

Unsure how much to commit to Roth or traditional accounts? This rule might help.

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'Higher-income investors have greater exposures to tax-schedule uncertainty, which can be managed using post-tax Roth options,' says a new paper from the Journal of Financial Economics.

A simple rule-of-thumb for allocating savings either to traditional tax-favored savings accounts (contributions deductible, withdrawals taxed) and/or Roth accounts (contributions taxed, withdrawals untaxed) is provided in a recent [paper](#) from the *Journal of Financial Economics*.

"We propose a practical rule with two steps to determine the allocation of savings across traditional and Roth accounts," wrote the authors, David C. Brown and Scott Cederburg of the University of Arizona and Michael S. O'Doherty of the University of Missouri. The two steps are:

1. Households that currently fall into a low tax bracket (e.g., the 10% or 15% brackets in the 2015 tax schedule) should invest 100% of their savings in Roth accounts.
2. Other households should allocate $(\text{Current age} + 20)\%$ of their retirement savings to traditional accounts with the remainder in Roth vehicles, subject to constraints on account access and investment limits.

"We demonstrate a large economic impact of optimally investing across traditional and Roth retirement accounts, and these effects remain significant in the presence of realistic contribution limits and constraints on account access," the authors wrote.

"Conventional wisdom suggests that retirement savers with relatively low current incomes benefit most from access to Roth accounts," while workers in higher tax brackets benefit more from tax-deductible savings account.

"We find, however, that higher-income investors have greater exposures to tax-schedule uncertainty, which can be managed using post-tax Roth options... Investors who believe that rates in the tax schedule are likely to drift upward (downward) prior to retirement should increase their allocations to Roth (traditional) accounts relative to our analysis," the paper said.

"We do not explicitly model the risk of a [future] structural change in the tax code or the regulations for a particular retirement vehicle," the authors wrote, they suggest that "a

consumption tax system would favor traditional accounts relative to Roth, whereas a flat income tax structure would reduce the tax benefit of traditional investments and make Roth accounts more desirable.”

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