Tax law changes increase applicability of traditional IRAs and add two new IRAs, expanding investor options but also adding complexity to the decision-making process.

Retirement Plan Rules, IRA Options Proliferate Under Tax Law Changes

By Clark Blackman II and Christine Romsdahl

President Clinton signed into law the Taxpayer Relief Act of 1997 on August 5. The Act significantly expands the opportunity for individuals to use individual retirement accounts (IRAs) in three distinct ways. First, access to the traditional IRA is increased and expanded in its flexibility and application. Second, Congress created a new non-deductible tax-free IRA called a Roth IRA. Third, Congress created Education IRAs. Taken as a whole, these three pieces of the legislation dramatically expand the application and opportunity for increasing tax-favored individual savings through the use of IRAs.

In addition, the excess distributions and accumulations tax penalty we have written so much about over the past several years in the *AAII Journal* is now gone.

Changes to the Old IRA

Restoration of IRA deduction for certain taxpayers:

The act increases the income limitation of those eligible to make deductible IRA contributions. Currently, deductions for IRA contributions are gradually phased out as income increases beyond $40,000 for married taxpayers filing jointly and $25,000 for single taxpayers. Under the act, those income levels will increase gradually to $80,000 by the year 2007 for married taxpayers filing jointly and $50,000 by the year 2005 for single taxpayers. The act also removes the restriction that prevents an individual who is not an active participant in an employer-sponsored retirement plan from making a deductible IRA contribution if his or her spouse is an active participant, provided their joint income is less than $150,000.

Effective date: This provision applies to taxable years beginning after December 31, 1997.

Penalty-free withdrawals from IRAs for higher education expenses and first-time homebuyers:

The act provides new exceptions to the 10% additional tax (but not income tax) on early withdrawals from IRAs for withdrawals used to pay qualified higher-education expenses and for qualified first-time home buyers. Qualified higher-education expenses include tuition, fees, books, supplies, room and board, and equipment expenses. A qualified first-time homebuyer distribution is a withdrawal of up to $10,000 during the individual's lifetime that is used within 120 days to pay costs (including reasonable settlement, financing, or other closing costs) of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer. This exception is available for the first-time homebuyer expenses of the individual, spouse, child, grandchild, or ancestor of such individual or spouse.

Effective date: This provision applies to distributions after December 31, 1997.

The Roth IRA

The act creates a new category of non-deductible IRA called the Roth IRA. The Roth IRA is funded solely with aftertax (non-deductible) contributions, but unlike current non-deductible IRAs, it exists as a separate account and offers the possibility of tax-free earnings.

The principal features of the Roth IRA are as follows:

- No tax deduction is allowed for contributions to the account.
- Income accumulates tax-free in the account.
- Qualified distributions from the account are not included in income.
- Income limitations for contributions begin at $150,000 for married taxpayers filing jointly and $95,000 for single taxpayers.
- The maximum contribution is coordinated with the deductible IRA and is limited annually to the maximum IRA contribution allowed for that individual.
- Contributions can be made even if

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the individual is beyond age 70½.

- No distributions are required when the individual attains age 70½.
- Distributions are only required upon death.
- Rollovers are permitted from one Roth IRA to another Roth IRA.

Non-taxable qualified distributions from a Roth IRA include distributions made at least five years after the first taxable year in which the individual made a contribution to the Roth IRA, if they are made: (1) after the individual reaches age 59½; (2) after death; (3) on account of disability; or (4) for qualified first-home purchases. Non-qualified distributions are includible in income to the extent of earnings after recovery of contributions, and are subject to the additional 10% early withdrawal tax.

Effective date: The provision applies to taxable years beginning after December 31, 1997.

The Education IRA

The act also provides an additional new tax-savings opportunity, the Education IRA. An Education IRA is a separate IRA account for the benefit of a named beneficiary that has the intended purpose of providing funds for the attendance in a program of higher education. Like the Roth IRA, this account is created without providing an income tax deduction for the contribution. However, the earnings of this account are subject to inclusion in gross income and the additional 10% tax upon distribution to the extent the distribution exceeds qualified higher-education expenses.

The Education IRA has the following principal features:

- Contributions of up to $500 annually are allowed (which is in addition to the $2,000 regular IRA limit).
- Contributions may be made regardless of whether the beneficiary has gross income.
- Contributions may not be made after the beneficiary attains age 18.
- Distributions of income from the account are included in income and subject to the additional 10% tax to the extent they exceed qualified higher education expenses.
- Income limitations for contributions begin at $150,000 for married taxpayers filing jointly and $95,000 for single taxpayers.

