the analysis in this article focuses ONLY ON SITUATIONS where you have the choice of making a CURRENTLY TAX-DEDUCTIBLE traditional IRA, 401k, etc. contribution VERSUS a CURRENTLY NON-TAX DEDUCTIBLE Roth IRA, 401k, etc. contribution. For most people, this is most of the time, because they have not maxed-out their current opportunities to make tax deductible account contributions. If under the U.S.'s incredibly complex tax-advantaged retirement account rules, you do not have any further opportunities to make tax-deductible current account contributions, then a Roth contribution is the choice to make. Since you cannot take a current tax-deduction and Roth accounts avoid future taxation of asset appreciation in retirement, that is why they are preferred over traditional accounts under these limited circumstances. Whether or not a person or family will save enough and invest efficiently across a lifetime dominates the "Roth versus traditional" contribution decision. If you do not save aggressively and you do not grow a very substantial investment asset portfolio for your retirement and estate, then you will not have to worry about being in high tax brackets in retirement. If you will not have substantial assets and income in retirement, then the current tax savings you can get from contributing to a traditional tax-advantaged plan will tend to be much more economically advantageous to you over your lifetime.On the contrary, if you are to justify making current Roth contributions, here are eight personal circumstances or variables that, taken together, might reverse the average person's preference for traditional tax-advantaged plan contributions:**1) You are a younger investor now, and you have a long time for your assets to appreciate before and during retirement.2) You are likely to make high enough taxable earned income over your working lifetime to have a realistic chance of amassing enough assets to cover your retirement expenses easily and to have excess estate assets.3) Your earned income will continue to rise in real dollar terms across your working lifecycle enhancing your future ability to feed your investment program through savings. 4) You will save at significant percentage rates across your working lifetime. This means consistently saving at rates that are well in excess of 10% of your gross earned income.** In one's early and middle household formation years, 10%+ savings rates may seem very difficult to achieve for many people. You should note, however, that some debt principal prepayments tend also to be a form of investment savings. Mortgage repayment is an example, because these payments can allow you to hold a valuable real estate asset that could appreciate. Mortgage principal repayments also increase your equity stake in this real estate asset. Therefore, we model mortgage principal repayments as "investment" debt payments and separate them from "consumption" debt payments, such as credit cards. We add your repayments of "investment" debt principal to your regular savings to get a more accurate measure of your projected savings rate, when you have investment related debt. True investment oriented debt would enhance your personal earnings capabilities or would allow you to acquire valuable debt leveraged assets, such as personal real estate purchased at reasonable prices. Because stock trading account margin interest rates are generally excessive, it is highly unlikely that a strategy of margin account borrowing to buy market-traded stocks is ever a good idea.**5) You will fully fund either traditional and/or Roth tax-advantaged accounts up to annual contribution limits.** Traditional and Roth tax-advantaged retirement plans have similar contribution limits. However, their tax treatment is different. If you meet various legal tests, you can contribute the similar amounts to either plan. Traditional plan contributions lower your current taxable income to the extent of you current contribution and provide a tax shield. However, traditional plans require mandatory distributions in retirement that are taxed at ordinary income tax rates. In contrast, Roth contributions do not provide a current tax shield or reduction in taxable income, but they are not taxed in retirement. Other rules also may apply.Note that you also need to model the lifecycle asset value of the tax shelter provided when your traditional tax-advantaged account contributions reduce your current taxable income and, therefore, your current taxes. For proper projection modeling and for an apples-to-apples "traditional versus Roth" contribution comparison, these tax savings should be modeled as additional investments into a taxable account each year and asset returns net of investment costs and taxes should be reinvested. When modeled, this "tax subsidy asset" would also need to reflect cumulative asset class growth rates, your preferred asset allocation, your tax basis, and other personal financial projection modeling factors. The cumulative value of this "tax subsidy asset" is another reason why these tradeoffs cannot be modeled on the back of an envelope to reach a decision.**Click here to learn more about: Retirement Planning Calculators**Go to Part 2 of this article ->>>

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