Why NOT to Choose the Roth IRA

by Ric Edelman

Money in the Roth IRA can be withdrawn in retirement tax-free (provided the money was in the account for at least five years and you are over 59½; if you have money in a Deductible IRA, you must pay taxes when you make withdrawals.

At first glance, therefore, it seems that the Roth is better. But it's not. Therefore, assuming you meet the eligibility rules to contribute to a deductible IRA, you should place money in the deductible IRA and *not* the Roth. Here's why.

Although the Roth lets money grow tax-free, that's because you pay taxes now on the money you contribute to it. This is the reason why the Roth is not the best move for most people. Let me explain, and for this example we'll assume you are in the 30% tax bracket.

Say you earn $100. You pay $30 in taxes, leaving you with $70. You invest the seventy bucks in a Roth IRA. Say that it eventually doubles in value. You now have $140 and you can withdraw it tax-free.

But say you choose the deductible IRA instead. That means you don't pay taxes on your $100 (it's a *deductible* IRA, right?) Thus, you get to invest the full $100. Say it too doubles over time, to $200, but when you withdraw the money you must pay taxes of $60. Result: you have $140, *the very same amount as the Roth produces.*

So why favor the deductible IRA if both produce the same future amount? For these two reasons:

1. By choosing the deductible IRA, you give yourself a tax break this year. By contrast, the Roth IRA is merely a promise of a tax break at some point in the future — perhaps 40 years from now. Choosing the Roth forces you to hope that Congress doesn't change the tax rules. We simply don't trust Congress enough to believe it will honor its promise.
2. You may NEVER pay taxes on the deductible IRA and you will ALWAYS pay taxes on the Roth contributions. Since you don't pay taxes on a deductible IRA until you withdraw the money, what if you never withdraw the money? Ahh…you say the required minimum distribution (RMD) rules require you to take the money out at age 70½. Yes, but you are only taking out 3.65% of the balance. Under the RMD rules, a $100,000 IRA at a 7% growth rate can last until age 125. Will you live to age 125?

This deferral can also be passed along to your heirs.

Choose the Roth over the Deductible IRA only if:

a. You are not eligible to contribute to the deductible IRA (because you earn too much and are covered under a retirement plan at work),
b. You are in a low tax bracket (because you earn too little), or have unique circumstances
c. You believe your tax bracket in retirement will be much higher than your current bracket (which is nothing but sheer speculation and for most people is highly unlikely).

Clearly, for most Americans, the Roth is not a good idea.

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	Roth IRA	Deductible IRA
Say you earn	$100	$100
Taxes due (@ 30%)	– 30	0
Amount Left Over	$70	$100
Investment Doubles to	$140	$200
Taxes Due Upon Withdrawal	0	$60
Net Value After Taxes	**$140**	**$140**

Which Would You Rather Pay?

In our example, the Roth IRA investor pays taxes of $30 now, while the Deductible IRA investor pays $60 later. Isn't it better to pay a small amount now instead of a large amount later?

Intuitively, it would seem so. But as the example shows, appearances are deceiving. The reason is a complex financial concept known as Present Value.

PV shows us that it's not fair to compare different amounts of money if the time periods are different. We all know this from the adage, "a dollar today is better than a dollar tomorrow." By that same notion, as the chart shows, paying $30 today is the same as paying $60 later.

Thus, instead of choosing one type of IRA over another based on how much each requires you to pay in taxes, focus on the amount of money each produces net of taxes. The chart shows that the net amount from each account is the same. Therefore, the Deductible IRA wins. Why? Since the wealth created is the same, you might as well delay the taxes as long as possible.

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