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Would You Benefit from a Roth IRA?

by Matt Moore and Pamela Villarreal

Millions of Americans are saving for retirement in 401(k)s and Individual Retirement Accounts (IRAs). These tax-deferred accounts allow people to invest pretax dollars, but require them to pay taxes on their deposits and accumulated earnings at the time of withdrawal. By contrast, a Roth account allows individuals to deposit after-tax dollars, but withdraw the accumulated balances tax-free. Given that taxes on retirees will likely be much higher in the future — due to taxes on Social Security benefits and the cost of Social Security, Medicare and Medicaid — Roth accounts make sense for many taxpayers.

Roth IRAs: Where It All Began. The Roth method of taxation was proposed by the National Center for Policy Analysis and the U.S. Chamber of Commerce in 1991. America was in the middle of a recession and policymakers were desperately looking for ways to spur economic growth through increased savings and investment. The NCPA/Chamber proposal contained five pro-growth tax changes: 1) a capital gains tax cut, 2) repeal of the Social Security earnings penalty, 3) repeal of the Social Security benefits tax, 4) immediate depreciation of business investment and 5) a new IRA (later called the Roth IRA).

The NCPA/Chamber proposal became the basis for congressional bills sponsored by Rep. Tom DeLay (R-Texas) and Sen. Malcolm Wallop (R-Wyo.), Sen. Phil Gramm (R-Texas) and Rep. Newt Gingrich (R-Ga.), Sen. Robert Kasten (R-Wis.) and several others. Eventually the package became the economic core of the 1994 "Contract with America." The Roth IRA, named after sponsor Sen. William Roth (R-Del.), was probably the most revolutionary proposal of the group.

Because the Roth method of taxation allows savers to avoid future tax hikes, proposals have been made over time to broaden and strengthen the Roth IRA. In 2003, for example, President Bush proposed the creation of Retirement Savings Accounts (RSAs), which would simplify workers' retirement planning by establishing a single tax-advantaged account. The RSA is basically a universal Roth IRA.

Traditional vs. Roth IRAs: Benefits and Restrictions. Both traditional and Roth IRAs grow tax-free and both allow withdrawals at age 59½ without penalty. However, there are differences: People with ordinary IRAs must stop making deposits when they reach age 70½ and begin making minimum withdrawals. People with Roth IRAs can contribute at any age and are never required to withdraw funds.

The maximum contribution is the same for both accounts: $4,000 per year ($5,000 for people ages 50 and older) — considerably less than the $15,000 contribution that can be made to a 401(k) plan.

There are income restrictions on who can participate in a Roth IRA. A single tax filer with an adjusted gross income (AGI) of more than $110,000 ($160,000 for a

Which Is Better: Regular 401(k) or Roth 401(k)?

At age 36			At age 65	
Annual Income[1]	Current Marginal Tax Rate	Annual Investment[2]	More or Less Spendable Income for Choosing a Roth 401(k)	Marginal Tax Rate at Retirement
$35,000	18%	$3,500	- $1,015	0%
$75,000	18%	$7,500	+ $809	24%
$125,000	28%	$12,500	- $1,476	23%

Note: Calculations were made by Pamela Villarreal of the National Center for Policy Analysis using ESPlanner™ financial planning software developed by Laurence Kotlikoff at Boston University. The model makes automatic adjustments to make the family's standard of living uniform over time.

[1] Assumes a married couple living in Illinois (state taxes apply) with one child and both parents working. Increases are assumed to grow with the rate of inflation.

[2] After paying taxes, the contributions to Roth 401(k)s are $2,803, $6,184 and $8,030, respectively.

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couple) cannot contribute and cannot make the full contribution if his income is between $95,000 and $110,000 (for a couple, $150,000 and $160,000).

Of course, there are also income restrictions on contributions to traditional IRAs. Contributions are fully tax deductible for singles with an AGI of up to $50,000 ($75,000 for couples). The deductibility of contributions to traditional IRAs phases out completely for singles with an AGI of $60,000 or more ($85,000 or more for couples).

Conversion Opportunities. Investors can convert a regular IRA into a Roth IRA. The entire amount is included in taxable income and taxed at the prevailing rate. Currently, only people with incomes of less than $100,000 can convert. However, Congress recently passed a measure that will allow people at any income level to convert traditional IRAs into Roth IRAs beginning in 2010, but the taxes must be paid over the two years following conversion.

New in 2006: Roth 401(k)s. Currently, 401(k) plans are taxed like ordinary IRAs. Contributions are made with pretax dollars and people pay income taxes on their deposits plus earnings when funds are withdrawn. Starting this year, however, employers can offer Roth 401(k)s. Workers can contribute after-tax dollars, and the money will grow tax-free and can eventually be withdrawn tax-free. The new plan is similar to a Roth IRA, but there are no income limits on participation, and the annual contribution limits and penalties for early withdrawals are the same as traditional 401(k)s.

Who Benefits from Roth Taxation? Which is better, a regular IRA or a Roth IRA? The answer depends on an individual's marginal tax rate while working compared to the rate the taxpayer will face during retirement. In general, one wants to pay taxes when the tax rate is lowest. It once was assumed that people will be in a lower tax bracket after they retire, so investing pretax dollars and paying taxes when the money is withdrawn meant they would pay fewer taxes over their lifetimes. But there are two reasons this assumption may be wrong — especially for many young people today.

First, the Social Security benefits tax will push many moderate-income families into higher tax brackets after they retire. Thus, paying taxes on accumulated savings after retirement may cost a family more over its lifetime. Second, as the baby boomers retire, the cost to society of providing Social Security, Medicare and Medicaid benefits will likely lead to higher taxes across the board. So it is probably a safe bet that tax rates on future retirees will be higher.

NCPA scholars used a financial planning model developed by economist Laurence Kotlikoff to determine whether a Roth account or a regular account is better for workers at different income levels. As the figure shows:

- A two-worker family earning $75,000 will face an 18 percent marginal tax rate while working and a 24 percent tax rate in retirement; thus, they are better off with a Roth 401(k).
- Families earning $35,000 and $125,000 face higher marginal tax rates while working than in retirement; thus, they are better off with a traditional 401(k).

Because of the rising costs of elderly entitlement programs and the growing national debt, we adopt Kotlikoff's projection that future tax rates will be 30 percent higher than under current law, and we assume a 30 percent reduction in Social Security benefits. As a result, marginal tax rates for some future retirees will reach as high as 60 percent. In addition, the effect of the Social Security benefits tax becomes apparent: a worker with $30,000 in non-Social Security earnings could well face a higher tax rate than someone earning $80,000!

Conclusion. It is difficult to predict how high tax rates will be in the future, and the best vehicle for retirement savings depends on individual circumstances. But this should not preclude people from investing. Whether they invest in a traditional or Roth IRA, people should plan for retirement, start investing at a young age and diversify their assets.

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