

# Invest in Individual Retirement Accounts (IRAs)

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**I**nvesting in IRAs can be a great way to save in a tax-advantaged manner. They're often used to complement or replace retirement savings at work, and Roth IRAs provide a means to tax-diversify your portfolio. Read on to discover how to use IRAs to increase your savings and fortify your nest egg.

## Types of Individual IRAs

IRAs come in two main types:

- ✓ **Traditional:** In a traditional IRA, you don't pay any taxes on the income and gains you generate until you withdraw them; all withdrawals will be taxed at your ordinary income tax rate. Annual contributions may or may not be tax-deductible, depending on your circumstances.
- ✓ **Roth:** With the Roth IRA, you make contributions on an *after-tax basis*. The income and gains you generate are never taxed; you can make withdrawals tax-free as long as you're over 59½ and the account has been open for more than five years.

Because you've already paid taxes, you can also remove your contributions or basis tax-free at any time. But if you convert money from a traditional (or SEP or SIMPLE) IRA to your Roth, you have to wait five years before withdrawing those converted funds tax-free.

## Contribution Limits

Here are the 2008 IRA contribution limits for both Roth and traditional IRAs:

- ✓ Regular contribution: \$5,000
- ✓ Catch-up contribution (for those 50 and older): \$1,000

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Table 33-1 presents the income limits for Roth IRAs for 2008. Note that if your AGI is within the phase-out range, you may make a partial contribution (for example, if you're halfway, you can make half the contribution).

<i>Filing Status</i>	<i>AGI Phase-Out Range for Roth IRA Contributions*</i>
Single or head of household	\$101,000–\$116,000
Married filing jointly	\$159,000–\$169,000
Married filing separately	\$0–\$10,000

\* The annual income limit for determining ability to convert traditional IRA to Roth IRA for all filers is \$100,000.

Table 33-2 shows 2008 deduction limits for traditional IRAs based on filing status and income if you aren't covered by a retirement plan at work.

<i>Filing Status</i>	<i>MAGI Phase-Out Range</i>	<i>Deduction</i>
Single or head of household	Any amount	Full deduction
Married filing jointly (neither spouse covered by a retirement plan at work)	Any amount	Full deduction
Married filing jointly (one spouse is covered)	\$159,000 or less	Full deduction
	\$159,001–\$169,000	Partial deduction
	\$169,000 or more	No deduction
Married filing separately	\$0–\$10,000	Full deduction

And Table 33-3 tells you 2008 deduction limits for traditional IRAs based on filing status and income if you *are* covered by a retirement plan at work.

**Table 33-3 2008 Income Limits for a Traditional IRA If Covered by a Retirement Plan**

<i>Filing Status</i>	<i>MAGI Phase-Out Range</i>	<i>Deduction</i>
Single or head of household	\$53,000 or less	Full deduction
	\$53,001–\$63,000	Partial deduction
	\$63,001 or more	No deduction
Married filing jointly	\$85,000 or less	Full deduction
	\$85,001–\$105,000	Partial deduction
	\$105,001 or more	No deduction
Married filing separately	\$0–\$10,000	Partial deduction
	\$10,001 or more	No deduction

## To Roth or Not to Roth

When you run the numbers using the same assumptions for each type of account, traditional and Roth IRAs are mathematically equal. In other words, if your income tax rate remains the same, you end up with the same amount of after-tax dollars in retirement — regardless of whether you take taxes out before or after you put your money in the IRA.

For example, assume you're in the 15-percent tax bracket and you have \$5,000 to contribute. Whether you put the \$5,000 into a traditional IRA and pay 15 percent in taxes on a withdrawal or you put the after-tax equivalent of \$4,250 ( $\$5,000 - 15 \text{ percent} = \$750$ ) into a Roth IRA, you'll have the same amount of after-tax dollars in retirement.



You do get a built-in advantage with a Roth IRA in terms of contribution limits. The maximum contribution for both Roth and traditional IRAs is the same; however, because you can withdraw the Roth dollars tax-free, the dollars you put into a Roth are worth more than the dollars you put into a traditional IRA. On an after-tax basis, you can save more money with a Roth than with a traditional IRA.

So what's all the fuss about? Just go with the Roth, right? Unfortunately, it's not that simple. Yes, assuming all things are equal, the Roth is a slightly better option only because you can save more on an after-tax basis. However, the Roth or traditional IRA decision comes down to a question of taxation: Do you expect your current income tax rate to be higher or lower than your income tax rate when you withdraw the money?

