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IRAs: Four Facts You Should Know

Overview: The decision between contributing to a traditional IRA and a Roth IRA depends on many factors. The following discusses some of the key concepts to consider when making such a decision.

Introduction

Individual retirement accounts (IRAs) allow individuals to invest in a tax-advantaged manner. There are two types of IRAs: traditional IRAs and Roth IRAs. The differences between the two have implications for investors when developing investment policy statements, making decisions about asset allocation, and choosing the preferred saving vehicle.

In this document, we will discuss primarily IRAs, but please note that the issues impacting the decision between choosing a traditional IRA and a Roth IRA are basically the same for those choosing between a traditional 401(k) or 403(b) and a Roth 401(k) or 403(b). The traditional 401(k) or 403(b) is akin to a traditional IRA and the Roth 401(k) or Roth 403(b) is akin to a Roth IRA.

Let's begin by looking at a Roth IRA. Contributions to a Roth IRA are made on an *after-tax* basis and distributions are not subject to income tax (assuming the client has attained age 59½ and has satisfied the five-year Roth IRA distribution rule). The traditional IRA is the mirror opposite. It allows contributions to be made on a *pre-tax* basis (on the tax return, the adjusted gross income is reduced by the amount of the contribution), but all withdrawals are subject to taxation (assuming there are not any non-deductible contributions in the traditional IRA).

John and Mary

Let's look at an example demonstrating the differences and similarities of the two accounts. Consider two investors, John and Mary. Both are in the 25 percent tax bracket, and they both expect to be in that same 25 percent bracket when they retire. They also have the same income and spending needs, and they both invest a \$1,000 bonus on the same day in the same mutual fund.

John invests his bonus in a Roth IRA. Given that he has to set aside 25 percent of his bonus to pay federal income taxes, John makes a \$750 contribution to his Roth IRA. John invests that amount in a mutual fund that invests in equities. John's investments increase in value by 33 1/3 percent. He now has \$1,000. Assuming that there was no penalty for early withdrawal, he would be able to withdraw \$1,000 and no taxes would be owed.

Mary decides to use her bonus to contribute \$1,000 to her traditional IRA. Despite being in the same situation as John, Mary can invest \$250 more than John because she doesn't have to pay the *current* income tax on the \$1,000 invested. Mary now invests her \$1,000 in the same mutual fund as John. Thus, she earns the same 33 1/3 percent return. The result is that she ends up with \$1,333. When she withdraws the funds from her traditional IRA (again assuming no penalty for early withdrawal) she will pay a tax of 25 percent. After paying taxes of \$333, she ends up with exactly the same \$1,000 that John did. Note that the tax of \$333 is equal to the original tax that was deferred of \$250 plus \$83 dollars. This example demonstrates four important facts.

Fact One: After-Tax Dollars Are Equal When Tax Brackets Remain Steady

The first fact is that a traditional IRA is actually identical to a Roth IRA if the tax rate at the time of contribution is the same as the tax rate on withdrawal. We saw the proof of this fact in the above example — both Mary and John had portfolios that generated \$1,000 net.

Fact Two: The Government Owns Part of the Traditional IRA

The second fact often is one that people seem to have a hard time understanding, perhaps because of incorrect preconceived notions. The fact is this: If there are no taxes on Roth IRAs, and the same investment in a Roth IRA and a traditional IRA results in the same ending dollars after withdrawal, there really is no tax on a traditional IRA.

The right way to think about it is that Mary never owned 100 percent of her \$1,000 investment. She only owned 75 percent of it; the government owned the other 25 percent. The government allowed Mary to invest its share of the money until Mary withdrew her share. At that point the government then claimed its 25 percent share. Mary is in the identical situation as John. She really started out not with \$1,000, but with just \$750 ($\$1,000 \times [1 - \text{tax rate}]$), just like John. And they both ended up with the same \$1,000. Thus, just as there was no tax on John's earnings, there really was no tax on Mary's *share* of the earnings.

The remaining \$333 can be broken down into the original \$250 that Mary owed the government (it was a deferral of the tax due) plus the \$83 (33 1/3 percent) return on the government's \$250. This example also addresses another piece of incorrect advice, which is that equities should not be placed in a traditional IRA because doing so converts capital gains into ordinary income. As we just saw, there is no tax on the gain. That doesn't change the fact that if investors have a choice between holding equities or fixed income assets in a taxable account or a traditional IRA, then they should hold equity in the taxable account and fixed income assets in the traditional IRA.

Asset Location Is Important

There are five reasons individuals should prefer holding equities instead of fixed income in taxable accounts:

- s Equities receive more favorable tax treatment than taxable fixed income investments since they are taxed at more favorable capital gains rates (versus ordinary income rates).
- s Equities are more volatile than fixed income assets. Therefore, the ability to take losses in a taxable account is worth more in the case of equities.
- s There is the potential for a step-up in basis for heirs of the estate.
- s Appreciated shares can be donated to charity, avoiding any tax.
- s Any foreign tax credits generated by investments are useless in an IRA.

