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In Defense of the Traditional IRA

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In Defense of the Traditional IRA

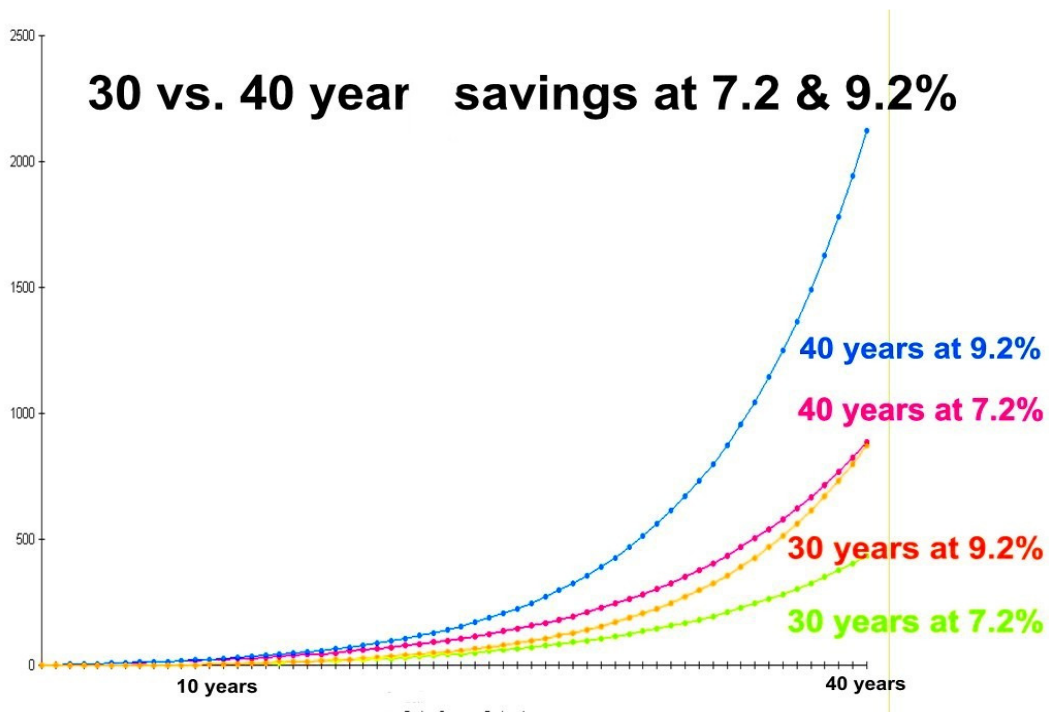
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For individuals filing income taxes in the United States, an option to deduct payments for traditional Individual Retirement Arrangements (IRAs) often exists. Note that an IRA account is not a repetitive misnomer although many refer to an IRA instead as an Individual Retirement Account. IRAs were created to aid those who did not have qualified pension plans and/or for those with lower incomes.

There are traditional (tax deductible), Roth (non tax deductible, named after its author), SEP, Self Directed, and Simple IRAs. The latter IRAs are generally for those who are self employed or do not otherwise have an employer supplied qualified pension plan (401[k] or 403[b]). This paper will focus on the traditional and Roth IRAs which are directed toward those who have ordinary income and may (or may not) have a pension plan. These often have the benefit of some employer matching; the matching amounts often range from some 25 or 50 percent to 100 or even 125 percent of the employee's contribution.

Regardless of whether one makes a deposit to a pension plan and/or to an IRA, the earlier one starts, the larger is the amount of final retirement amount. One would double the terminal amount when starting at the age of 20 instead of 30 with a retirement age of say 60 (or starting at 30 versus 40 with a retirement age of say 70). Moreover, if one were to obtain 2 percent more than say 7.2 percent, then the amount at retirement would double yet again. One can save possibly at least one or more percent annually by using no load mutual funds (or commission free for ETFs or Exchange Traded Funds which are similar to mutual funds but trade as common stocks) and with low expense ratios. I've used 7.2 percent here because compounded annually it doubles every 10 years:



Doubling by Starting 10 Years Earlier and by 2 Percent More

A traditional deductible IRA is tax deductible (generally for both state and Federal income taxes) and is fully taxable upon withdrawals. Deposits to an IRA for 2012 may be up to \$5,000 per year per spouse (whether working or not, a more recent revision to the rules) or \$6,000 per year

if over the age of 50 (called a catch up amount); for 2013 the maximum deposits are \$5,500 or \$6,500 if over the age of 50. Withdrawals must start by the age of 70½. Withdrawals from a Roth IRA may start at the age of 59½ without penalty if deposited two years or more previously (emergency and home purchase exceptions exist).

