Benefits of Traditional IRA Contributions for Renters

Category : Financial Planning When You Rent

Published by The Skilled Investor on Jul/8/2007

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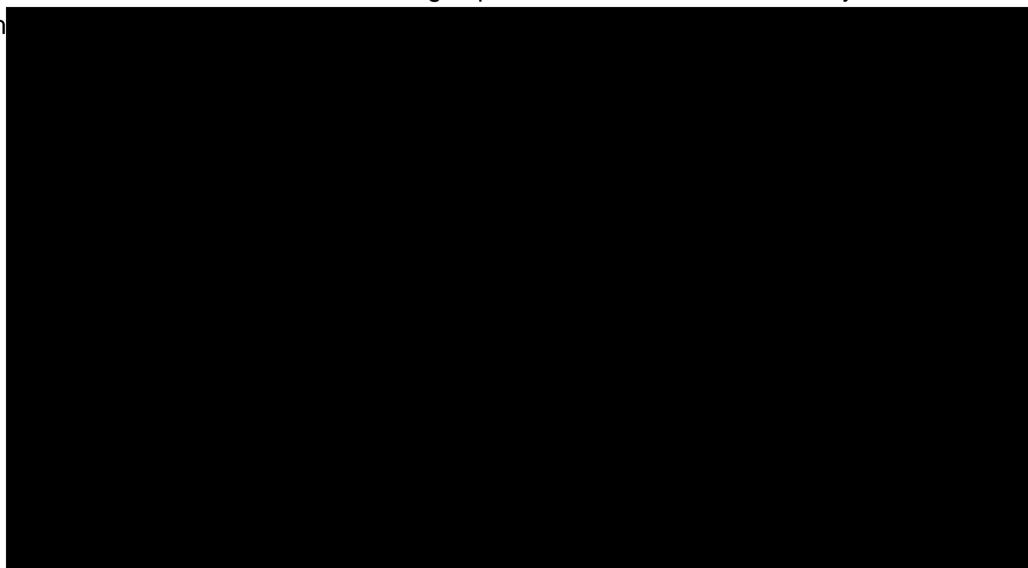
Introduction In a series of articles, *The Skilled Investor* compares different lifetime financial planning projections for Fran and Fred Frugal to illustrate the relative value of adopting different financial planning strategies. Fran and Fred, both age 30, are a married working couple with $100,000 in combined annual earned income. (See the "Fran and Fred's Baseline Lifetime Planning Assumptions:" section at the bottom of this article for more information about Fran and Fred's current personal finances and their other lifetime financial planning assumptions.)
Fran and Fred's baseline lifetime financial plan is described in an article entitled: "Retirement Savings Needs of Renters -- prior to any financial planning improvements." Obviously, in this baseline scenario Fran and Fran have NOT adopted many of the lifetime financial planning practices that would make it easier to achieve financial success in life. **Click here to learn more about the best IRA Investment Calculator** **Improving on Fran and Fred's lifetime financial plan by using traditional IRA contributions** In their baseline projections without certain financial planning optimizations, Fran and Fred would not utilize any tax-advantaged retirement investment accounts, such as IRA or 401k accounts. The following baseline scenario graphic for Fran and Fred projects their lifetime assets held in taxable accounts. All their assets are held in taxable accounts across their lives, and they do not use tax-deferred investment accounts of any kind.
While it might seem odd to you to develop a baseline lifetime financial plan without traditional IRA contributions, millions of Americans who could afford to make IRA contributions simply do not do so. They put their assets into taxable accounts, and worse, many of them hold excessive cash positions and pay current taxes on interest returns with a large inflationary component.

How much longer could Fran and Fred's retirement assets last, if they used traditional tax-advantaged IRA retirement accounts?To find out the answer to this question, Fran and Fred modeled their lifetime cash, bond, and stock fund assets in both taxable and tax-deferred IRA

accounts. In this scenario, Fran and Fred are only evaluating the possible lifetime value of using "traditional IRA" accounts which are currently limited to annual contributions of $4,000 per year, plus an additional $1,000 for over age 50 contributions. Because the tax rules related to IRAs are almost bizarrely complex, we will not go into further detail. The lifetime financial planning tool that Fran and Fred use fully automates these complex rules, so that they can focus on personal financial decision-making.