Fact Three: Taxes Need to be Integrated Into Investment Policy

The fact that Mary only actually owned 75 percent of her \$1,000 investment has implications for investment policy and the asset allocation decision. Let’s assume that Mary and John each started with \$1,000 of equity holdings in taxable accounts. John then invests another \$750 in his Roth and Mary invests another \$1,000 in her traditional IRA. They both put the money into bond funds.

What are their respective asset allocations? The conventional way to arrive at the answer would be as follows. John has \$1,000 in stocks and \$750 in bonds. His asset allocation is 57 percent stocks and 43 percent bonds. Mary’s allocation would be \$1,000 in stocks and \$1,000 in bonds. Her allocation would be 50/50. However, it should be apparent from our previous example that Mary’s allocation must actually be the same as John’s allocation. Her allocation cannot be 50/50. It would be 57/43.

Mary’s Holdings			
\$1,000 in Taxable Account (Stocks)		\$1,000 in Traditional IRA (Bonds)	
Mary’s Share	Government’s Share	Mary’s Share	Government’s Share
\$1,000	\$0	\$750	\$250

If Mary wanted to have an allocation of 50/50, her holdings should have been \$875 of stocks and \$125 of bonds in the taxable account and \$1,000 of bonds in the traditional IRA. The reason is that 25 percent of the \$1,000 of the IRA’s bond holdings belongs to the government as taxes.

It is important to note that the tax code impacts the asset allocation of taxable accounts as well as IRAs. For example, if John had a taxable account that owned an equity mutual fund with a cost basis of \$1,000 and a present value of \$11,000 (assuming a long-term federal and state capital gains tax of 20 percent and no step-up in basis expected), for the purposes of determining John’s asset allocation we should consider that he holds not \$11,000 of equities but just \$9,000 because the government “owns” \$2,000 of the \$11,000 (20 percent x the \$10,000 unrealized gain).

Fact Four: The Expected Difference in Tax Rate Should be a Factor

If an individual has a choice between contributing to a traditional or Roth IRA, the preference should be based on whether the expected tax rate on withdrawal will be higher or lower than it was at the time of contribution. If the tax rate at withdrawal is expected to be lower than at contribution, the preferred choice should be the traditional IRA. The reason is that the government will own a lower percentage of the investment dollars.

Let's look at an example. Let's assume John's tax rate is 25 percent on contribution. He can contribute \$1,000 pre-tax to a traditional IRA or \$750 after-tax to a Roth IRA, with his investment earning a return of 33 1/3 percent. How do his accounts fare if John's tax brackets are different at withdrawal than at the time of his contribution?

John's Retirement Account Withdrawals After Taxes			
Tax Bracket — 25 percent at contribution, 15 percent at withdrawal		Tax Bracket — 25 percent at contribution, 33 percent at withdrawal	
Traditional	Roth	Traditional	Roth
\$1,133	\$1,000	\$893	\$1,000

As shown in the table above, John should prefer deposits in a traditional IRA if he expects his tax bracket to be lower at withdrawal than at contribution. On the other hand, if the tax rate at withdrawal is expected to be higher than at contribution, the preferred choice should be the Roth. However, there is another consideration.

Maximizing the Benefits of the Tax Code

The maximum contributions to traditional and Roth IRAs are the same. For 2007, the maximums are \$4,000 for those under age 50 and \$5,000 for those age 50 and older (allowing for what is called a "catch up"). Let's assume that Mary and John are both age 40. Thus, they can each contribute a maximum of \$4,000. Let's assume that each has sufficient cash flow to make a \$4,000 contribution to a Roth IRA. Remember, as we have discussed, the traditional IRA allows for more current cash from a cash flow perspective because the contribution is sheltered from *current* income taxes. With that understanding, we can look at the implications of John's making a \$4,000 investment in a traditional IRA versus Mary's making a \$4,000 contribution to a Roth IRA.

John's \$4,000 contribution in a traditional IRA allows him to save \$1,000 of current income taxes. Thus, he now has \$1,000 to invest in a taxable account along with the \$4,000 in his traditional IRA, for a total of \$5,000. However, he does not own the full \$4,000 of his traditional IRA. He only owns \$3,000 ($\$4,000 \times [1 - \text{tax rate of } 25 \text{ percent}]$). The government owns the remaining \$1,000. His total holdings are thus \$3,000 that will not be subject to any tax (remember we showed that there are no taxes on the portion of the traditional IRA owned by the individual) and \$1,000 that will be subject to taxes on any gains. That is a total of \$4,000 ($\$3,000 + \$1,000$).

