9.3: Individual Retirement Accounts (2021)

Purpose

The purpose of the IRA is to provide a tax-incentive for personal retirement savings. Theoretically this should increase the savings rate and encourage more people to prepare for their financial future.

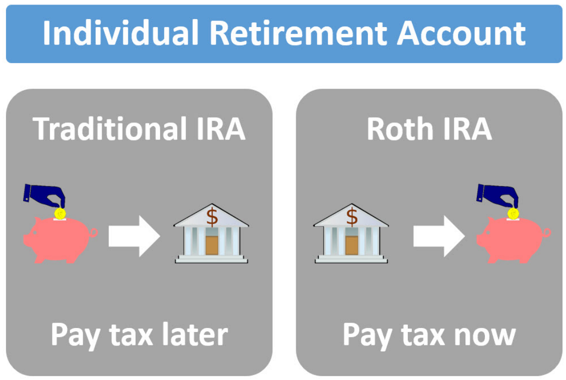

Figure 9.3.1: Tax situation for traditional IRA (pay tax on withdrawl) and Roth IRAs (pay tax on deposit)

Traditional IRA

Each individual can contribute up to $6000 per person per year into an IRA with the following stipulations (for 2021 tax year — some of these numbers will change for future years).

1. The contribution cannot exceed a person's earned income. However, a non-working spouse is eligible to contribute the full $6000, assuming sufficient family income.
2. If you are not an active participant in an employer sponsored pension program, you can contribute the full $6000 regardless of income (if you are not covered and your spouse is, there is an income cutoff, but it is higher).
3. If you earn (Adjusted Gross Income) less than $66,000 per year (single) or $105,000 (joint), you may contribute the full $6000 even if you are an active participant in an employer sponsored pension program.
4. If you earn (AGI) more than $76,000 per year (single) or $125,000 (joint), you can NOT make a tax-deductible contribution to an IRA if you are an active participant in an employer sponsored pension program. Note that at incomes above these limits, you can still contribute, but your contribution will NOT be tax deductible.
5. If you are above the lower limits and below the upper limits, you can contribute a portion of the $6000. For example, a single individual earning $69,000 per year is eligible to contribute $4200 per year [($7000/$10,000)*$6000]. A married couple earning $115,000 would each be able to contribute $3000 [($10,000/$20,000)*$6000] per year.
6. If you are 50 years of age or older, you can contribute up to $7000 per person per year instead of $6000.

The contributions to the IRA are tax-deductible in the contribution year. For instance, if you had a taxable income (single) of $50,000 prior to an IRA contribution and contributed the full $6000 to an IRA, the IRS would lower your taxable income in that year to $44,000. This level of income places the individual in a 22% marginal tax bracket for taxable income between $40,526 – $86,375 for 2021, so would result in a tax benefit of $1,320 ($6000*0.22) in the year of contribution.

All interest, capital gains, and dividend income are allowed to compound tax-free during the investment period.

Withdrawals taken after age 59½ are taxed as ordinary income at the time they are withdrawn.

Any withdrawals taken prior to age 59½, are subject to a 10% tax penalty unless they are (note – regular taxes are still due, just not the penalty):

- To purchase a primary residence for yourself, your parents, grandparents, spouse, child or grandchild. You can withdraw up to $10,000 (total during your lifetime). The distribution generally is available if you have not owned a primary residence for two years. Home-buying funds must be used within 120 days for expenses such as settlement charges, financing fees and closing costs.
- For qualified college expenses, such as tuition, fees, books, supplies, equipment, and room and board.
- If distributed in "substantially equal" payments, such as an annuity, based on your life expectancy.
- Due to death or permanent and total disability.

- To pay certain medical expenses if your medical bills exceed 7.5 percent of your adjusted gross income.
- For health insurance premiums if you've received unemployment compensation for 12 weeks or longer.
- Being called up to active military duty.

Withdrawals must be initiated by the time an individual reaches age 72

Typical investment options include mutual funds, individual stocks, bank CDs, and bonds. Some investments such as derivatives with potentially unlimited loss, collectibles, life insurance, etc. are not permitted in IRAs.

Roth IRA

Each individual can contribute up to $6000 per person per year into a Roth IRA with the following stipulations (for 2021 Tax Year).

