Sophia

Individual Retirement Accounts

by Sophia

WHAT'S COVERED

In this lesson, you will learn how to use individual retirement accounts (IRAs) to save for the future. Specifically, this lesson will cover:

1. Overview of IRAs

Individual retirement accounts (IRAs) (sometimes referred to as individual retirement arrangements) are retirement savings accounts that provide individuals with:

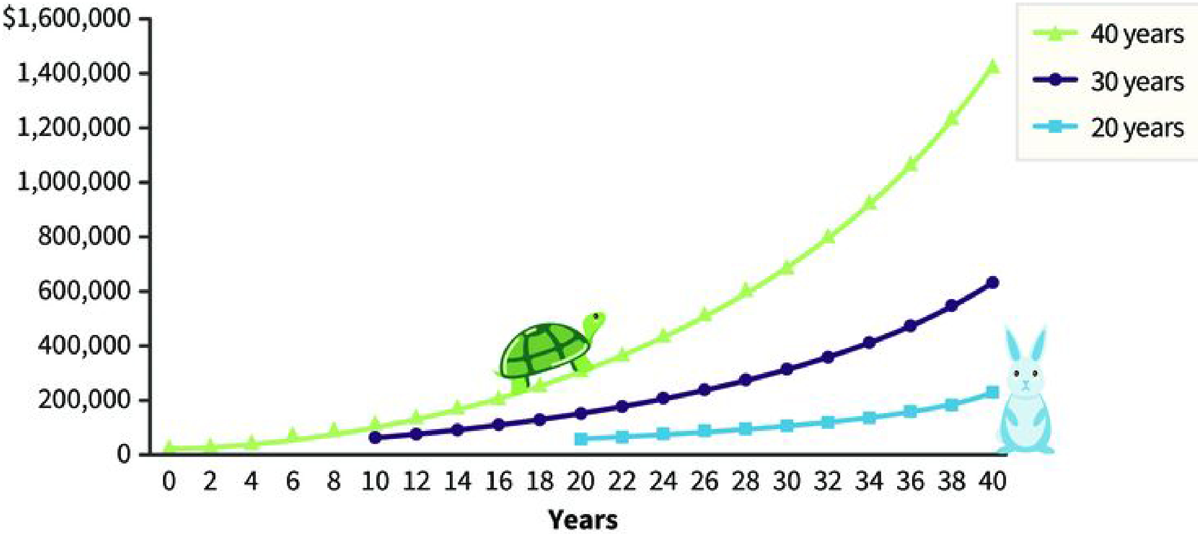
- Valuable tax benefits.
- Asset protection from creditors.
- Access to retirement savings in the event of certain emergencies.
- Eligibility for an additional $1,000 tax credit (the Retirement Saver's Credit).

HINT

You must be older than 18 years of age, have an adjusted gross income of less than $30,000, and not be a full-time student to qualify for the Retirement Saver's credit.

- Ability to make contributions for a tax year until the due date of the tax return for that year.

Because all money in an IRA grows on a tax-deferred basis, it is possible to accumulate significant wealth with a modest annual contribution. The line graph below shows what an IRA would be worth if $5,500 were contributed to the account annually for 40 years, 30 years, or 20 years, at an average annual rate of return of 8%.



There are two types of IRAs that you can establish:

1. Traditional IRA
2. Roth IRA

Let's look at these two options in more detail.

TERM TO KNOW

Individual Retirement Account (IRA)

IRS-approved accounts that allow someone with earned income to earn money for retirement on a tax-deferred basis.