A Roth IRA is non tax deductible and incurs no tax upon withdrawal. With the tax reforms for 2013 now set, the tax benefit for qualified stock dividends will no longer exist and the capital gains rate will rise from 15 to 20 percent for many individuals. These tax benefits were not obtained with qualified stock dividends and lower capital gains rates are not available with IRAs whether taxable or not. For those with a qualified pension plan, there are restrictions as to qualifications and deductibility in the case of the traditional deductible IRA. The 2012 and 2013 tax year limits are generally based upon modified adjusted gross income (AGI); see Internal Revenue Service publication 590 for specifics. The limits are:

Modified AGI Limits	Single	Married
2012		
Trad. w/Pension	\$ 58,000- 68,000	\$ 92,000-112,000
Roth w/Pension	110,000-125,000	173,000-183,000*
2013		
Trad. w/Pension	\$ 59,000- 69,000	\$ 95,000-115,000
Roth w/Pension	112,000-127,000	178,000-188,000*

*or traditional IRA married joint return, spouse with a pension but not for the filer

A person at the upper end of these limits is disqualified for an IRA and those at the lower end of the limits is fully qualified; a sliding scale computation is made for modified AGIs in between. A person may combine a traditional deductible IRA and a Roth non taxable IRA but still within the total 2012 contribution of \$5,000 (\$6,000 if over 50 years of age) or for 2013 \$5,500 (\$6,500 if over 50 years of age). One may make deposits to an IRA for the prior tax year with the deduction and computation upon the current year's tax filing.

A provision exists for a Roth conversion wherein one can convert a traditional IRA into Roth IRA making the remaining proceeds tax free. The conversion is generally accomplished with a tax upon the traditional IRA account value at the time of conversion. Provisions exist for reversing this process.

Many a person, broker, institution, and investment guru have touted Roth IRAs and/or conversions thereto. And if one does expect later a substantially higher tax rate during periods of withdrawals then Roth IRAs merit investigation. Plus if one can afford it, Roth IRAs set aside more cash with 2012 deposits of \$5,000 (\$6,000 if over age 50) or for 2013 deposits of \$5,500 (\$6,500 if over age 50) instead of the net cash flows for a 2012 traditional deductible IRA of say \$3,330 (\$4,000 if over age 50) with a 33.3 percent combined state and Federal income tax rate.

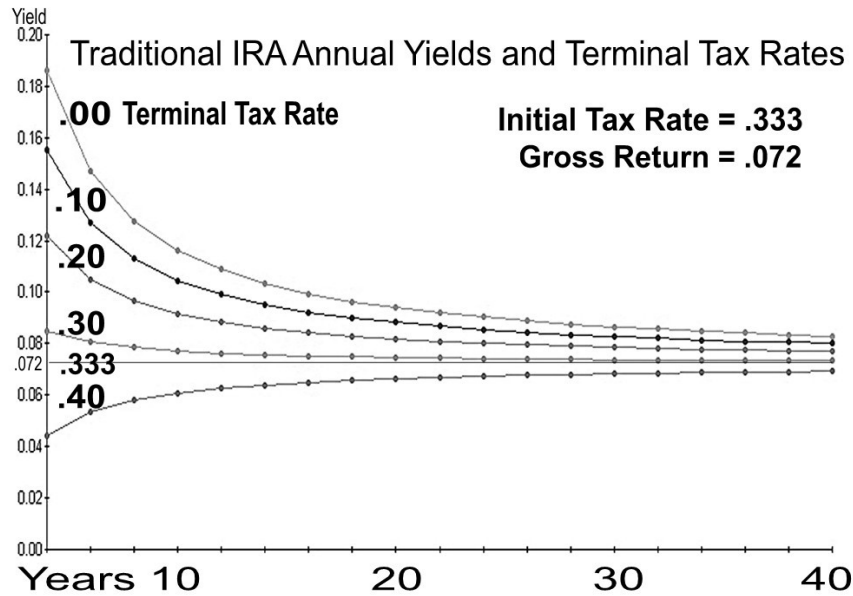
For a Roth IRA, payments are $-C_0$ and C_t at time t . For a traditional IRA, payments are $-C_0+C_0X_0$ and $C_t-C_tX_t$ for tax rate X_t at time t . The annualized return k_R for a Roth IRA would be when $C_0(1+k_R)^t$ equals C_t . Likewise, the annualized return k_D for a deductible traditional IRA

would be when $(C_0 - C_0 X_0)(1 + k_D)^t$ equals $C_t - C_t X_t$. If X_0 equals X_t and rewriting the deductible traditional IRA payments as $(C_0[1 - X_0])(1 + k_D)^t$ and $C_t(1 - X_0)$, then the equality is maintained by canceling $(1 - X_0)$ which results in $C_0(1 + k_D)^t$ equaling C_t and thus k_D equals k_R . Moreover, if X_t is larger (smaller) than X_0 , then k_D is smaller (larger) than k_R ; k_D equals $(1 + k_R)([1 - X_t]/[1 - X_0])^{1/t} - 1$.