1. The contribution cannot exceed a person's earned income. However, a non-working spouse is eligible to contribute the full $6000, assuming sufficient family income.
2. If you earn (AGI) less than $125,000 per year (single) or $198,000 (joint), you may contribute the full $6000.
3. If you earn (AGI) more than $140,000 per year (single) or $208,000 (joint), you can NOT make a contribution to a Roth IRA.
4. If you are above the lower limits and below the upper limits, you can contribute a portion of the $6000. For example, a single individual earning $128,000 per year is eligible to contribute $4800 per year [($12,000/$15,000)*$6000]. A married couple earning $207,000 would each be able to contribute $600 per year [($1000/$10,000)*$6000].
5. If you are 50 years of age or older, you can contribute up to $7000 per person per year instead of $6000.

Contributions to a Roth IRA are NOT tax-deductible in the year of the contribution. For example, if your taxable income was $40,000 prior to making a $6000 contribution to a Roth IRA it would remain $40,000 after your contribution. There is no tax benefit at the time of contribution.

All interest, capital gains, and dividend income are allowed to compound tax-free during the investment period.

Withdrawals taken after age 59½ (and minimum 5 years) are NOT taxed. This is one of the primary benefits of the Roth IRA.

Early withdrawals are subject to penalty unless special situation (see traditional IRA). Note that withdrawals of contributions are not penalized or taxed. Only early withdrawal of investment income is penalized/taxed. While there may not be a penalty associated with withdrawing your contributions, it is not recommended as this greatly limits the ability of the Roth IRA to take advantage of the power of compounding.

Withdrawals do NOT need to be initiated by the time an individual reaches a specific age. This is because withdrawals are not taxed and therefore, there is no tax revenue to be generated by requiring investors to withdraw capital at a certain point.

Typical investment options include mutual funds, individual stocks, bank CDs, and bonds. Some investments such as derivatives with potentially unlimited loss, collectibles, life insurance, etc. are not permitted in IRAs.

Rollover IRA

Rollover IRAs are designed to allow individuals to move their pension plan into a tax-sheltered account when they switch jobs, essentially turning the old pension plan into a traditional IRA. If the rollover is done directly (so that the previous employer handles the transaction directly with the institution offering the IRA), the full amount is transferred. If the previous employer transfers the money to the individual, allowing the individual to then set-up the rollover IRA, there will be a 20% withholding charge. If the new account is established (for the full amount) within 60 days, the IRS will return this withholding.

How Much Benefit Can an IRA Make?

This answer varies based on time horizons, tax rates, and rates of return. Also, if you use a traditional IRA, it depends on whether you reinvest your tax savings each year or spend them. I am going to run through a scenario with several assumptions to give you an idea of the financial benefits of an IRA. Note that your specific benefits will vary – these results are specific to this example, but are designed to provide a realistic look at how much you can gain from choosing an IRA over an ordinary taxable account. Typically, you can expect greater benefits for using an IRA when you have

Longer time horizons (starting in your 20's vs. starting in your 40's)
Higher tax rates (because the IRA is a tax shield)
Higher rates of return (the compounding effect is bigger)

However, to give you an idea, consider the following scenario

Let’s assume you are 22 years old and want to start saving for retirement.

You plan to save

$100 per month at the end of each month for the next 5 years
$200 per month for the following 10 years
$300 per month for the remaining 23 years until you retire at age 60.

Assume you will earn a 9% rate of return over the entire 38-year time frame.

Also, assume that you pay an average tax rate of 18% on your investment income and an average tax rate of 25% on your ordinary income (note that these are different because dividends and long-term capital gains are currently taxed at lower rates than ordinary income).

You want to take out your money at the start of each month for 35 years

You will earn a 6% rate of return during retirement (the lower return is because you plan to move to less risky investments in retirement).

If you use a traditional IRA, you will reinvest your tax savings each year.

Given all these assumptions, here is how much you will have at retirement and to spend each month during retirement if you (A) don’t use an IRA, (B) use a traditional IRA, or (C) use a Roth IRA. Note that you can’t easily do this with your financial calculator because of all the assumptions. I used a spreadsheet to generate these values. Also, note that while you have more money at retirement with the traditional IRA, because you have to pay tax on each $1 you withdraw, you actually have a higher after-tax monthly income with the Roth IRA. In this scenario, using a Roth IRA generates an additional $1670.69 every month over your 35-year retirement compared to just an ordinary taxable account – a very substantial benefit.

Don’t Use an IRA (Ordinary Taxable Account)
Retirement Wealth $490,127.93
Monthly Income $2438.67

Traditional IRA
Retirement Wealth $846,835.17
Monthly Income $3691.68

Roth IRA (Ordinary Taxable Account)
Retirement Wealth $724,303.18
Monthly Income $4109.36
