Taxes

The UNDERUTILIZATION of IRAs

By Joseph D. Beams, CPA, and Esther A. Houser, CPA

Many individuals with employer-provided retirement plans fail to take advantage of the opportunity to make IRA contributions even though they are eligible. A common misconception is that only lower-income taxpayers can contribute to an IRA if they are covered by an employer-provided retirement plan. This isn't true. Most wage earners (i.e., taxpayers) can make a contribution to their IRA and, depending on the individual's or couple's income level, may have a choice between a traditional and a Roth IRA.

The only restriction on contributions to a Roth IRA is based on income, and the limits are moderate. Married taxpayers with modified adjusted gross income (MAGI) of up to $150,000 ($95,000 for single filers) are able to make a $4,000 contribution in 2005 and 2006 for each spouse ($4,500 in 2005 and $5,000 in 2006 if age 50 or older). Married taxpayers with MAGI amounts between $150,000 and $160,000 ($95,000 and $110,000 for single filers) are able to make a reduced contribution.

Taxpayers also have the option to contribute to a traditional IRA instead of the Roth IRA. The traditional IRA has a different set of income restrictions that are tied to the taxpayer's ability to participate in a company-provided retirement plan. In addition, the contribution may be deductible or nondeductible.

ROTH IRA

In contrast to most retirement plans, a Roth IRA doesn't allow the taxpayer a current-year deduction on his or her contributions, but the entire distribution (both principal and earnings) from a Roth IRA is tax exempt if the taxpayer satisfies certain restrictions. This represents a significant difference from other retirement plans, such as traditional IRAs and 401(k) plans, which allow for the deferment of taxes on the earnings until distributions are made.

The maximum amount an individual can contribute to a Roth IRA is $4,000 for the 2005 and 2006 tax years. Under IRC §219(b), married taxpayers can contribute up to $4,000 each as long as the couple's total IRA contributions aren't more than their total combined compensation. Individuals age 50 or over can contribute an additional annual contribution of $500 in 2005 and $1,000 in following years. If both spouses are age 50 or over, a married couple can contribute a total of $9,000 ($4,500 each) in 2005 and $10,000 in 2006.

The amount that can be contributed is reduced only if an employee makes contributions to a traditional IRA or a specific type of pension plan referred to as §501(c)(18) pension plans. Other types of retirement plans, such as 401(k) and 403(b) plans, don't affect the amount that can be contributed to a Roth IRA.

Because the Roth IRA doesn't allow a current-year tax deduction, there are no deductibility limits as there are with a traditional IRA. As noted earlier, there are limitations to making a Roth IRA contribution based on the taxpayer's income. IRC §408A(c) allows married taxpayers with MAGI under $150,000 ($95,000 for single) to contribute up to $4,000 each to a Roth IRA regardless of whether they are covered by an employer plan. The Roth contribution phases out for married taxpayers with MAGI between $150,000 and $160,000 ($95,000 and

Table 1: Decision for Married Taxpayers Who File a Joint Return and Who Have an Employer-Provided Retirement Plan

Modified Adjusted Gross Income	Traditional IRA	Roth IRA (not affected by employer retirement plan)
Income below $70,000	$4,000 contribution is deductible	Can make full $4,000 contribution
Income between $70,000 and $80,000	$4,000 contribution allowed, but deductibility phases out between $70,000 and $80,000 of income	Can make full $4,000 contribution
Income between $80,000 and $150,000	$4,000 contribution allowed but is not deductible (must file Form 8606 for nondeductible IRA)	Can make full $4,000 contribution
Income between $150,000 and $160,000	Same as income between $80,000 and $150,000	Amount of contribution phases out
Income above $160,000	Same as income between $80,000 and $150,000	No Roth contribution allowed

Table 2: Decision for Single Taxpayer Who Has an Employer-Provided Retirement Plan

Modified Adjusted Gross Income	Traditional IRA	Roth IRA (not affected by employer retirement plan)
Income below $50,000	$4,000 contribution is deductible	Can make full $4,000 contribution
Income between $50,000 and $60,000	$4,000 contribution allowed, but deductibility phases out between $50,000 and $60,000 of income	Can make full $4,000 contribution
Income between $60,000 and $95,000	$4,000 contribution allowed but is not deductible (must file Form 8606 for nondeductible IRA)	Can make full $4,000 contribution
Income between $95,000 and $110,000	Same as income between $60,000 and $95,000	Amount of contribution phases out
Income above $110,000	Same as income between $60,000 and $95,000	No Roth contribution allowed

$110,000 for single). Table 1 compares contributions for traditional and Roth IRAs for married taxpayers who are covered by an employer-provided retirement plan. Table 2 compares contributions for traditional and Roth IRAs for a single taxpayer who is covered by an employer-provided retirement plan.

TRADITIONAL IRA

A traditional IRA can be deductible, nondeductible, or partially deductible. If a traditional IRA qualifies as deductible, the taxpayer receives a current-year tax deduction for the amount of the IRA contribution. Whether the contribution is deductible or not, a traditional IRA allows the earnings on the assets to grow tax-free until they are distributed to the owner. When the distribution is from a traditional deductible IRA, both earnings and principal are taxed as ordinary income. If the distribution is from a traditional nondeductible IRA, the earnings are taxed as ordinary income, but the principal isn't taxed upon distribution.