1a. Traditional IRAs

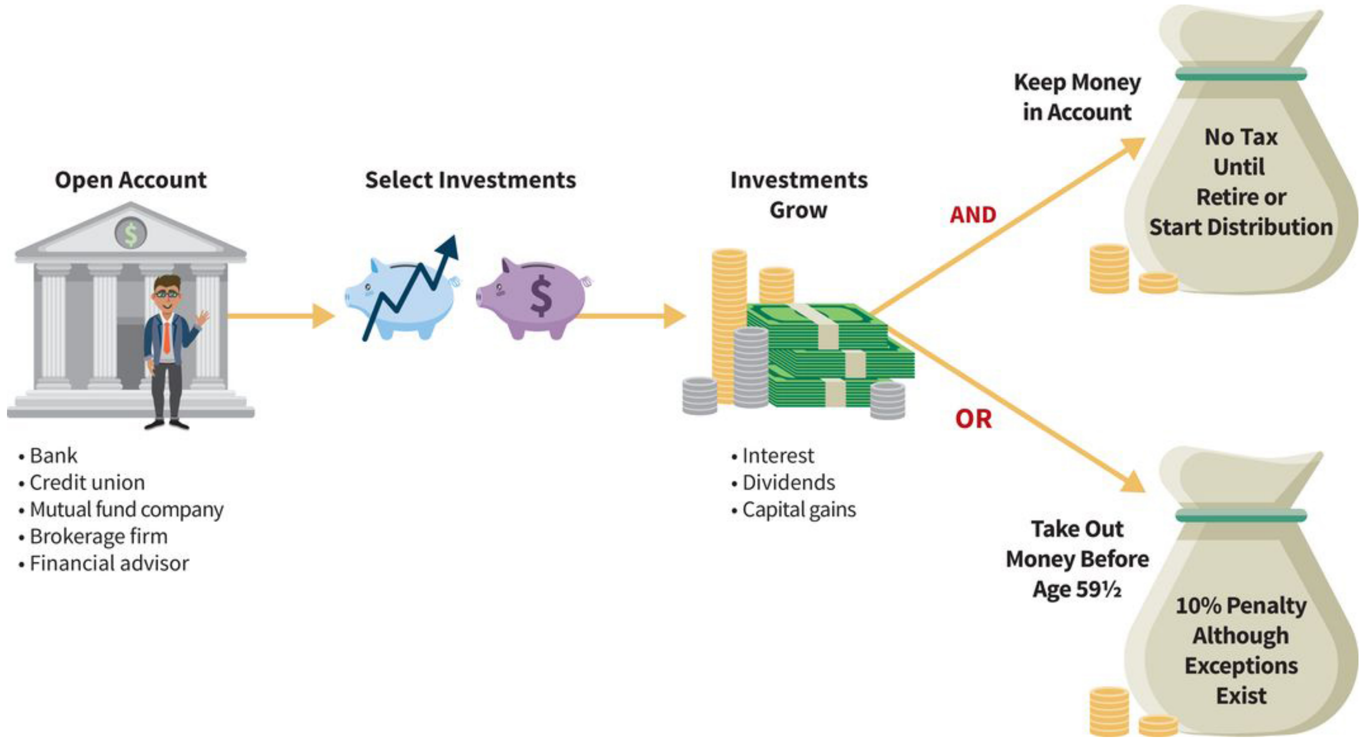
Traditional IRAs allow you to claim a **tax deduction**, if you qualify, on your federal tax return for the amount of the contribution.

- If you do not have access to an employer-provided retirement plan, then 100% of your IRA contribution may be deducted from your federal income tax return.
- Individuals participating in an employer-sponsored retirement plan may also be able to deduct contributions to a traditional IRA, but the amount may be limited based on income.

