Wander CPA

Tax-Saving Tips

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Roth IRA versus Traditional IRA: Which Is Better for You?

Roth IRAs tend to get a lot of hype, and for good reason: because you pay the taxes up front, your eventual withdrawals (assuming you meet the age and holding-period requirements—more on these below) are completely tax-free.

While we like “tax-free” as much as the next person, there are times when a traditional IRA will put more money in your pocket than a Roth would.

Making the Decision on What’s Best

Example. Say that your tax rate is 32 percent and that you will invest $5,000 a year in an IRA and earn 6 percent interest. Should you put the $5,000 a year into a Roth or a traditional IRA?

Say further that neither you nor your spouse is covered by a workplace retirement plan, so you can contribute the $5,000 a year without worry because it’s under the contribution limits. If your income is too high for the Roth IRA, you make the $5,000 contribution via the backdoor.

If you invest the $5,000 in a traditional IRA, you create a side fund of $1,600 ($5,000 x 32 percent). On the side fund, you pay taxes each year at 32 percent, making your side fund grow at 4.08 percent (68 percent of 6 percent).

Roth IRA

Roth contributions are not deductible; this means no side fund, so your annual investment remains at $5,000.

Cashing Out

For the Roth, your marginal tax rate at the time of your payout doesn’t matter because you paid your taxes *before* the money went into the account. The whole amount is now yours, with no additional taxes due.

But for the traditional IRA, your current tax bracket matters a great deal. You have taken care of the taxes on the side fund annually along the way, but the traditional IRA (both growth and contributions) is taxed at your current marginal tax rate at the time you cash out.

The table below shows you how this looks with tax rates of 22 percent, 32 percent, and 37 percent at the time you cash out (winners are in bold):

Marginal tax rate at cash-out	10 years @ 6%	20 years @ 6%	30 years @ 6%	40 years @ 6%

22%	**Trad: $74,557** Roth: $69,858	**Trad: $202,074** Roth: $194,964	**Trad: $421,482** Roth: $419,008	Trad: $801,048 **Roth: $820,238**
32%	Trad: $67,571 **Roth: $69,858**	Trad: $182,578 **Roth: $194,964**	Trad: $379,581 **Roth: $419,008**	Trad: $719,024 **Roth: $820,238**
37%	Trad: $64,079 **Roth: $69,858**	Trad: $172,830 **Roth: $194,964**	Trad: $358,630 **Roth: $419,008**	Trad: $678,012 **Roth: $820,238**

You can see that the traditional IRA needs a low tax rate at the time of cash-out to win. But even in the 22 percent cash-out tax rate, the Roth wins at the 40-year mark.

Rate of Growth

What about your rate of growth? Do variances here change things any? Let's take a look.

Here, we'll look at different rates of growth for a fixed period (30 years) before you withdraw your money. Once again, we'll consider three different marginal tax rates at the time you cash out—22 percent, 32 percent, and 37 percent.

Marginal tax rate at cash-out	3% for 30 years	6% for 30 years	9% for 30 years	12% for 30 years
22%	**Trad: $257,760** Roth: $245,013	**Trad: $421,482** Roth: $419,008	Trad: $716,547 **Roth: $742,876**	Trad: $1,256,032 **Roth: $1,351,463**
32%	Trad: $233,259 **Roth: $245,013**	Trad: $379,581 **Roth: $419,008**	Trad: $642,260 **Roth: $742,876**	Trad: $1,120,886 **Roth: $1,351,463**
37%	Trad: $221,008 **Roth: $245,013**	Trad: $358,630 **Roth: $419,008**	Trad: $605,116 **Roth: $742,876**	Trad: $1,053,312 **Roth: $1,351,463**

In the scenarios above, the traditional IRA/side fund combo wins only when your marginal tax rate is lower at the time of withdrawal *and* only at the lower growth rates.

At higher rates of return—9 percent and 12 percent, in our examples above—the Roth still wins, even if you're in a higher tax bracket when you withdraw your money.

Tax Factor

What's going on here? For starters, the side fund is not tax-favored in any way. Plus, taxes hobble your cash-out on the traditional IRA:

- You pay taxes as you earn the money in the side fund.
- You pay taxes on the accumulated growth inside the traditional IRA when you withdraw the money.

Creating More Business Meal Tax Deductions After the TCJA

Here's good news for business meals: the Tax Cuts and Jobs Act (TCJA) removed the "directly related and associated with" requirements from business meals.

The net effect of this change is to subject business meals once again to the pre-1963 "ordinary and necessary" business expense rules.

