IRAs – Weighing Your Options

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This time of year, many people are looking for last minute opportunities to reduce their April tax bill. Most are familiar with the Individual Retirement Account (IRA) as a tax planning tool and retirement vehicle, but many are unaware of the differences between the two basic varieties of IRA-- Traditional and Roth IRAs that have different characteristics, advantages and disadvantages.

Executive Summary

An analysis of our client base revealed that most of our clients are ineligible to contribute to either a Roth or a deductible Traditional IRA, thanks to their high adjusted gross incomes. Non-deductible Traditional IRAs are available to any taxpayer with earned income, however we do not recommend non-deductible IRAs for our clients. Read on through the rest of this summary and the detailed comparison that follows to better understand IRAs and the rationale for our recommendations.

We believe that the Roth IRA is one of the most attractive retirement savings and estate planning vehicles available today. For clients who are eligible, we recommend fully funding a Roth IRA each year, and evaluating their conversion options.

Deductible Traditional IRA contributions may be a worthy investment opportunity for some clients. Eligible clients who have sufficient liquid investments, and who have fully funded their employers' qualified retirement plans might consider establishing and contributing annually to a Traditional IRA—particularly if they anticipate dropping to a very low tax bracket during retirement.

After-tax contributions to a Traditional IRA only serve to reduce liquidity and increase future tax liability. They do not offer the benefit of an immediate tax deduction. Distributions are subject to a variety of rules and penalties; at the same time they are taxed as ordinary income. We encourage our clients to redirect planned non-deductible IRA contributions to their taxable portfolios where earnings are eligible for favorable capital gain treatment and provide the possibility of harvesting and using losses to reduce future taxes. We do not recommend establishing or funding a Traditional IRA if you are ineligible to deduct your contributions.

As a part of our semi-annual review, we will discuss the particulars of your situation, and provide individualized recommendations on your IRAs, conversion opportunities and your overall retirement planning and tax planning strategy.

Traditional IRA

History and Characteristics

The Traditional IRA first became popular in the 1980's when it was introduced by the Carter Administration to encourage individual saving and investment. Originally, IRA contributions were fully deductible for all taxpayers. After a few years, income restrictions were imposed, limiting deductibility. For years, only individuals who did not qualify for participation in any employer sponsored qualified retirement plan, or those with adjusted gross incomes below $35,000 ($50,000 for a married couple) were able to deduct their IRA contributions. In 2001 Congress and the Bush Administration relaxed the restrictions on IRA deductibility. Under current rules, Traditional IRA contributions of $3,000 ($3,500 for taxpayers who are 50+ years old) are fully deductible for individuals with adjusted gross income of $95,000 or less (married couples with AGI under $150,000). Taxpayers can contribute to their Traditional IRA through age 70.

Deductible IRA contributions and the earnings they accrue are not subject to federal or state income tax until the funds are withdrawn or distributed from the IRA account. Distributions after the age of 59 ½ are fully taxed as ordinary income. Distributions prior to age 59 ½ are also subject to a 10% penalty for early withdrawal. After age 70 ½, traditional IRA owners must take annual distributions (minimum required distribution – MRD) based upon their actuarial life expectancies. These distributions are fully taxable as ordinary income. Failure to take a required distribution results in severe penalties.

Advantages

- For eligible taxpayers, the Traditional IRA enables them to shelter up to $7,000 (for a married couple over age 50) from income taxes each year.
- Earnings accrue tax deferred until the funds are distributed. For individuals and couples who fall into a lower tax bracket during retirement this postponement can result in after-tax savings.

Disadvantages

- Contributions are allowed only through age 70.
- Minimum required distributions can create considerable tax liability during retirement. For individuals and couples with significant retirement income (from investments and/or pensions) much of the distributed IRA income is lost to state and federal taxes.
- Inherited IRA funds are subject to double taxation – as ordinary income, and as IRD – income in respect of a decedent. As much as 90% of the IRA can be paid out in federal income taxes upon distribution.

Taxpayers with incomes above the eligibility limits can make after-tax contributions to a traditional IRA, but we believe doing so needlessly reduces portfolio liquidity and exposes clients to the disadvantages noted above.

Roth IRAs

History and Characteristics

The Roth IRA was introduced in the mid 1990's as a vehicle to encourage individual retirement saving and investment (sound familiar?). Current contribution limits and eligibility requirements for the Roth are the same as those for the deductible Traditional IRA. As with the Traditional IRA, taxpayers at or over the age of 50 are allowed to contribute an additional $500 each year to their Roth IRAs.

Roth IRA contributions are not deductible, but earnings accrue tax-free within the Roth IRA through the death of the owner, and (if properly handled) even through the lifetime(s) of his or her beneficiary(ies). Distributions after the age of 59 ½ and a five-year holding period are tax-free and penalty free. There are no minimum distribution requirements and contributions can continue throughout the Roth owner's lifetime.

Advantages

- For eligible taxpayers, the Roth IRA enables them to invest up to $7,000 (for a married couple over age 50) that will grow tax-free for the rest of their lives and beyond.
- The ability to pass on wealth free of all income taxes to younger beneficiaries makes the Roth IRA an exceptional estate planning vehicle for high-net worth individuals and families.

Disadvantages

- Roth IRA contributions are not tax deductible in the year of contribution.

Traditional IRA balances can be converted to Roth IRAs. The converted balance will be recognized as ordinary income in the year of conversion. For clients who have sufficient funds to cover the tax liability, conversion may be an excellent tax and estate planning opportunity.