Just the Facts On Retirement Issues

March 2003, Number 7

Center for Retirement Research at Boston College

A Primer on IRAs

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Introduction

Individual Retirement Accounts (IRAs) now hold more assets than either defined benefit or defined contribution pension plans, but many people do not understand how they work. This *Just the Facts* reminds readers of the differences between Roth and conventional IRAs and describes their role to date as saving vehicles.

A Brief History

Conventional IRAs were introduced in 1974 under the Employee Retirement Income Security Act (ERISA). The goal was to enable those without pension coverage in employer-sponsored plans to save in a tax-deferred fashion. That is, the government would not tax the original contribution to an IRA nor the returns on those contributions until the funds are withdrawn from the plan. Withdrawals from conventional IRAs before age $59^1/_2$ are subject to a 10-percent penalty.[1] And people must begin to withdraw their funds by age $70^1/_2$.

Although eligibility was limited initially to those without pensions, it was expanded in 1981 to encompass all workers, including those currently covered by pension plans. It soon became evident, however, that while IRAs were offered to all, they were being used primarily by higher-income people. As a result of this pattern of usage, Congress substantially tightened IRA provisions in the Tax Reform Act of 1986. Specifically, contributions to IRAs were fully tax-deferred only for persons who were not active participants in an employer-sponsored pension plan or whose adjusted gross income fell below certain thresholds ($40,000 for a couple and $25,000 for an individual).

The Taxpayer Relief Act of 1997 eased these restrictions and created the Roth IRA, named for Senator William Roth of Delaware, Chairman of the Senate Finance Committee at the time.[2] In contrast to the conventional IRA, initial contributions to a Roth IRA are not deductible. But interest earnings accrue tax free and no tax is paid when the money is withdrawn. Holders of Roth IRAs are not required to start withdrawing their funds during their lifetime.

In 2001, both the Roth and conventional IRAs allowed a maximum contribution of $2,000. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) raised these limits to $3,000 in 2002, to $4,000 in 2005, and to $5,000 in 2008. Thereafter, the limit is indexed for inflation annually in $500 increments. EGTRRA also permits individuals who have reached age 50

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The author would like to thank Daniel Halperin for valuable comments.

[1] Withdrawals are not subject to the penalty in the case of disability or death or when the funds are used to pay for higher education or to buy a first home ($10,000 limit).

[2] The original ERISA legislation allowed employees without an employer-provided plan to contribute up to $1,500 per year. In 1976, the limit was increased to $1,750 for an employee with a non-employed spouse. When the Economic Recovery Act of 1981 extended IRA benefits to all employees, it also raised the contribution limit to $2,000. The Taxpayer Relief Act of 1997 gradually increased the income limits for fully-deductible IRAs to $80,000 for a couple and $50,000 for an individual by 2007. It also introduced spousal IRAs, which permit a full $2,000 for a spouse not covered by a pension plan for couples with adjusted gross income up to $150,000.

to make “catch up” contributions of up to $500 beginning in 2002 and up to $1,000 in 2006 and thereafter.

Taxpayers with incomes of less than $100,000 can covert their conventional IRAs to Roths. To do this, they withdraw their money from the conventional IRA, pay income taxes as on any normal withdrawal, and deposit the after-tax amount into the Roth. They do not have to pay the 10-percent penalty in the process of conversion nor on withdrawals from the Roth, except those that occur within five years of conversion.

Identical in Theory

Although the conventional and Roth IRAs may sound quite different, in fact they offer virtually identical tax benefits. Unfortunately, the easiest way to demonstrate this point is with equations. Assume that t is the individual's marginal tax rate and r is the annual return on the assets in the IRA. If an individual contributes $1,000 to a conventional IRA, then, after n years, the IRA would have grown to $\$1,000\ (1+r)^n$. When the individual withdraws the accumulated funds, both the original contribution and the accumulated earnings are taxable. Thus, the after-tax value of the IRA in retirement is $(1-t)\ \$1,000\ (1+r)^n$.

Now consider a Roth IRA. The individual pays tax on the original contribution, so he puts $(1-t)\ \$1000$ into the account. (Note the original contribution in this case is smaller than for the conventional IRA. This point is discussed below.) After n years, these after-tax proceeds would have grown to $(1+r)^n (1-t)\ \$1,000$. Since the proceeds are not subject to any further tax, the after-tax amounts under the Roth and conventional plans are identical:

Conventional		Roth
$(1-t)\ \$1,000\ (1+r)^n$	$=$	$(1+r)^n\ (1-t)\ \$1,000$

Of course, the preceding exercise assumes that the tax rate people face in retirement is the same as that when they are young. If people's tax rates decline after retirement when they withdraw the funds, then they will pay less tax and have more after-tax income with the conventional IRA than with the Roth. But for most people, changes in tax rates before and after retirement are not that significant, so the tax treatment of the two types of IRAs can be viewed as identical.[3]

A Few Real World Differences

While the arithmetic says the tax treatment is the same, the two plans differ in terms of both perception and legalities. The most obvious issue of perception is that contributions to conventional IRAs produce an immediate tax cut. Roth IRAs do not provide tax relief today and therefore may not seem as appealing to the typical taxpayer. On the other hand, there is something nice about knowing the money in your account is the amount you will have available to spend. Since no further taxes are required on a Roth IRA, the full amount is available for support in retirement. Funds in a conventional account will be taxed upon withdrawal, so the amount available for support is always less than the account balance.