The contribution limits for a traditional IRA are the same as for a Roth IRA. The maximum amount an individual can contribute to a traditional IRA is $4,000 for the 2005 tax year ($4,500 if age 50 or over). There is no income limit that prevents a taxpayer from making a contribution to a traditional IRA. The deductibility may be limited, however, depending on the presence of an employer-provided retirement plan and the taxpayer's income level. Therefore, almost everyone with earned income can make an IRA contribution, so the question becomes choosing the right IRA.

LIMITS ON DEDUCTIBILITY FOR TRADITIONAL IRA

Although most taxpayers can make some type of IRA contribution, not all taxpayers have a choice about which IRA contribution they are eligible to make, as we noted previously. If a contribution to a traditional IRA is deductible, it can reduce the taxpayer's taxable income by as much as the contribution amount (up to $4,000 for the 2005 tax year).

The deductibility of a traditional IRA is determined by the taxpayer's MAGI and whether the taxpayer or spouse is covered by an employer's retirement plan. If neither the taxpayer nor spouse is an active participant in a company-sponsored retirement plan, both are able to make deductible or nondeductible contributions regardless of their MAGI.

If the taxpayer or spouse is an active participant in a company-provided retirement plan, IRC §219(g) provides that the spouse covered by the company plan can make and deduct a traditional IRA contribution if the couple's combined income is $70,000 or less ($50,000 for single). The ability to deduct the contribution is phased out for the taxpayer covered by the company plan when the cou-

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ple's MAGI is between $70,000 and $80,000 ($50,000 and $60,000 for single). If a taxpayer isn't covered by an employer plan but his or her spouse is, IRC §219(g)(7) provides that the deductibility of the taxpayer's IRA is phased out with MAGI between $150,000 and $160,000.

The point is that even if the taxpayer's income exceeds the limit that allows the contribution to be deductible, the taxpayer can still make the contribution; it simply becomes a nondeductible IRA contribution. If any part of the contribution to a traditional IRA is nondeductible, the taxpayer must file Form 8606 with the IRS.

DISTRIBUTIONS FROM A TRADITIONAL IRA

Most individual and company retirement plans allow for the deferment of income taxes. The tax on the earnings in these accounts is postponed until the money is taken out of the account at retirement. This is true for the traditional deductible IRA as well as company-provided plans, such as 401(k) and 403(b). With these plans, the portion of the taxpayer's salary contributed to the retirement account isn't taxed. Instead, the entire distribution, including both principal and interest, is taxed as ordinary income at the time of distribution.

This deferment of tax is beneficial because the earnings have been allowed to grow without being reduced by taxes each year and because many taxpayers are in a lower tax bracket when they retire so will pay less tax on the earnings. The distributions from retirement accounts are taxed as ordinary income, not capital gains; therefore, the distributions can affect tax brackets. Penalties can apply to both traditional and Roth IRAs if distributions are taken out prematurely, although there are circumstances where a withdrawal can be made without penalties.

CHOOSING BETWEEN TRADITIONAL AND ROTH IRAS

Taxpayers who have a choice between a *nondeductible* traditional IRA and a Roth IRA should opt for the Roth IRA. There is no current deduction under either, and the Roth IRA will allow the earnings to be distributed tax free rather than tax deferred.

Taxpayers who are eligible for a *deductible* traditional IRA or for a Roth IRA must consider several factors. The benefit of the current-year deduction from the traditional IRA must be compared to the benefit of the tax-free earnings from the Roth IRA. The amount of benefit from a traditional IRA is a function of the taxpayer's marginal tax rate since an individual with a higher marginal tax rate will save more tax from the current-year deduction. The benefit of the tax-free distribution of earnings from the Roth IRA is affected by the taxpayer's marginal tax rate at retirement and the length of time until distribution. Factors such as required distributions after age 70.5 from traditional IRAs or the likelihood of taking early withdrawal may also be a consideration in the decision.

Much research has been conducted comparing the benefits of traditional and Roth IRAs. Generally, with the exception of those in the highest tax brackets and close to retirement, most taxpayers will receive a greater benefit from the Roth IRA if they are eligible. If a taxpayer is unsure which choice is better, there are many online sites provided by investment companies that give comparisons of the benefits of both.

FULLY BENEFITING FROM AN IRA

Taxpayers aren't fully utilizing the benefits from IRAs. Many taxpayers don't know that they can make an IRA contribution when they have an employer retirement plan so will miss out on the benefits if their tax preparers don't make them aware of the rules. The IRA contribution limits increased to $4,000 per taxpayer for 2005, making IRAs an even more useful retirement planning tool. Additionally, since a Roth IRA isn't deductible, the limitation on deductibility doesn't apply. Married taxpayers with income below $150,000 (or single taxpayers with income less than $95,000) can make a Roth IRA contribution even if they have an employer-provided retirement plan. ■

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