

# TIME FOR AN IRA

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Millions of Americans are saving for retirement in 401(k)s and Individual Retirement Accounts (IRAs). These tax-deferred accounts allow for individuals to invest pretax dollars, but require them to pay taxes on their deposits and accumulated earnings at the time of withdrawal.

A Roth account allows for individuals to deposit after-tax dollars, but withdraw the accumulated balances tax-free. Given that taxes on retirees will likely be much higher in the future due to taxes on Social Security benefits and the cost of Social Security, Medicare and Medicaid, Roth accounts make sense for many American taxpayers.

The Roth method of taxation was proposed by the National Center for Policy Analysis and the U.S. Chamber of Commerce in 1991. America was in the middle of a recession and policymakers were desperately looking for ways to spur economic growth through increased savings and investment. The NCPA/Chamber proposal contained five pro-growth tax changes: 1) a capital gains tax cut, 2) repeal of the Social Security earnings penalty, 3) repeal of the Social Security benefits tax, 4) immediate depreciation of business investment and 5) a new IRA (later called the Roth IRA).

Both traditional and Roth IRAs grow tax-free and both allow withdrawals at age 59½ without penalty. However, there are differences: People with ordinary IRAs must stop making deposits when they reach age 70½ and begin making minimum withdrawals. People with Roth IRAs can contribute at any age and are never required to withdraw funds. The maximum contribution is the same for both accounts: \$4,000 per year (\$5,000 for people ages 50 and older) which is considerably less than the \$15,000 contribution that can be made to a 401(k) plan.

There are income restrictions on who can participate in a Roth IRA. A single tax filer with an adjusted gross income (AGI) of more than \$110,000 (\$160,000 for a couple) cannot contribute and cannot make the full contribution if his income is between \$95,000 and \$110,000 (for a couple, \$150,000 and \$160,000). Of course, there are also income restrictions on contributions to traditional IRAs. Contributions are fully tax deductible for singles with an AGI of up to \$50,000 (\$75,000 for couples). The deductibility of contributions to traditional IRAs phases out completely for singles with an AGI of \$60,000 or more (\$85,000 or more for couples).

Investors can convert a regular IRA into a Roth IRA. The entire amount is included in taxable income and taxed at the prevailing rate. Currently, only people with incomes of less than \$100,000 can convert. However, Congress recently passed a measure that will allow people at any income level to convert traditional IRAs into Roth IRAs beginning in 2010, but the taxes must be paid over the two years following conversion.

Currently, 401(k) plans are taxed like ordinary IRAs. Contributions are made with pretax dollars and people pay income taxes on their deposits plus earnings when funds are withdrawn. Starting this year, however, employers can offer Roth 401(k)s. Workers can contribute after-tax dollars, and the money will grow tax-free and can eventually be withdrawn tax-free. The new plan is similar to a Roth IRA, but there are no income limits on participation, and the annual contribution limits and penalties for early withdrawals are the same as traditional 401(k)s.

The million dollar question is...***“Which is better, a regular IRA or a Roth IRA?”***

The answer, depends upon an individual's marginal tax rate while working compared to the rate the taxpayer will face during retirement. In general, one wants to pay taxes when the tax rate is lowest. It once was assumed that people will be in a lower tax bracket after they retire, so investing pretax dollars and paying taxes when the money is withdrawn meant they would pay

fewer taxes over their lifetimes. But there are two reasons this assumption may be wrong, especially for many young people today.

First, the Social Security benefits tax will push many moderate-income families into higher tax brackets after they retire. Thus, paying taxes on accumulated savings after retirement may cost a family more over its lifetime. Second, as the baby boomers retire, the cost to society of providing Social Security, Medicare and Medicaid benefits will likely lead to higher taxes across the board. So it is probably a safe bet that tax rates on future retirees will be higher.

It is impossible to predict where tax rates will be in the future, as we are witnessing a huge debate is taking place regarding George W. Bush's tax cuts which will expire in two years. Choice of an investment vehicle is dependant on an individual's unique situation and circumstances. Not knowing where tax codes will be or what bracket one might reside in is not an excuse for inaction. Whether it is a traditional or Roth IRA, start now, do not wait for some politician to give you the go ahead. The earlier one starts to save the less they have to save. Let compounding work its magic.