It would appear from the language used in the law that up to 19 contributions could be made for a child if you begin contributions at birth. The last contribution would have to be made in the calendar year the beneficiary turns 18, but on or before the beneficiary's birthdate. The following example demonstrates a likely balance of an Education IRA at age 18, assuming a maximum annual contribution of $500 is made each year on the beneficiary's birthday and the account provides an 8% annual rate of return:

Age	Value	Contributions
Birth	$ 500	$ 500
5	$ 3,668	$ 3,000
10	$ 8,323	$ 5,500
15	$ 15,162	$ 8,000
18	$ 20,723	$ 9,500

In the above example, the entire investment balance of $20,723, plus ongoing earnings, could be used to pay qualified higher education expenses. To the extent the funds distributed exceed those expenses, the *earnings* on the account would be includible ratably in income and are subject to the additional 10% tax. The amount may be transferred to the Education IRA of another family member or another qualifying family member can be designated as beneficiary. Although the Education IRA is techni-

Table 1.
Comparing IRAs:
Same Tax Rate in Year of Contribution and Withdrawal
(32% in year of contribution and withdrawal)

Assumptions: Cash contributions for the IRA, Roth IRA, non-deductible IRA, and corporate bond represent the contributions available subsequent to taxes being assessed at some previous time. The rate of return on the investments is 8% compounded annually. The ending withdrawals from the IRAs are not subject to the additional 10% penalty tax. The year-one tax savings amounts shown for the deductible IRA grow at an 8% rate of return compounded annually. The growth of the year-one tax savings are subject to a tax rate equivalent to the year of contribution until the final year when the withdrawal rate applies. Tax rates were calculated as combined federal and state tax rates using federal rates of 28% and 15% and state rates of 5% and 4%, respectively. The state rates are applied to the federal rates on an aftertax basis for total combined tax rates of 32% and 18%

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	Cash Contribution ($)	Gross Funds After 10 Years ($)	Net Funds Avail in Year 10 on First-Year Tax Savings ($)	Taxes Due in Year 10 ($)	Net Funds Available After Tax in Year 10 ($)	Winners
Deductible IRA	2,000	4,318	1,087	1,382	4,023	
Roth IRA	2,000	4,318	—	—	4,318	✔
Non-deductible IRA	2,000	4,318	—	742	3,576	
Corporate Bond	2,000	3,397	—	—	3,397	

Table 2.
Comparing IRAs:
Lower Tax Rate in Year of Withdrawal
(32% in year of contribution, 18% in year of withdrawal)

Assumptions: Cash contributions for the IRA, Roth IRA, non-deductible IRA, and corporate bond represent the contributions available subsequent to taxes being assessed at some previous time. The rate of return on the investments is 8% compounded annually. The ending withdrawals from the IRAs are not subject to the additional 10% penalty tax. The year-one tax savings amounts shown for the deductible IRA grow at an 8% rate of return compounded annually. The growth of the year-one tax savings are subject to a tax rate equivalent to the year of contribution until the final year when the withdrawal rate applies. Tax rates were calculated as combined federal and state tax rates using federal rates of 28% and 15% and state rates of 5% and 4%, respectively. The state rates are applied to the federal rates on an aftertax basis for total combined tax rates of 32% and 18%.

	Cash Contribution ($)	Gross Funds After 10 Years ($)	Net Funds Avail in Year 10 on First-Year Tax Savings ($)	Taxes Due in Year 10 ($)	Net Funds Available After Tax in Year 10 ($)	Winners
Deductible IRA	2,000	4,318	1,099	777	4,640	✔
Roth IRA	2,000	4,318	—	—	4,318	
Non-deductible IRA	2,000	4,318	—	417	3,901	
Corporate Bond	2,000	3,433	—	—	3,433	

cally a non-deductible tax-deferred IRA, it is in essence a functional equivalent of the Roth IRA to the extent of qualified higher-education expenses.

Effective date: This provision applies to taxable years beginning after December 31, 1997.

Choosing Your Options

Suppose a taxpayer has saved $2,000 of aftertax funds in 1998 and is looking to move those funds into one of the IRA investments. How does that person decide which of these tax-advantaged plans to use, or whether to invest in a taxable instrument such as a corporate bond? Which option is the “winner” in terms of aftertax return on investment? In answering these questions, it is important to consider the limitations still in place for investment in an IRA and determine that this is an available option. Assuming that a taxpayer is not limited, the following example demonstrates some of the differences and similarities of the possible investment options.

