

## Crooked and Straight Thinking on Roth IRA's

“Roth IRA’s are a bad deal” the internet article explained, “because of the time value of money.” It elaborated, “a traditional IRA’s deduction of \$2,000 in a 28% tax bracket saves \$560 in taxes each year that can be invested over a lifetime. You get to earn money on funds that would have gone to the government.” Sounds plausible doesn’t it? Only one problem: it’s false.

But what if I told you that the annual contribution limit on Roths was actually \$3,000, while only \$2,000 for traditional IRA’s? Would that be news to you? It’s true. The purpose of this article is to straighten some crooked thinking on Roths and reveal one obscure truth.

If one is eligible for either the traditional or the Roth IRA, many choose between the two primarily based on their guess about tax brackets now relative to withdrawal time. A higher bracket now with a lower one in the future steers you toward a traditional IRA. A lower bracket now with a higher one in the future steers you toward a Roth. But what if brackets are the same at both times or what about the fact that we simply don’t know? You can speculate on the future- no income tax (re: a national sales tax) or astronomical rates (remember the 50% or even 70% days?). The fact is we can’t know. Let’s consider an example.

Assume two brothers, Roth and Trad, will be in the same 28% bracket both now and at retirement. They each choose different options to invest 2,000 pretax dollars. Roth funds a Roth IRA while Trad funds a traditional IRA. This example proves our introductory point.

<b>Roth</b>	<b>Trad</b>
2000 pre-tax dollars	2000 pre-tax dollars
<u>560</u> (tax @ 28%)	<u>x 63</u>
1440 net into Roth	126,000 gross accumulation
<u>x 63</u> (factor used for 20 years at 10% per year)	<u>-35,280</u> (tax @ 28%)
90,720 after-tax dollars	90,720 after-tax dollars

Trad invests significantly more each year for twenty years yet it doesn’t make any difference. The bottom lines are the same. To get from pre-tax to post-tax, you multiply by .72. (This is one minus the tax bracket). To calculate the future value of a certain amount invested for 20 years earning 10% per annum, multiple by 63. (A financial table gives us this factor.) Roth’s bottom line is (2000 x .72) x 63, whereas Trad’s is (2000 x 63) x .72. They are equal because we use the same three factors, which multiplied in any



\$2,000 in a Roth appears to equal \$2,000 in a traditional, but the Roth actually represents \$2,778 pre-tax dollars whereas the traditional represents only \$2,000 pre-tax dollars. By prepaying taxes, Roth effectively compressed 2,778 pre-tax dollars for ultimate IRA advantages. However only 2,000 of Trad's pre-tax dollars will ever get any type of IRA advantage. Trad's other \$778 is fully taxed today like with a Roth, but will not be tax-free in the future, as will a Roth. This reveals the chief advantage of the Roth: **the Roth shelters more pre-tax money.** In fact if you consider state income taxes at 6%, fully funding a Roth shelters over \$3,000 of pre-tax income.

Comparing \$2,000 in a Roth with \$2,000 in a traditional IRA is like comparing apples with oranges. But translating them into pre-tax equivalents puts them in the same terms. It's like with fractions. Before you can add them or compare them you have to translate them into the least common denominator. For example, which fraction is larger, 2/3's or 3/5's? It's hard to tell until you translate them into a common form, say fifteenth's- 10/15's and 9/15's respectively. Then it's easy to see which is larger. Translating both IRA types into pre-tax equivalents uses this mathematical technique and reveals the Roth's chief advantage: **the Roth shelters (considerably) more pre-tax money.**

Let's end with several observations:

- **The time value of money issue has no bearing on the Roth decision.** It's more of a relative tax bracket decision.
- But we can't know our future tax bracket (and if it's the same, the Roth has the edge), so perhaps we should make our decision based on the following point.
- Accelerating the tax-bite with the Roth is actually an advantage because it effectively compresses a larger amount of pre-tax dollars for ultimate favorable IRA tax treatment. (We often fail to grasp this because the cap on both is denominated with the same numeral of 2000.) **It's more accurate to think of the traditional IRA cap as \$2,000 and the Roth cap as \$3,000, which is closer to the pre-tax dollars each will shelter.** The Roth is superior because it shelters more pre-tax money.
- Collateral observation: Educational IRAs are like mini-Roth IRAs for your children. After-tax money goes in but comes out tax-free if used for qualified educational expenses. Consider it as sheltering about \$750 of pre-tax money per child per year.