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- ✓ Generally, if you expect to be in a lower tax bracket in retirement than when you make your contribution, the traditional IRA is the better option. You effectively defer your taxes until they're at a lower rate.
- ✓ If you expect to be in a higher tax bracket when you withdraw the money, the Roth IRA is the better deal. Here, you lock in your lower tax rate and avoid paying taxes at your future higher tax rate.

This decision may seem straightforward, but determining whether your tax rate at withdrawal will be higher or lower than today may be harder than you think. Consider these factors:

- ✓ **Changing tax rates:** Most people make the mistake of assuming that today's tax rates are the same tax rates they'll have in retirement. But considering that income tax rates are at an historical low, you may find yourself with a lower income but an equal or higher tax rate.
- ✓ **Career path:** Although you don't always anticipate it, many career paths are filled with twists and turns. Are you sure about your future income?
- ✓ **Size of your nest egg:** If you're a super-saver, you may live on a higher income in retirement. On the other hand, a small nest egg may fund only a portion of the income you take home today.
- ✓ **A murky future outlook:** Much can change, and making accurate assumptions about the next 20 to 30 years is difficult.



Because the future is uncertain, it's impossible to know whether a Roth or a traditional IRA will be better for you. You may be better off hedging your bets and saving in both tax-deferred (traditional IRA) and after-tax (Roth IRA) vehicles. This strategy is often described as *tax diversification*.

Don't forget that you may already be saving in a tax-deferred manner through your 401(k) or other retirement plan at work. So after looking at all the options, a Roth IRA may trump a traditional IRA if for no other reason than it's the only available option for saving on an after-tax basis — assuming your employer doesn't offer a Roth 401(k) option.



If cash is tight and you feel uncomfortable locking away your money in a retirement vehicle with hefty penalties for early withdrawal, a Roth IRA may be for you; you can still save in a tax-advantaged manner, but you can withdraw your contributions (not your gains) at any time penalty- and tax-free.

### Converting to Roth

If your adjusted gross income (regardless of filing status) is below \$100,000, you can convert traditional IRA assets to Roth IRA assets without penalty.

Unfortunately, you still have to pay income tax on the assets converted, but you would've done that eventually, anyway. Converting now can help you tax diversify.

If your adjusted gross income is above \$100,000, don't worry. In 2010, the income limit for conversions is lifted. Anyone can convert traditional IRA assets to Roth assets (although it may not make sense tax-wise).

Even better, the changes going into effect in 2010 provide two additional perks:

- ✓ **Taxes are deferred to 2011 and 2012.** Converting a large balance to a Roth IRA will generate a sizeable tax bill, but Congress lessened the burden by allowing the income tax you must pay to be split between 2011 and 2012. If you expect your 2010 tax bracket to be lower than your future bracket, you can still recognize all the income in 2010.
- ✓ **You can sidestep the income limit.** Although an income limit on Roth contributions will still technically exist before and after 2010, you can easily sidestep that limit. You can contribute to a nondeductible IRA (see the next section) and then convert it to a Roth. Before going this route, make sure you understand the tax rules, especially if you have IRAs funded with both deductible and nondeductible contributions, because income tax will be due on the proportionate share of deductible contributions (for all your IRAs, not just your nondeductible IRAs).

## Nondeductible IRAs

A *nondeductible IRA* is a bit of a misnomer because it really describes contributions to a traditional IRA that aren't tax-deductible. You lose the tax-deduction either because you've exceeded the annual limit for contributions or because your income exceeds the limit for that year.

The primary benefit of nondeductible IRA contributions is tax-deferred growth of earnings. The problem is that withdrawn earnings are taxed at ordinary income rates, possibly as high as 35 percent. This holds true even for what would otherwise be long-term capital gains, which would be taxed at only 15 percent in a taxable account.



Outside of using a nondeductible IRA to sidestep contribution limits on a Roth IRA, contributing to an IRA on a nondeductible basis is rarely a good strategy. Before contributing to a nondeductible IRA, be sure you've exhausted other more advantageous investment vehicles, such as your employer's retirement plan, a traditional or Roth IRA, and the 529 college savings plan. You'll also want to weigh the benefits of saving in a plain old taxable account.