HINT

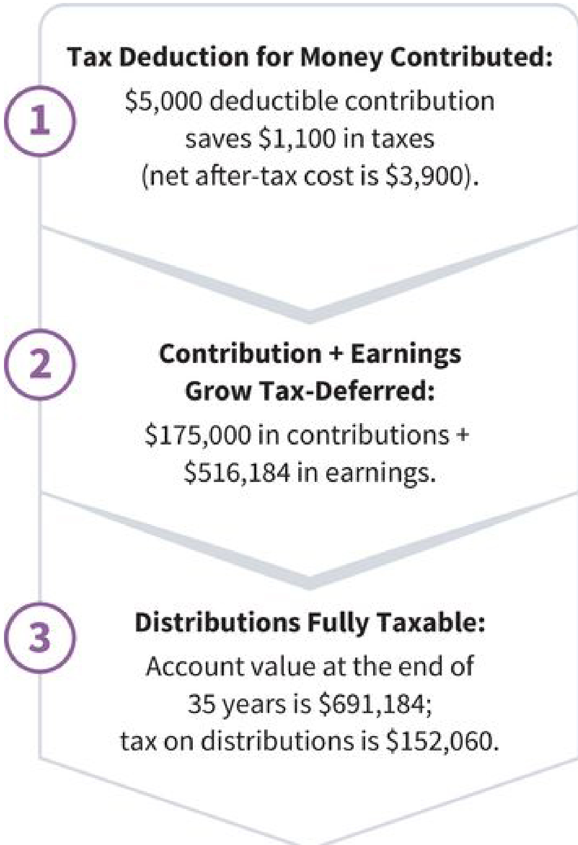
See IRS Publication 590-A at the IRS website to find out if your ability to deduct a traditional IRA is limited.

The following illustration shows how the traditional IRA funding process works.



1. You open an account with a bank, credit union, mutual fund company, brokerage firm, or financial advisor.
2. You select the investments in the account.
3. The earnings from the investments, usually in the form of interest, dividends, or capital gains, accumulate in the account on a tax-deferred basis.
4. If you keep the earnings in the account, you will not be taxed until you retire or begin taking distributions. Keep in mind that you must begin taking IRA distributions no later than age 70½. However, if any money is taken from a traditional IRA account before age 59½, then a 10% penalty will generally be assessed by the Internal Revenue Service (IRS). Exceptions to the 10% penalty exist, for example, if the money is used for the purchase of a new home, to fund qualified education expenses, because of death or disability, to pay health insurance premiums while unemployed, if you take substantially equal periodic payments, or if you roll the money over to another retirement account.
5. When you take money out of the account during retirement, all the distribution will be taxed as ordinary income in that year (if you claimed a tax deduction when you made the original contribution). That is, traditional IRA owners often get a tax deduction in the year they contribute to the account, but they end up paying taxes on that money in the future when it is pulled out in retirement. However, as long as the money is left in the IRA, none of the investment income is taxable. This is what is meant by the term **tax-deferred earnings**.

To illustrate how a traditional IRA works (see the steps shown below), consider Lamar. Lamar is 30 years old, single, and is in the 22% federal marginal income tax bracket. His employer does not offer a retirement plan.



- If Lamar makes a $5,000 contribution to a traditional IRA, Lamar will receive a tax deduction this year.
- The deduction is worth $1,100 ($5,000 × 22%).
- This means the after-tax cost of contributing is only $3,900 ($5,000 – $1,100).
- However, the full $5,000 goes into the account and grows based on the account's investment returns. If Lamar contributes $175,000 ($5,000 × 35 years) by the time he retires at age 65, because of the tax deductions Lamar received, the after-tax cost of his contributions will be only $136,500 ($3,900 × 35).

KEY CONCEPT

Each of the calculations shown in this topic can be modified based on retiring at, before, or after age 65. For example, the normal retirement age for Social Security purposes is 67.

Let's say that Lamar can earn 7% on an annualized basis. At the end of 35 years, the account will be worth $691,184 (calculated using the future value of an annuity formula). Remember that Lamar will need to pay tax on this money when he makes withdrawals from the account. If Lamar is in the 22% marginal tax bracket in retirement, then he will pay a 22% tax on the money pulled out, or $152,060 ($691,184 × 0.22). Lamar's after-tax wealth will be $539,124 ($691,184 – $152,060).

TERMS TO KNOW

Tax Deduction

A dollar reduction in the amount of taxable income.

Tax-Deferred Earnings

Interest, dividends, and other unearned income generated on assets held in tax-deferred accounts; tax-deferred earnings are not currently taxable.

