TRADITIONAL AND ROTH – RELATED, BUT NOT TWINS

By Andy Ives, CFP®, AIF® IRA Analyst

Tim and Robert are identical twins. They wear the same clothes. They have similar hair styles. They have similar jobs and similar incomes. Tim and Robert are both concerned about taxes, and they agree that saving money for the future is very important. It can be difficult to tell them apart.

Where Tim and Robert differ is in their attitudes toward their nest eggs.

Tim likes the traditional IRA. He wants the tax deduction now, in the year he makes his contribution. Tim also believes that he will be in a lower tax bracket when he is retired. At that point, Tim is willing to pay the taxes due on his IRA withdrawals.

Robert likes the Roth IRA. He receives no tax deduction when he makes his contribution. While Robert is unsure what the tax rates will be in the future, he believes he will be better off in the Roth because his earnings will grow tax free.

When Tim and Robert are 30 years old, they both find themselves in the 24% tax bracket. They each contribute $5,000 to their favorite IRA – Tim to the traditional, Robert to the Roth. Since Tim earns a deduction this year by leveraging the benefits of a traditional IRA, he saves $1,200 on his taxes. Robert gets no such deduction from the Roth.

They continue this process for 20 years: $5,000 into a traditional IRA for Tim, $5,000 into a Roth for Robert. They choose the same investments within their respective IRA accounts and both earn an average of 6% annually. They remain in the 24% tax bracket.

At age 50, a summary of their IRA financial status looks like this:

Tim: $100,000 contributed; $24,000 saved in taxes; $195,000 approximate account value

Robert: $100,000 contributed; $0 saved in taxes; $195,000 approximate account value

Tim and Robert stop depositing new money into their IRA accounts and let them run at an average of 6% annually for another 20 years. When they are 70, their account balances have grown to roughly $625,000 each.

At this point, it becomes a little easier to tell Tim and Robert apart.

Tim must begin taking a required minimum distribution (RMD) from his traditional IRA at age 70 ½, and he must pay taxes on his withdrawals at ordinary income tax rates. Robert has no withdrawal requirement from his Roth.

Tim's RMD requirements are eating into his principal, reducing his annual earnings within the IRA. Robert continues to grow his full Roth IRA nest egg.

At age 80, both Tim and Robert pass away. While Tim saved $24,000 in taxes when he originally funded his traditional IRA, he has been forced to take required minimum distributions (and pay taxes on those RMDs) for a decade. He passed the remaining traditional IRA to his beneficiaries who, as the assets are withdrawn, pay taxes on their portion of the inheritance at their ordinary income rates.

Robert's Roth IRA, which provided no tax breaks in the early years, continued to grow at 6% annually for 50 years and is valued at over $1.1 million. This passes completely tax-free to his beneficiaries.

While a Roth IRA and a traditional IRA may be related, they certainly aren't twins. Be sure to understand the similarities and differences before making a long-term commitment.