

Is This the Year to Do a ROTH?

By Dennis J. Rogers, CPA, CFP®

Uncertain times often present opportunities as well as challenges. Tax and financial planning strategies should be revisited any time our situation changes considerably. One thing to consider is whether it is time to fund a ROTH instead of the Traditional IRA or even if it might make sense to convert some Traditional to ROTH IRAs.

If the present economic circumstances have caused you to have a significant reduction in taxable income this might be the time to fund a ROTH instead of a Traditional IRA. The key difference is that the ROTH is funded with after-tax dollars (the payment is not deducted from taxable income). However, it grows tax free, so you pay no tax when you take it out (assuming you meet certain criteria).

To do the math to evaluate the choices you have to make certain assumptions about future tax rates and rates of return. However, the basic rule of thumb is if your tax rate at retirement will be the same or higher than it is today, funding a ROTH might make sense. Otherwise, the Traditional IRA is probably better for you.

For example, Mr. & Mrs. A have a temporary reduction of income which will drop them into the 12% marginal tax bracket. They have the cash available to fully fund \$12,000 to their IRAs. If they are 45 and earn an average of 8% annually on it the \$12,000 will grow to \$55,931 in twenty years. If they take a withdrawal of 10% of the balance in the first year of retirement when their income is higher and their tax bracket is 22%, they will net \$4,363 (\$5,593 less \$1,230 in tax).

If they took the same \$12,000 and deposited \$10,560 (after their 12% tax) into a ROTH, the fund would grow to \$49,220. The same 10% withdrawal at retirement would give them \$4,922 net because there would be no tax on the ROTH withdrawal. That is a 12.8% increase in the net funds available by using the ROTH.¹ As you can see though the tax rates before and after retirement are critical to this calculation. Some employer plans allow for the ROTH option within their company 401(k), so do not rule out the possibility of switching that as a strategy as well.

This may also be an opportune time to consider a ROTH conversion, as well. I will deal with that soon in a future article.

¹ The average return shown is for illustrative purposes only. Past performance is not a guarantee of future returns.

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