1b. Roth IRAs

Roth IRAs are similar to traditional IRAs (you get to choose the investments in the account, and the earnings within the Roth IRA are tax-deferred, like a traditional IRA). The difference is that Roth IRAs provide you with a different tax outcome. If certain conditions are met, all the money distributed from the account (earnings and contributions) will be tax-exempt. This means that money you pull from a Roth IRA in retirement is tax-free to you. Qualifying distributions from Roth IRAs are tax-free if both of the following conditions are met:

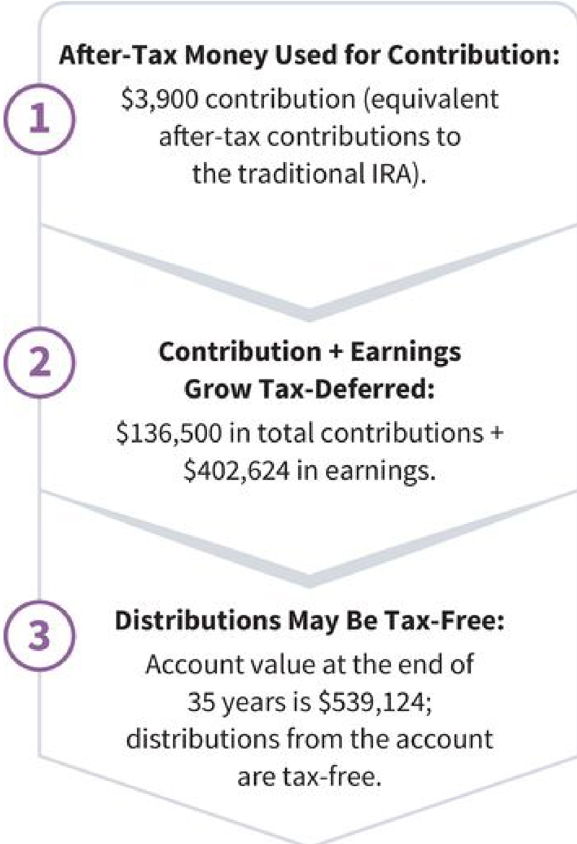
1. The account has been open longer than 5 years.
2. The account owner is older than age 59½ when the distribution is made, or the owner of the account has become disabled or died.

The ability to withdraw principal from a Roth IRA without paying taxes makes these accounts an attractive option for those adding to an emergency savings fund or saving for a child's education. For example, you may withdraw all your own contributions to a Roth IRA at any time without penalty or taxation.

HINT

Penalties and tax apply to nonqualified distributions of *account earnings* but do not apply to amounts contributed and later distributed.

Let's now look at how a Roth IRA works using the same example and information as above. Lamar is still single, 30 years old, and is in the 22% federal marginal income tax bracket, but he now decides to contribute to a Roth IRA instead of a traditional IRA (see the illustration below).



- If Lamar contributes to a Roth IRA, he is not able to claim a tax deduction today.
- Lamar decides that he can only afford to contribute $3,900 (the after-tax cost of his traditional IRA contribution); just like a traditional IRA, the account grows on a tax-deferred basis.
- If the account earns 7% on an annualized basis, Lamar will have $539,124 in the account after 35 years (calculated using the future value of an annuity formula).
- The total amount that Lamar has contributed to the Roth IRA will be $136,500 ($3,900 × 35 years). The after-tax amount is the same because Lamar did not receive a tax deduction for these contributions.
- *The difference is that all distributions from the account can be taken on a tax-free basis.* Thus, Lamar's after-tax wealth will be $539,124.

The table below shows a comparison of Lamar's two choices. As shown, if Lamar is in the same marginal tax bracket in retirement that he is in today, then Lamar's after-tax wealth will be the same, $539,124.

HINT

If Lamar's tax rate goes up in retirement, the Roth IRA will create more after-tax wealth.