As Tables 1 and 2 demonstrate, all three IRA options would earn $2,318 after 10 years, leaving the taxpayer with $4,318 of gross funds. The corporate bond would earn about $900 less over that same period because of the annual taxation of interest income. The deductible IRA, Roth IRA, and non-deductible IRA all leave the taxpayer with more in net aftertax funds in year 10 than the corporate bond, but that is not the whole story. The deductible IRA is a more valuable investment than the non-deductible IRA because the $2,000 aftertax investment in the deductible IRA provides a first-year tax benefit of $640 ($2,000 multiplied by the 32% tax rate). This money represents a tax savings in year one that may be invested in a taxable investment with compounding growth opportunity until the end of year 10 (the year of withdrawal in the example). Thus, the taxpayer using the deductible IRA benefits to the extent of the compounded aftertax earnings of the $640 invested for 10 years in addition to the inside tax-deferred growth of the IRA. In contrast, the non-deductible IRAs (including the Roth IRA) receive no current-year tax savings. Despite the aftertax growth of the first-year tax savings, the Roth IRA is the clear winner, assuming equal tax rates in the year of contribution and distribution, because no tax is due on withdrawal with this account.

On the other hand, if the tax rate in the year of withdrawal is lower than in the year of contribution, then the deductible IRA is the clear winner with the Roth IRA as the runner-up. This scenario represents a typical retirement planning expectation that tax rates will be lower in the year of withdrawal.

The three types of IRAs outperform the aftertax investment in the corporate bond in both Tables 1 and 2. However, other factors unrelated to taxes may make some non-tax-favored investments more attractive (that is, the flexibility to withdraw funds without incurring penalties, the ability to invest more than the IRA annual contribution limit, etc.). Therefore, when choosing an investment, many factors unique to the individual taxpayer must be considered. Those factors include, but are not limited to, applicable tax rates at contribution, expected tax rates at distribution, available rates of investment return, and desired flexibility of the investment.

Repeal of Excise Taxes

The act permanently repeals the 15%

excise tax on distributions from retirement plans (including both IRAs and qualified plans) that exceed $150,000 in any year, and the 15% estate tax on excess IRA and plan accumulations remaining at death. A provision in last year's tax bill provided individuals with a three-year "holiday" from the excess distributions excise tax for 1997, 1998, and 1999. As you may recall from reading AAII articles over the past year regarding strategies to avoid this tax, repeal was cited several times as a "risk" of accelerating income taxes to avoid the future penalty.

Summary

The Taxpayer Relief Act of 1997 provides individual taxpayers with many benefits, including more options to fund retirement, a child's education, and a first home purchase. Before you take advantage of these benefits, though, make sure that you understand the ramifications of your choices given your individual situation, and have a clear picture of how each vehicle fits into your personal financial plan.

Deductible IRAs will continue to have tremendous appeal to taxpayers, particularly when future tax rates during retirement may be lower than tax rates in those years contributions are being made.

Table 3 provides a summary of the rules relating to deductibility of IRA contributions.

Table 3.
A Guide to Deducting IRA Contributions

1998 limitation amounts are reflected in the table, with annual adjustments through 2007 in the section below.

	Scenario One	**Scenario Two**	**Scenario Three**
Contributor Participates in employer-sponsored qualified retirement plan	No	No	Yes
Spouse Participates in employer-sponsored qualified retirement plan	No	Yes	Yes or No
IRA is Deductible.....	Yes	Sometimes (see below)	Sometimes (see below)
IRA is Deductible if Adjusted Gross Income (AGI) is Below These Amounts for:			
-Married Filing Joint Taxpayers		$150,000	$50,000
-Single Taxpayers		N/A	$30,000
IRA Deduction is Phased Out for AGI Between These Amounts for:			
-Married Filing Joint Taxpayers		$150,000-$160,000	$50,000-$60,000
-Single Taxpayers		N/A	$30,000-$40,000
IRA is Non-Deductible for AGI Over this Amount for:			
-Married Filing Joint Taxpayers		$160,000	$60,000
-Single Taxpayers		N/A	$40,000

The phaseout ranges in Scenario Three will continue to grow as follows:

	Single Taxpayers	Married Filing Joint Taxpayers
1999	$31,000–$41,000	$51,000–$61,000
2000	$32,000–$42,000	$52,000–$62,000
2001	$33,000–$43,000	$53,000–$63,000
2002	$34,000–$44,000	$54,000–$64,000
2003	$40,000–$50,000	$60,000–$70,000
2004	$45,000–$55,000	$65,000–$75,000
2005	$50,000–$60,000	$70,000–$80,000
2006	$50,000–$60,000	$75,000–$85,000
2007 and thereafter	$50,000–$60,000	$80,000–$90,000