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Roth IRAs: Good for you or not?

Advisers debate whether Roths are the right move for many investors

By [Andrea Coombes](#), MarketWatch
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SAN FRANCISCO (MarketWatch) -- If you've only got so much to put aside every year into a retirement account, you want to ensure you're stashing it in the best retirement-savings vehicle around. Does that mean a Roth IRA? A traditional IRA? Your standard 401(k) or, now, the Roth 401(k)?

Planners often say that, because Roth IRAs allow your money to grow tax-free -- the contributions you put in are after-tax but your investment returns are untaxed when you pull them out -- they trump traditional deductible IRAs, in which you enjoy a tax deduction now but pay taxes on your payouts later.

Similarly, advisers often say those who have a 401(k) at work should put as much into it as needed to get the full employer match, if there is one, and then stash the rest of their cash in a Roth. (Eligibility for Roth IRAs is restricted by income limits. Those income limits don't apply to the new Roth 401(k), but those plans are only available through employers, and not all companies offer them.)



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One financial adviser challenges that conventional wisdom.

Roland Manarin, founder of Manarin Investment Counsel, in Omaha, Neb., says investors will watch their dollars grow faster in a tax-deferred account, such as a deductible IRA or a 401(k), because the tax-deferral allows savers to contribute more now than they can afford to contribute to an after-tax Roth -- and that greater savings rate compounded over years of investing equals a much bigger pot of money when it comes time to retire.

"To put \$4,000 into a Roth, you have to effectively earn \$6,000," because of taxes, Manarin said. "To put \$4,000 into a regular [deductible] IRA, your take-home pay goes down by \$3,000. What a huge difference," he said.

"Let's turn it around: You put \$4,000 in a Roth, that's the equivalent of putting \$6,000 in a regular IRA. There's just no comparison."

Then, "you compound that difference over 20, 30 years. Now I'm facing retirement, I'm going to be in a lower tax bracket, I've got three times the money in my regular IRA versus the person in the Roth," Manarin said.

Plenty of other advisers disagree, some of them vehemently. The problem, they say, is that it's almost inevitable tax rates will jump higher in the years ahead.

Even with a bigger account balance in a tax-deferred account, "what if that compounded growth gets taxed at 50%, 60%, or 70%?" said Ed Slott, the Philadelphia-based host of IRAhelp.com and author of "Your Complete Retirement Planning Road Map."

"We have a multitude of financial crises -- health care, the death of defined-benefit pensions, 78 million aging baby boomers -- somebody's got to pay for this ... Taxes have to go up. We're probably in the lowest tax rates we'll ever see in our lifetime," Slott said.

"Having a Roth removes the uncertainty of what future tax rates might be," he said. Plus, he pointed out another benefit to Roth IRAs: "Once you hit age 70 1/2, with traditional IRAs, you have to take the money out and pay the tax," Slott said. "With Roths, there are no required distributions. That money can stay growing tax free for the rest of your life."

Certainly, traditional IRAs trump Roth IRAs in terms of total assets, but Roths are much newer, enacted into law in 1997, some 23 years after traditional IRAs, which were created in 1974 by the Employee Retirement Income Security Act.

About 30% of U.S. households owned a traditional IRA in 2006 versus about 13% who owned a Roth IRA, and traditional IRAs held a total of \$3.7 trillion in assets, compared with \$178 billion in Roth IRAs, according to the Investment Company Institute, a trade group of mutual-fund and other investment companies.

Uncertainty ahead

Income taxes could increase. Or, the tax code may change entirely. Some policymakers are calling for a consumption-based tax, for instance.

It's that tax-law uncertainty which prompts Mandarin and his colleagues to focus on tax benefits today, rather than in the future.

"That's another appeal to us of the traditional [deductible] IRA. You're getting the benefit today," said Aron Huddleston, a vice president of Manarin Investment Counsel.

"We would rather take what we can get today. There are proposals out there like the Fair Tax, the flat tax, the national sales tax, what if one of those takes over? There might not even be an income tax," Huddleston said. "Looking forward 30 years, who knows what the tax situation is going to look like?"

Others say that uncertainty means it's best to hedge your bets against a variety of outcomes. Planners call it "tax diversification," said Sheryl Garrett, a certified financial planner and founder of the Garrett Planning Network, in Shawnee Mission, Kan. "You're hedging: What if [tax rates] go up, what if they don't?"

Tax diversification entails contributing to your 401(k) plan at least up to the company match, and then owning a Roth on the side.

Another idea is to focus on a Roth when you're young, Huddleston said. Your 20s are likely to be your weakest earning years, and thus your lowest tax-bracket years. Then, once your income rises, and your tax rate too, leave the Roth alone and focus on contributing into your tax-deferred plan.

"When you're in your 30s, 40s, 50s, you're probably in some of your peak earning years, relative to the rest of your life," Huddleston said.

"Most likely you're going to be in a higher tax bracket. That means you'll be able to get more money working for you in a traditional IRA," he said. "At retirement, you won't be working, so the odds are your tax rate will be lower when you make the withdrawals."

Different outcomes

The answer to the question of "which investment vehicle" works best will vary dramatically depending on your own personal situation, as well as the tax-law situation when you retire, said Laurence Kotlikoff, an economist at Boston University.

"The results very much depend on your age and income levels" when you begin your retirement savings, he said.

Kotlikoff co-authored a research study in December titled "To Roth or Not to Roth, That Is the Question," answering that question by running a number of hypothetical savings situations through his retirement-planning software, ESPlanner. [See related story.](#)

In many of the hypothetical situations, a 401(k) (or a deductible IRA) trumped a Roth, although sometimes just slightly. In other cases, the Roth led to a better outcome. Often, the difference was only slight.

"A regular 401(k) beats a Roth for a majority of our stylized households, but both offer a significant improvement over fully taxed savings," Kotlikoff and his co-authors wrote in the paper.

"Of course, future changes to the tax code can increase or decrease the value of either type of account," the paper says. "We therefore recommend investing in a combination of both account types that is tailored to household circumstances and attitudes toward risk."

Still, to Manarin's mind, the benefit of Roths is overblown. "What drives me wild is when they talk people into cashing in their IRA, paying all those taxes and putting the money into a Roth. It just makes zero sense to do that."

Andrea Coombes is MarketWatch's assistant personal finance editor, based in San Francisco.

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