Table: A Comparison of Lamar's IRA Choices

	Traditional IRA	Roth IRA
Marginal tax bracket rate now	22%	22%
Pretax contribution	$5,000	$3,900

After-tax contribution	$3,900	$3,900
Number of years contributing	35	35
Rate of return	7.0%	7.0%
Balance after 35 years	$691,184	$539,124
Marginal tax bracket rate in retirement	22%	22%
Tax on distributions	$152,060	$0
After-tax amount of distributions	$539,124	$539,124

There are lots of factors that can change the look of the accumulation and distribution table; the most significant is whether you will have a lower or higher marginal tax rate at retirement than you have now. For that reason, to help you make the choice between these two types of IRAs, consider the rules shown in this table.

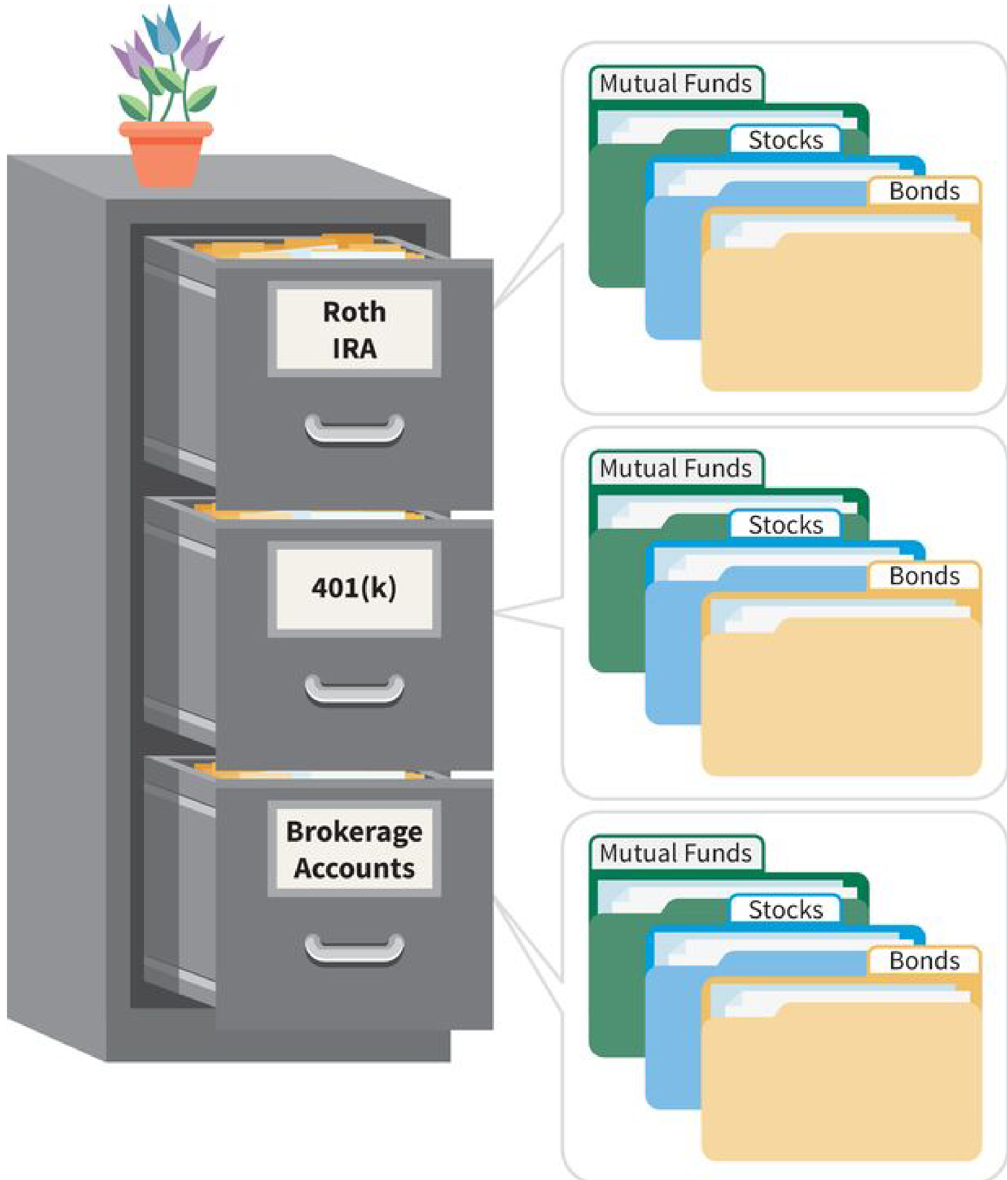
Table: IRA Choice Rules

Roth IRA	If your marginal tax rate in retirement is going to be higher than it is today, then a Roth IRA would likely be better.
Traditional IRA	If your marginal tax rate in retirement will be less than your current tax rate (say that you are in your peak earning years today), then you would likely be better off contributing to a traditional IRA.
Roth IRA	If you are younger than age 30 and your investment portfolio is at least 60% stock, then as a general rule you are likely better off contributing to a Roth IRA and receiving the tax-free income in retirement.

2. IRAs and Your Overall Retirement Plan

2a. Planning Your Retirement Investments

Because you will probably end up with several retirement plans and multiple IRAs during your lifetime financial journey, it is important to keep track of these accounts. Remember that when it comes to reaching your retirement goals, you must make sure that your money is working for you at all times. This means that *you need to make sure that you are adequately diversified across retirement plans.* Also, it is essential that you earn a rate of return that will allow you to accumulate enough wealth to retire. It might help to think of retirement plans, like IRAs and 401(k) plans, as being similar to the file cabinet shown in this illustration.



2b. Reaching Your Retirement Goal

How much will you need to fund retirement? It is not unrealistic to think that you will need more than $1 million when you retire. Here are some guidelines to help make this happen.

- If you are in your 20s, save between 10% and 15% of your paycheck for retirement.
