

[Factors that tend to favor Roth tax-advantaged plan contributions \(Part 2 of 2\)](#)

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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. (continuation of the article...)Click here to learn more about VeriPlan -- >> [Retirement Investment Calculator](#)***6) In the early years, you may have proportionately higher front-loaded itemized deductions (e.g. mortgage interest and real estate taxes) and lower earned income that effectively lowers your federal, state, and local marginal ordinary income tax rates compared to your more distant retirement years.7) You will adopt a very low-cost investment strategy to improve your chances of capturing higher asset appreciation rates. Therefore, you will not transfer a significant percentage of your asset returns annually to financial intermediaries who will promise to deliver more, but who are more likely to deliver less.**Elsewhere, [The Skilled Investor has written extensively about excessive investment costs](#), but the bottom line is that every year the average individual investor probably wastes about 2% of his total assets in visible and hidden investment costs (management fees, marketing fees, loads, trading costs, custody fees, etc.). The cost efficiency of your investment strategy could make or break your "traditional versus Roth" contribution decision. For example, a typical 30-year old professional couple might end up with \$1 million in financial assets (cash, bonds, and stock) at age 100 with a low cost investment strategy. Holding everything else in our model constant, when we instead plug in the average costs of the average investor, this couple's financial assets would be exhausted around age 90. If they are lucky enough to live to age 100, then they would have to liquidate their home or other assets to make ends meet after age 90. In the first circumstance, they are happily paying for their grandchildren's education and traveling. In the later situation, they have to sell their home and watch every penny. Clearly, the cost efficiency of your investment portfolio can completely flip your "traditional versus Roth" tax-advantaged account contribution decision. If, year after year, your investment costs drag down your asset growth significantly, then you could use up the smaller balances in your traditional or Roth accounts to eat and have a roof over your head in retirement. You would not have to worry about whether mandatory withdrawals from traditional plans would push you into higher marginal tax brackets, because you already gave away perhaps 2% of your assets every year through excessive investment costs.**8) You will maintain an investment asset allocation that is skewed heavily toward equities, and your assets will continue to grow at rates that are similar to long-term historical rates of return.** The long-term history of inflation-adjusted, real dollar cash, bond, and stock returns has demonstrated significantly higher returns for bonds over cash and for equities over bonds, albeit with increasing volatility. ([See these articles in the "Returns and Risk Premiums"](#)

[category](#) of The Skilled Investor website.) An all-equity asset allocation would more strongly favor making Roth contributions, when compared to an all-bond strategy. While the risks of taking the all-equity road are higher, historical equity growth rates have far exceeded fixed income growth rates, even after taxes have been optimized. Differential market returns between stocks and bonds can become a dominant variable. Whether market returns in the future will be similar to the past is anyone's guess, but the bond and equity securities markets tend only to pay market risk premiums to investors. Equities have commanded on average about a 4% higher annual risk premium for the past 75 years, before taxes are considered. Once federal, state, and local personal taxes are factored in, the differential advantage increases for equities in taxable accounts because of more favorable tax rates on long-term capital gains. Remember that a properly modeled "Roth versus traditional" apples-to-apples comparison requires including - on the traditional tax-advantaged contribution side of the comparison ledger - an additional taxable side account to measure the value of the tax shelter provided when traditional contributions are made. In that taxable account, equities would usually grow assets faster than bonds. Because this side account's value would tend to grow more rapidly with equities, this additional account might seem to strengthen the case for making traditional plan contributions, when using an all-equity strategy. However, an all-equity strategy would also increase dramatically the growth of assets held in the main traditional tax-advantaged account, which would be much larger at the outset than the tax shelter side account and which would grow more rapidly, because it would not be taxed until retirement. During retirement, this larger all-equities tax-deferred account must be distributed and taxed at ordinary income tax rates. Depending upon the amount of equity assets in this account, very large amounts of annual income could be taxed at the highest marginal federal, state, and local ordinary income tax rates. In contrast, equity assets held in Roth accounts would not be taxed during retirement. For Roth account contributions to be more economically desirable, the current value of the Roth retirement tax savings needs to exceed the current value of the traditional tax-shelter account. An all-equity strategy compared to an all-bond strategy tends to increase the value of the Roth tax shelter in retirement. However, without an automated model to consider all these factors, your head would hurt badly by the time you worked this out on the back of a giant envelope!

On a related topic, if you hold an asset allocation composed of a mixture of cash, bonds, and stocks, as most people would, then your taxable versus tax-deferred "asset location" decision should also be optimal from a taxation standpoint. This means a preference for placing ordinary income producing fixed income assets in tax-deferred accounts and equities in taxable accounts to receive lower long-term capital gains tax rate treatment. When your equity allocation is very high, you will tend to have all equity assets in your taxable accounts (except a small cash emergency fund). You will also probably have equity assets in your tax-advantaged accounts along with perhaps bonds and some cash. CONCLUSION: Given all these factors, you may find that your assets in traditional tax-advantaged accounts would grow to be so substantial that when they are distributed under the mandatory distribution rules after age 70 & 1/2, you are pushed into much higher marginal tax brackets. If your traditional tax-deferred assets are sufficiently large, then the ordinary income taxes on these mandatory distributions COULD wipe out the value of the tax shield assets that you gained by making traditional account contributions that reduced your current taxable earned income. This is the crossover point where Roth contributions become more desirable on a present value basis. To figure out whether it is better to make traditional or Roth contributions in your particular circumstances, you need to have a comprehensive and automated lifecycle planning tool that can run a range of personalized scenarios for you quickly. Across your working years and through retirement, you need to model and compare the lifecycle value of making either: A) all traditional contributions, B) all Roth contributions, and C) various mixes in between. Unfortunately, there is no simple answer to this decision. Without using an automated tool, you cannot understand whether your current decision is correct for you. However, if you think that most of the list of factors above will

apply to you, then Roth contributions COULD be the right answer for you. If you have doubt, then the balance of the argument would probably shift back toward favoring contributions into traditional tax-advantaged plan accounts. **Click here to learn more about [Investing for Retirement](#)**

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