Mary also invested \$4,000, but all of Mary's contribution is in a tax-free account. Thus, if the tax rates at contribution and withdrawal are expected to be the same, the preferred choice for those that can make the maximum contribution is the Roth account. Doing so allows investors to hold more funds in a tax-free environment.

The decision between the two accounts gets more complicated when the tax rate at withdrawal is expected to be lower than when the contribution is made. In that case, the traditional IRA should be preferred. Thus, the benefits of the lower tax rate on withdrawal would have to be weighed against the benefit of being able to invest more

dollars in the tax-free environment. The individual needs to decide which is more valuable: being able to contribute a greater amount to a tax-advantaged account, or having the government take a smaller share. The following are the issues that should be considered:

- s The first is the size of the expected difference in the tax rates — the larger the difference, the more it favors the traditional IRA.
- s The second is the length of the investment horizon — the longer the period, the more it favors the Roth.
- s The third is the level of tax efficiency of the taxable investments — the more tax efficient, the less advantage the Roth provides.

Even when accounting for these issues, the preferred choice would still be the traditional IRA if the tax rate is expected to be lower at withdrawal. However, it would be prudent to seek expert counsel.

Before continuing, it is important to note that the issues related to the ability to maximize contributions also relate to a Roth 401(k). The difference is that the Roth 401(k) is not constrained by the same income limitations or contribution rules that constrain a Roth IRA. As we discussed, individuals under age 50 are limited to contributing \$4,000 to a Roth IRA, and those age 50 and above can contribute \$5,000 for 2007. Additionally, Roth IRA contributions are prohibited when taxpayers earn a modified Adjusted Gross Income (AGI) of more than \$110,000 or \$160,000 for those that are married and file jointly.

However, with the Roth 401(k), employees can contribute funds on a post-tax basis in addition to or instead of pre-tax deferrals under their traditional 401(k) plans. Also, employee contributions to a Roth 401(k) account are not limited by the employee's modified AGI. An employee under age 50 can defer (whether to a traditional 401(k), a Roth 401(k) or both) up to \$15,500 for tax year 2007. If they are age 50 or older, they may contribute an additional \$5,000, or a total of \$20,500. Note that employer contributions (such as employer match or profit sharing contribution) are always pre-tax. The Roth option is only available for employee contributions.

Since individuals should always try to maximize their contributions to tax-advantaged accounts, the Roth 401(k) is a valuable tool. Note that the same issues apply to 403(b) accounts.

Pay Me Now, or Pay Me Later

As the above examples show, the government eventually takes its toll. It is just a case of when the "tax bell tolls." But investors control the timing, and the choice should be based on when the government's percentage ownership is *likely* to be lower. The word likely has been emphasized because we don't know for certain what future tax rates will be. Since we don't have a clear crystal ball, one strategy is to assume that tomorrow's tax rates will be the same as today's. Another strategy that is worth considering is that of diversifying the risk of tax rates changing. Since we cannot know for certain what the tax rate will be on withdrawal, a prudent approach might be to diversify the risk of tax

rates changing in an unfavorable manner by splitting the contributions between a Roth IRA and a traditional IRA.

The Impact of Required Minimum Distributions Should Be Considered

We need to cover a fifth fact, one that highlights an important difference between traditional and Roth IRAs. An advantage of a Roth IRA is that while a traditional IRA requires minimum withdrawals (RMDs), a Roth IRA does not. A Roth IRA does not have this requirement because the government has already collected its toll (taxes on the income have already been paid).

The result is that if individuals believe that they will not need the RMD to pay for living expenses, the choice of the Roth IRA could be better even if the tax rate was expected to be lower upon withdrawal than at the time of contribution. In addition, it is important to remember when estimating future tax rates to consider the impact of an RMD on the marginal tax rate.

One more difference between traditional and Roth IRAs should be mentioned. Due to the specific formulas for the calculation of estate taxes for investors who are likely to be subject to the estate tax, the dollars accumulated in Roth IRAs are, in effect, taxed less heavily than the dollars in a traditional IRA. Since the formulas are complicated, these investors should seek professional estate tax advice from their CPA.

Summary

Integrating the tax code into investment plans can be very complex, especially as tax rates and unrealized gains and losses change. There are two ways to address this issue. The first is to tax adjust current holdings to account for the government's share. The other approach is to build the tax code into the Monte Carlo simulation used to determine the odds of an investment plan's success. The simulation will account for the government's share and will figure the estimated odds of the plan succeeding in achieving its goal.¹ That goal can range from not outliving assets to leaving an estate of a certain dollar amount. We prefer the latter approach for its simplicity. However, either way will help with making the right decisions.

Hopefully, this has shown how essential it is to integrate the tax code into investment plans. Understanding the differences between the two accounts and putting those differences to the client's advantage is one way a good financial advisor can add value.

¹ We urge caution in using software tools that purport to analyze the benefits of traditional IRA and Roth IRAs. They often contain errors, missing some of the key points raised in this document.

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