- If you don't start saving until you are in your 30s, then the amount you will need to save is between 15% and 25%.
- If you wait to start saving until you are in your 40s, you will need to save between 25% and 40% of your income each year for retirement.

Once you have determined an amount to save, the next step in reaching your retirement goal is to choose how you want your money invested. One easy solution is to simplify things and purchase a **target date mutual fund**. Reaching your retirement goals, as the following table summarizes, consists of a few easy steps. Just like the tortoise in Aesop's fable, a steady approach will help you achieve success!

Table: Keys to Reaching Your Retirement Goals

1. Start saving early.	As soon as you begin working full-time, you should start saving for retirement.
2. Save at least 12% of your income.	No matter what you earn, you should be saving at least 12% of your income for retirement. If you want to retire early, save more.
3. Automate your savings.	Don't force yourself to choose whether to save or spend each paycheck; just decide now to save and then make it happen.
4. Invest aggressively.	Remember, you are saving for a goal 30 or 40 years away; don't be bothered by yearly ups and downs in the markets. Generally, you will want to invest in assets that have done well over the long run, such as stock index mutual funds. Older individuals with shorter time horizons may want to invest in more conservative investments.

TERM TO KNOW

Target Date Mutual Fund
A special type of asset allocation fund managed based on an individual's expected year of retirement that adjusts the amount held in stocks, bonds, and cash over time.

SUMMARY

In this lesson, you covered an **overview of individual retirement accounts (IRAs)**. You compared **traditional IRAs** with **Roth IRAs** where one primary difference is the tax distribution. IRAs can be an important part of your **overall retirement plan**. Since you might have several different IRAs during your lifetime, it's a good idea to diversify your retirement investments to mitigate risk. Naturally, when you purposefully **plan your retirement investments**, you'll be more likely to **reach your retirement goals**.

Here's one rule of thumb you can use for setting goals: If you are in your 20s, aim to save between 10% and 15% of your paycheck for retirement.

TERMS TO KNOW

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