In terms of legalities, the primary differences between the two types of IRAs are eligibility criteria and contribution amounts. As shown in Table 1, the Roth IRA allows people much further up the income scale to contribute than the conventional IRA. Thus, for people who exceed the conventional IRA limits, the Roth is the obvious option. The Roth is also more generous in terms of contribution amounts. This is not

Table 1: Maximum Income for Full IRA Contribution, 2002

	Roth	*Conventional*
Married Couple[a]	$150,000	$54,000
Single	$95,000	$34,000

a. Filing jointly.

Note: Individuals who are not actively participating in an employer-sponsored retirement plan are not subject to the income caps. Individuals who are covered by an employer plan and exceed the income caps can make up to a $3,000 contribution to a conventional IRA, although these contributions will not be tax-deductible.

Source: U.S. Department of the Treasury, Internal Revenue Service, 2002.

[3] Although the federal personal income tax had five rates in 1998 (15, 28, 31, 36, and 39.6 percent), only 34 percent of taxpaying units faced rates above 15 percent (Aaron, et al., 1999). Thus, for the vast majority of taxpayers, the applicable rate is 15 percent — both before and after retirement.

obvious given that individuals could contribute $3,000 under either plan in 2002. But for the individual in the 27-percent personal income tax bracket, a $3,000 after-tax contribution is equivalent to $4,110 before tax. Thus, in effect, the contribution limit is higher under the Roth IRA.

The treatment of conventional and Roth IRAs also differs in terms of estate planning. Conventional IRAs are subject to both estate tax at death of the account holder, and then income tax (with a deduction for the estate tax paid) when the funds are withdrawn. A Roth IRA reduces the taxable estate because the income tax is in essence pre-paid. The Roth beneficiary is thus left with a tax-free account that can continue to grow as it is paid out over the beneficiary's life expectancy. In short, while conventional and Roth IRAs face identical tax liabilities in theory, these plans are subject to different regulations and estate tax treatment.

How Important Are IRAs?

In 2002, roughly 42 million households (40 percent of the total) owned an IRA. As shown in Table 2, conventional IRAs outnumber Roths by a ratio of nearly 3 to 1.

TABLE 2: U.S. HOUSEHOLDS OWNING IRAS, 2002

Type of IRA	*Millions of Households*	*Median Holdings*
Any IRA	42.0	$20,000
Conventional IRA	34.8	$37,300
Roth IRA	12.9	$12,400
Employer-Sponsored	8.3[a]	$30,000

a. Includes SIMPLE IRA, SEP-IRA, or SAR-SEP IRA.

Note: Some households own more than one type of IRA account so that ownership by type exceeds the total number of households with IRAs.

Source: Investment Company Institute, 2002.

The total assets in IRAs amounted to $2.5 trillion at the end of 2001. This is really an enormous sum, exceeding the total holdings of either defined benefit or defined contribution plans (Table 3).

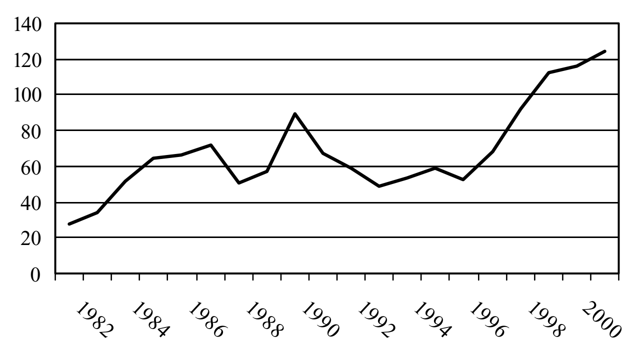
TABLE 3: ASSETS IN PRIVATE RETIREMENT PLANS, 2001

Type of Plan	*Trillions*
IRAs	$2.5
Defined Benefit Plans	$1.8
Defined Contribution Plans	$2.4

Source: Board of Governors of the Federal Reserve System, 2002.

The interesting aspect of these IRA accumulations, however, is that they are not new saving — that is, they did not come from annual deposits of $2,000. Rather the enormous growth in IRA assets is the result of rollovers from both defined benefit and defined contribution plans.[4] For example, one study reports that 22 percent of the annual increase in IRA accounts can be attributed to rollovers and 76 percent to investment returns primarily on rollover amounts; only about 2 percent of the annual increase comes from tax-deductible contributions (Copeland, 2001). This finding is consistent with a study of personal income tax returns over the period 1987-1996 that indicated the share of individuals contributing to an IRA decreased from 8 percent to 4 percent (Smith, 2001).[5] As shown in Figure 1, flows of assets into IRAs dropped off after the 1986 legislation limited participation. But they picked up again in the mid-1990s as the stock market boom boosted the value of accumulated pension assets and as rollovers from employer plans increased.

FIGURE 1: FLOWS INTO IRAS, 1982-2001
(BILLIONS OF DOLLARS)



Source: Board of Governors of the Federal Reserve System, 2002.

[4] Under current law, people with incomes of $100,000 cannot roll over their pension accumulation into a Roth IRA, so most of the rollovers go into conventional IRAs.

[5] Indeed, a recent study shows that only 13 million of the 35 million households with a conventional IRA made a tax-deductible contribution of any amount in 2001 (Investment Company Institute, 2002).

Conclusion

Although households hold a lot of money in IRAs, these accounts do not appear to have been major vehicles for new saving. Despite the valuable tax benefits associated with both the conventional and Roth IRAs, people tend to use these accounts mainly as depositories for rollovers from their employer-sponsored plans rather than for new saving. One reason of course is that contributions have been limited since 1986 to those with moderate incomes or those without a pension. These limitations in turn reflect the original intent of those who included IRAs in the 1974 legislation.

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The research reported herein was performed, in part, pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium. The opinions and conclusions expressed are solely those of the author and should not be construed as representing the opinions or policy of SSA or any agency of the Federal Government, or the Center for Retirement Research at Boston College.

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