You are going to like these rules.

Restaurants and Bars

Question 1. If, for business reasons, you take a customer to breakfast, lunch, or dinner at a restaurant or hotel, or to a bar for a few drinks, but you do *not* discuss business, can you deduct the costs of the meals and drinks?

Answer 1. Yes. Even though you did not discuss business, the law provides that if the circumstances are of a type generally considered conducive to a business discussion, you may deduct the expenses for meals and beverages to the extent they are ordinary and necessaryexpenses. Consider this "no discussion" meal a "quiet business meal."

Question 2. What are circumstances conducive to a business discussion?

Answer 2. This depends on the facts, taking into account the surroundings in which the meals or beverages are furnished, your business, and your relationship to the person entertained. The surroundings should be such that there are no substantial distractions to the discussion.

Generally, a restaurant, a hotel dining room, or a similar place that does not involve distracting influences, such as a floor show, is considered conducive to a business discussion. On the other hand, business meals at nightclubs, sporting events, large cocktail parties, and sizable social gatherings would not generally be conducive to a business discussion.

Meals Served in Your Home

Question 3. Does a business meal served in your home disqualify the deduction?

Answer 3. No, as long as you serve the food and beverages under circumstances conducive to a business discussion. But because you are in your home, the IRS adds that you must clearly show that the expenditure was commercially rather than socially motivated.

Goodwill Meals

Question 4. If, for goodwill purposes, you take a customer and his or her spouse to lunch and don't discuss business, will the cost of the lunch become non-deductible?

Answer 4. Not if, in light of all facts and circumstances, the surroundings are considered conducive to a business discussion, and the expenses are ordinary and necessary expenses of carrying on the business rather than socially motivated expenses.

Question 5. Is the situation the same if the taxpayer's spouse accompanies the taxpayer at a dinner for business goodwill reasons?

Answer 5. Yes, the meal is deductible. This is true whether or not the customer's spouse is present. Again, the meal must meet the ordinary and necessary business expense standards.

Document the Meal Deductions

You need to keep records that prove your business meals are ordinary and necessary business expenses. You can accomplish this by keeping the following:

1. Receipts that show the purchases (food and drinks consumed)
2. Proof of payment (credit card receipt/statement or canceled check)
3. Note of the name of the person or persons with whom you had the meals
4. Record of the business reason for the meal (a short note—say, seven words or fewer)

The costs of your business meals continue to be 50 percent deductible (as they were before the TCJA).

Beware: IRS Error in Rental Property Deduction Publication

Here's a heads-up on mortgage insurance.

Personal Residence Mortgage Insurance

The deduction for mortgage insurance on a qualified residence ended on December 31, 2017. But don't give up on the deduction.

The personal residence mortgage insurance deduction is part of what is called "tax extenders," and it's highly possible that lawmakers will reinstate the deduction retroactively for all of 2018 and 2019. That's the good news. The bad news is that to claim the retroactive deduction we will need to amend your 2018 tax return.

Rental Property Mortgage Insurance—IRS Mistake

Online at the IRS frequently asked rental property questions, you will find the following question and incorrect answer:

Question: Can you deduct private mortgage insurance (PMI) premiums on rental property? If so, which line item on Schedule E?

Answer: No, you can't claim a deduction for private mortgage insurance premiums.

This is wrong.

The cause for the error comes from IRS Publication 527, Residential Rental Property (Including Rental of Vacation Homes), where on page 1 in the "What's New" section, the IRS states that the deduction for mortgage insurance premiums expired and you can't claim that deduction for premiums after 2017 unless lawmakers extend the break.

The mistake that the IRS makes in its publication and FAQ is that the expiration of the mortgage insurance deduction applies to your qualified personal residence, not your rental property.

Rules for Rental Property Mortgage Insurance

You generally treat mortgage insurance on rental property loans and mortgages as an ordinary and necessary business rental expense that you deduct on Schedule E against the income from that rental property. Depending on the type of loan, you could pay the mortgage insurance either in a lump sum or annually as you make your mortgage payments.

How you treat the mortgage insurance premiums depends on how the proceeds of the loan are used, rather than on the character of the property that you mortgage. For example, you could take a mortgage on your personal residence and use the proceeds from the loan for a rental property, an investment, or personal purposes.

Planning note. You deduct the mortgage insurance on the rental properties over the period of benefit. For example, if you make a one-time payment, you amortize the mortgage insurance over the life of the loan.

If you make annual payments because of, say, a mortgagor requirement of a loan-to-equity ratio or other formula, you deduct the mortgage insurance premiums as you pay them.