In this projection scenario, Fran and Fred are NOT evaluating whether to use any Roth tax-advantaged accounts (IRA or otherwise -- a future article will address Roth contributions). Neither would they make any additional contributions into 401k, 403b, Keogh, or other retirement investment accounts that behave like "traditional tax-advantaged" accounts. Contributions to traditional style accounts allow for a reduction in current income to the extent permitted by the tax laws. Assets grow tax free until they are taxed in retirement either: due to withdrawals to cover necessary living or tax expenses or due to mandatory withdrawals that would force income tax recognition in retirement. The results can be found in the graph below. This graphic projects what would happen if Fran and Fred were to utilize 100% of their maximum traditional IRA contributions, during their working years. The blue wedge represents the buildup and drawdown of their traditional tax-advantaged IRA assets. The green wedge projects their taxable assets. Instead of their assets running out at age 95 in the "no IRA" scenario above, their assets are projected to last until they are both at least age 100. Furthermore, at age 100 they are projected still to have about $98,000 in remaining assets -- mostly in tax-advantaged accounts, which would cover their living expenses for almost another two years, until age 102 for both



Fran and Fred can make 100% annual traditional IRA contributions with limited concern about early withdrawal penalties Sometimes, people hesitate to invest in tax-advantaged IRA accounts, because they are worried that they might need the money for some emergency before retirement. People may be aware of and concerned about the 10% federal early withdrawal penalty on most IRA distributions prior to age 59 & 1/2. (Some states, like California, also tack on an additional state early withdrawal penalty, e.g. 2.5%.) Is this something the Fran and Fred should worry a lot about? In their 100% traditional IRA contribution (only) scenario graphic above, they still are saving enough beyond their IRA contributions, so that they also build up an increasing amount of financial assets in taxable accounts (see the green wedge). In fact, Fran and Fred have even more room to make further tax-advantaged retirement account contributions, which could extend their assets further into the future or could perhaps allow them to reduce their required savings rate and/or retire a little earlier than planned.

Note that there are some scientific finance studies that have addressed the likelihood of people involuntarily having to pay early withdrawal penalties due to unanticipated negative financial events

in their lives. In general, the conclusions of these studies were that such situations were quite unlikely for the vast majority of people. Furthermore, the benefits of tax-deferred investing tended to outweigh the costs of early withdrawal penalties in just a few years.

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Fran and Fred's Baseline Lifetime Planning Assumptions: Fran and Fred Frugal, now age 30, are a married working couple with $100,000 in total annual earned income. Their major lifetime financial planning goals are to have enough financial assets until at least age 95, in case both live that long. These are Fran and Fred's major baseline projection assumptions.
NOTE: Of course, some of Fran and Fred's assumptions are not optimal. In various scenarios, we will change these assumptions to illustrate the relative value of different financial planning improvements. (IN THIS SCENARIO, FRAN AND FRED WILL MAKE MAXIMUM CONTRIBUTIONS TO TRADITIONAL IRA TAX-ADVANTAGED RETIREMENT ACCOUNTS -- with taxes deferred until withdrawals in retirement.) **Fran and Fred expect the following:**
WORKING INCOME: Both intend to work full-time, until retirement at age 65. They expect their earned income to grow with the rate of inflation. **RETIREMENT INCOME:** They expect to collect 60% of currently quoted Social Security retirement benefits. They do not expect to have any pensions. **LIVING EXPENSES:** They expect that their living expenses, before and after retirement, will grow with the rate of inflation. They plan always to rent and never to buy their residence. They do not plan to have any children. They expect that their retirement living expenses with be the same as their living expenses, when they were working. **DEBTS:** They plan to pay off their current $20,000 in educational debts and $15,000 in credit card debt, as required by these debt contracts. Then, they plan to remain debt free throughout their lives. **TAXES:** They plan to file income taxes using standard tax deductions. They expect always to live in Massachusetts, a state with a 5.3% flat income tax rate. **INVESTMENT STRATEGY:** They now have $10,000 in money market funds, $10,000 in bond funds, and $10,000 in stock funds. They expect to use an average investment strategy with an average asset allocation throughout their lives. They intend to hold only money market fund, bond fund, and stock fund investments. They hope to earn very long-term historical asset class investment rates of return. They plan to pay average investment costs. They intend to buy-and-hold very broad market index funds, to withdraw assets only to meet expenses, and to pay long-term capital gains tax rates, as much as possible. **TAXABLE versus TAX-DEFERRED ACCOUNTS:** They expect to use only taxable investment vehicles and do not plan to use any tax-advantaged retirement accounts. .