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WEALTH MANAGEMENT

ROTH IRA vs. Traditional IRA: Which is Better?

Reminder: April 15th is the last day to make your 2018 IRA Contributions.

I must be living in a bubble. I thought everyone had a least one IRA, ROTH IRA or qualified retirement account. Most people I meet have more than one, yet it turns out that only 53% of households with people age 55 and older have a retirement account such as a 401(k) or IRA. This leads me to believe that most Americans are not reading my blog ☺. Okay, I admit that the general population is not as focused on retirement planning as I am, and many folks have trouble making ends meet. However, I also know many workers would save for retirement if they just knew where to begin. To them, I say, start with an IRA.

The next question is: Are you better off with a ROTH IRA or Traditional IRA? Fundamentally, the answer lies in whether you want to pay your taxes now or later. The traditional IRA gives you a current year tax-deduction and tax-deferred growth, followed by taxable withdrawals in retirement. The ROTH works the opposite way. ROTH IRAs require you to pay your taxes up front in exchange for tax-free growth and tax-free withdrawals in retirement.

This surprises a lot of people…

Many people are surprised to find out that you end up with the exact same number of spendable dollars (after taxes), assuming you are in the same tax bracket when you're funding your IRA as when you're withdrawing the funds. So, the old saying, "It's better to pay tax on the seed than the harvest" doesn't really hold water…unless you're in a higher tax bracket during harvest time. Let's look at an example:

Suppose you are in the 25% tax-bracket and you have $6,000 of gross income to contribute to an IRA. You could put all $6,000 in a traditional IRA, since you would get a tax-deduction and, therefore, not owe any taxes. Alternatively, you could pay your taxes: $6,000 minus 25% = $4,500 and deposit that amount in a ROTH IRA. Remember that whatever the ROTH grows to will all be tax-free, whereas future withdrawals from the Traditional IRA will all be taxable.

	Roth IRA	Traditional IRA
Gross Income	$6000	$6000
Tax on Contribution	25%	0%
Net Contribution	$4,500	$6000
Investment Returns	7% annual	7% per year
Time Invested	20 years	20 years
Ending Balance	$17,413	$23,218
Tax on Withdrawal	0	25%
Net Spendable	$17,413	$17,413

The investor in the above example would have been better off with the traditional IRA if he were in the 15% bracket during retirement. This would have yielded $19,735 of spendable income. The advantage comes into play because he took the tax deduction when he was in the higher bracket (25%) and withdrew the funds and paid taxes when he was in the lower bracket (15%).

The opposite would have been true if our investor was in a higher bracket during retirement. For example, an investor in the 35% bracket during retirement would have only had $15,091 spendable, after taxes.

The main advantage of a ROTH IRA only comes into play if…

The main advantage of a ROTH IRA only comes into play if you are in a low tax-bracket when you are contributing (early in your career, in between jobs, semi-retired, etc.) and expect to be in a higher tax-bracket in the future. Most people find the opposite to be true. They are in a higher tax-bracket when they are working/contributing and drop to a lower tax-bracket in retirement. In this case, the traditional IRA is a better bet than the ROTH.

That being said, people love ROTH IRAs! They love the idea of tax-free growth forever and leaving a tax-free inheritance to their kids. Other benefits to the ROTH IRA include the ability to contribute after age 70½ and the fact that there are never Required Minimum Distributions. Below is a super-helpful chart I created for you. Your welcome ☺

ROTH IRA vs. Traditional IRA Comparison Chart:

NOTE: All figures for 2018 (I'll update after 4/15/2019)	**ROTH IRA**	**Traditional IRA**
Age Limit	You can contribute at any age.	You must be under 70½ years old to contribute.
Contribution Limits	$5,500 per year if you are under age 50, and $6,500 if you are 50 or older.	$5,500 per year if you are under age 50, and $6,500 if you are 50 or older.