It will be argued here, in addition to those who cannot afford the extra cash required for a Roth IRA, that a traditional tax deductible IRA may be preferred. Assumed here is a combined Federal and state tax rate of 33.3 percent (close to that of a California resident with middle class income) and compound annual investment rate of 7.2 percent (which has the nice property of doubling every 10 years). The after tax rate would be 4.8 percent (from $7.2[1 - .333]$). Consider the following scenarios where the terminal tax rate and the after tax cash flows are examined:

		Terminal			
	Tax	Year 0	Year 10	Year 20	Year 30
Roth	0 %	\$-6000	\$12000	\$24000	\$48000
Trad	40	-4000	7200	14400	28800
Trad	33.3	-4000	8000	16000	32000
Trad	25	-4000	9000	18000	36000
Trad	15	-4000	10200	20400	40800
Trad	0	-4000	12000	24000	48000
Roth	0 %		7.2%	7.2%	7.2%
Trad	40		6.1	6.6	6.8
Trad	33.3		7.2	7.2	7.2
Trad	25		8.5	7.8	7.6
Trad	15		9.8	8.5	8.1
Trad	0		11.6	9.4	8.6

Here's a generalized graphic:



The after terminal tax results can be restated as follows: 1) the after tax annually compounded returns produce no difference in returns between traditional deductible IRAs and tax free Roth IRAs at like tax rates, and 2) as the future tax rates decline, the more the annual return increases to a traditional deductible IRA but less so as the withdrawals are later in time. It might be likely that a person's tax rate would decline during retirement years, but a greater future tax rate is indeed possible from either a greater taxable income or from an external change in tax policy or moving from a place with a lower rate. Of course, a series of payments across a number of years would have a yield somewhere in between.

For those who do make IRA payments, one may wonder from where the spare cash would come from. A typical investment guru might suggest decreasing the purchase of expensive exotic coffee drinks or brown bagging (bringing your own lunch). I would offer the following additional suggestions starting with the obtaining of free cash rebate credit cards. These include: Bank of America with a one time \$100 back plus 1%, 2% grocery, and 3% gas/restaurant rebates; Chase with a one time \$100 back plus 5% quarterly on gas, grocery, drugs, hotel, or travel, and Capital One with one time \$100 back plus 1% plus 1/2% yearly bonus. These are generally all up to \$1500 in purchases per quarter. Further there are Ralph's and Vons grocery 1 percent or \$.10 per gallon Shell Oil and Chevron rebates on gasoline purchases. There are credit cards which offer airline frequent flyer miles but generally the annual membership (after the introductory fee) makes them often relatively unattractive (a frequent flyer mile is worth about some 1.5 to 2.5 U.S. cents or about 2 percent). Of course the usage of frequent flyer miles from the purchase of air/train travel is valuable and often results in the 4th or 5th trip being free. Here's a current summary including air miles:

	Groc	Gas/Drug	Air/Hotel	Rest
JanMar	2 BofA	5 Chase	1.5 CapO	3 BofA
AprJun	5 Chase	3 BofA	1.5 CapO	1.5 CapO
JulSep	2 BofA	5 Chase	1.5 CapO	5 Chase
OctDec	2 BofA	3 BofA	5 Chase	1.5 CapO
Average	2.75	4	2.37	2.75
plus	2.5	.10/gal	.02/mile	
Total	5.2	10	19	2.75

If one has a credit card balance with a typical 18 percent per year rate (20 per year as an annual percentage rate compounded monthly) with a typical balance for a U.S. resident of some \$8,000 to \$9,000, one would save some \$1,600 to \$1,800 per year if paid off. Note that the taxable equivalent rate would be about 30 percent (20/[1-.333]) which occurred only once in the history of the U.S. stock market. Or consider the 10 cent Action Comics featuring the first Superman which was purchased in the 1930s and which was recently sold for \$10,000,000 and achieved a 30 percent compounded annual rate.

Other places to gain savings include:

Mow your own lawn at \$20/week	\$1000/year
Basic cable or basic coffee saves \$40/month	\$480/year
3 percent on cigarettes at gas stations or a \$4 coffee/week	\$200/year
Florescent bulbs save 5x60wattsx10hours/day x \$.20/kwh	\$200/year
Save with higher insurance deductions	\$200/year
Basic measured rate telephone service (\$32-\$18=\$14/mo)	\$168/year
4 percent average on gas \$75/week	\$150/year
Cut your own hair \$20/2months	\$120/year
Chas. Schwab card avoids \$2/week ATM fee	\$100/year
One dollar coupon or senior discount restaurant	\$100/year
Tipping 10 vs. 15 percent (if appropriate) on \$20/week	\$ 50/year
2 percent on groceries \$50/week	\$ 50/year
2 percent average on \$2,000/yr travel	\$ 40/year
10 cents on gas \$1.50/bimonthly	\$ 36/year
Recycle cans	\$ 36/year

These total sufficient savings of almost \$3,000 so that one may easily fund a \$5,000 IRA account (saving some \$1,330 on income taxes for a traditional IRA). Thus, one would need about a net \$700 toward funding your retirement account. See/hear also my DrCinvests video on YouTube at: http://www.youtube.com/watch?v=Olz1_3H8x3E

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