Can I deduct my contribution for tax purposes?	No.	Yes. You get a full deduction on both state and federal taxes, unless you or your spouse are active participants in a company retirement plan (e.g., a 401k, 403B). See IRA Deduction Limits 2018 if you or your spouse are active participants.
Income: Minimum requirements	You cannot contribute more than your earned income for the year. However, a spouse's income satisfies the earned income requirement.	
Income: Maximum Limitations	Single tax filers are only eligible to contribute if their modified AGI (Adjusted Gross Income) is less than $120,000 or a partial contribution is allowed for AGI of $120,000 – $135,000. Married couples filing jointly are eligible to contribute with modified AGIs of less than $189,000, and partially contribute if their AGI is $189,000 – $199,000.	Anyone with earned income can contribute. However, if you are an active participant in another qualified plan (e.g., 401k) your tax deduction will be phased out above the income thresholds (see links above). I usually do NOT recommend making non-deductible contributions for the reasons explained

		at the bottom of: **FAQs Regarding IRA Contributions.**
Are withdrawals taxable?	No: You can always withdraw your contributions tax-free. Earnings can also be withdrawn tax-free after you are 59½ and you've had any ROTH IRA account for five years.	Yes: You will pay ordinary income tax on withdrawals (earnings and contributions).
What is the penalty for "premature" withdrawals taken before the age of 59½?	10% penalty on withdrawals of earnings taken before age of 59½. Contributions can be withdrawn penalty-free at any age.	10% penalty on withdrawals prior to age of 59½.
Are there any exceptions to the 10% penalty on early withdrawals?	Yes. The most common exceptions are: First-time home buyer up to $10,000, qualified education expenses, death, disability, and medical bills exceeding 10% of AGI. Here is a complete list of **IRA withdrawal penalty exceptions from the IRS**.	

Additional Benefits		Contributions lower your AGI, potentially qualifying you for other tax incentives.
Are there Required Minimum Distributions (RMDs)?	There are no RMDs during your lifetime.	RMDs must begin by April 1 of the year after you reach age 70½ and by every Dec 31st thereafter.
Will my beneficiaries be taxed when they inherit the account?	No. Distributions to beneficiaries from an inherited ROTH IRA are tax-free. Beneficiaries can cash out the entire account or take distributions as they wish. They must take a Required Minimum Distribution (RMD) each year. First distribution is required in the calendar year following death. Beneficiary can stretch out distributions over his or her remaining life expectancy to keep the account growing tax-free.	Yes. Beneficiaries pay income taxes on withdrawals from inherited IRAs. Beneficiaries can cash out the entire account or take distributions as they wish. They must take a Required Minimum Distribution (RMD) each year. First distribution is required in the calendar year following death. Beneficiary can stretch out distributions over his or her remaining life expectancy to keep the account growing tax-deferred.

ROTH IRAs and Traditional IRAs are both good investment vehicles. They both offer a tax-advantaged way to **invest for retirement**. The trade-off for getting tax benefits is that these accounts are not considered liquid prior to age 59½. I would argue that is a good thing. The early withdrawal penalties deter people from raiding their IRAs to pay off credit cards, take vacations, or buy new cars or houses that are out of their budget. The largest assets most Americans have are their houses followed by their qualified retirement plans or IRAs…both illiquid assets that involve systematic savings and tax-advantages.
Reach out if you have any questions about which IRA would be the best for you…or whether you should convert your traditional IRA to a ROTH.

Also, if you really want to beef up your IRA knowledge, check out: **IRA Contribution FAQs** or **Required Minimum Distribution FAQs**.

THE REAL ESTATE MARKET IN CHARTS

One of the most interesting finance articles of the past week was Ben Carlson's post: The Real Estate Market in Charts. Highlights follow below, as well as a link to the full article and all the charts.

- Nationwide, home prices are up 47-57% (depending on which index you look at) since the real estate market hit bottom in 2012.
- However, if you look at home prices since the peak in 2006, they are only up 4 – 21% (again depending on which index you use). That is less than the increase in inflation or wages since that time.
- If you ignore, the boom, bust, boom volatility, home prices have basically doubled since the turn of the century (19 years ago).
- The number of homes sold peaked at around 1.3 million new homes and 7.2 million existing homes in 2005. Annual sales dropped to a low of about 300 thousand new, and 3.6 million existing homes at the low in 2011. Home sales have rebounded to 621 thousand new and 4.94 million existing homes last year. These numbers are fairly close to the average numbers of homes sold per year over the past 20 years.
- Several housing markets have not fully recovered to their pre-crash (2006) highs. These cities include Las Vegas, Chicago, Miami, and New York.

See all the charts HERE.