Q. What types of nonemployer-sponsored retirement savings accounts are available?

A. The two big types are traditional individual retirement accounts (IRAs) and Roth IRAs. The main difference: when the feds take their cut.

TRADITIONAL IRAS VERSUS ROTH IRAS

Workers and their spouses do not need their employers' help to save in tax-favored retirement accounts. They may open individual retirement accounts, which mostly come in two forms: traditional IRAs and Roth IRAs. (Other types of IRAs, such as IRA-SEPs and SIMPLE-IRAs, are only available through employers.) The primary difference is the timing of any tax on contributions or distributions.

Qualified contributions to traditional IRAs are excluded from tax and grow tax-free, but withdrawals are taxed. Contributions to Roth IRAs, conversely, are taxed in the year they are made. But account assets grow tax-free, and withdrawals after age 59½ are not taxed. Even though statutory contribution limits are the same for both traditional and Roth IRAs, the effective amount a saver can place in tax-preferred status is higher with a Roth IRA because the saver is contributing post-tax income.

As of 2017, 43.9 million households (or 34.8 percent) owned at least one IRA. Some 35.1 million households (or 27.8 percent) held traditional IRAs, while 24.9 million (or 19.7 percent) owned a Roth IRA. Some households owned both.

THE FINE PRINT

These rules are a bit confusing. Taxpayers with income over a specified level, which varies with tax-filing status, may not contribute to a Roth IRA and may not deduct contributions to a traditional IRA. Nor may taxpayers who participate (or whose spouses participate) in employer-provided pensions deduct traditional IRA contributions if their income exceeds a specified limit.

For single taxpayers without access to an employer-sponsored pension, and for married couples in which neither spouse participates in such a pension plan, there are no income restrictions on the deductibility of traditional IRA contributions. A married taxpayer who does not participate in an employer-sponsored plan, but whose spouse does, may contribute the maximum statutory amount to an IRA, provided the couple's joint income does not exceed $186,000 for 2018.

Key Elements of the U.S. Tax System

What types of nonemployer-sponsored retirement savings accounts are available?

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Q. What are Roth individual retirement accounts?

A. Roth individual retirement accounts offer no up-front tax breaks. However, withdrawals of earnings and principal (with some restrictions) are not taxed.

A Roth IRA is a form of individual retirement account in which investors make contributions with after-tax earnings. Eligibility is limited by income. There's still a big tax break: contributions accrue tax-free in the account, and withdrawals are not taxed under normal circumstances. In 2017, 24.9 million people, representing 19.7 percent of all US households, owned a Roth IRA.

ELIGIBILITY AND CONTRIBUTION LIMITS

Only people with incomes under specified limits are eligible to contribute to a Roth IRA. In 2018, the contribution limit for IRAs is the lesser of $5,500 ($6,500 for individuals over age 50) or the taxpayer's taxable compensation. The contribution limit falls once household income exceeds certain thresholds, eventually reaching zero (table 1).

TABLE 1

IRA Eligibility and Contribution Limits

2018

Filing status	Modfied Adjusted Gross Income	Contribution
Single or Head of Household	Less than $120,000	$5,500 (or $6,500 if over 50)
	Between $120,000 and $135,000	A reduced amount
	$135,000 and over	Zero
Married filing jointly or qualifying widow(er)	Less than $189,000	$5,500 (or $6,500 if over 50)
	Between $189,000 and $199,000	A reduced amount
	$199,000 and over	Zero
Married filing separately	Less than $10,000	A reduced amount
	$10,000 and over	Zero

What are Roth individual retirement accounts?

WITHDRAWALS

Investors can withdraw their contributions (but not investment returns earned on those contributions) at any time without being subject to tax. However, to receive tax benefits on investment returns, withdrawals must be qualified distributions. This means that the investor withdraws funds at least five years after his or her first contribution and after reaching age 59 years and 6 months, dying, becoming disabled, or making a qualified first-time home purchase. Nonqualified distributions do not satisfy the above conditions and are therefore subject to a 10 percent penalty tax. There are several exceptions to the penalty for early withdrawal of investment earnings.

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Q. How does the availability of tax-favored retirement saving affect national saving?

A. Incentives for retirement savings only increase *private saving* if the tax breaks encourage households to set aside additional cash rather than simply transfer it from other nest eggs. And it only increases *national saving* if the increase in private saving exceeds the revenue loss from the tax subsidy.

Tax-favored retirement savings accounts are popular: half of working adults take advantage of them. It's unclear, however, whether the accounts make much difference to overall savings and retirement preparedness. Although traditional pensions and other tax-deferred vehicles such as 401(k) plans and individual retirement accounts do make up a sizable share of households' wealth, the accounts only increase private saving if they encourage households to finance their own contributions through reduced consumption or increased earnings.

Put another way, incentives do not increase private saving if households finance their contributions by borrowing, by shifting their existing assets into tax-favored accounts, or by shifting funds they would have saved even in the absence of the incentive. Likewise, private saving does not increase if households respond to employer-provided pensions or contributions with equivalent reductions in other saving or with increased borrowing.

The earliest research on both traditional defined-benefit pensions and defined-contribution plans suggested that they had a strong impact on private wealth and saving. These studies, however, were marred by technical missteps. Later research has found a significantly smaller impact—and, in some cases, none at all. To the extent that the tax incentives do raise private saving, we can expect the impact to be greater for lower- and middle-income households than for high-income households, who tend to use the accounts to reduce present or future tax liability.

How does the availability of tax-favored retirement saving affect national saving?

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Q. What's the difference between front-loaded and back-loaded retirement accounts?

A. Your choice: pay the IRS now or pay them later.

Broadly speaking, there are two types of tax-favored retirement accounts: "front-loaded" accounts, such as traditional IRAs and 401(k)s, and "back-loaded" accounts, such as Roth IRAs. With front-loaded accounts, contributions are tax deductible but withdrawals are taxed. These accounts are also called EET accounts (the contribution is *exempt* from taxation, the accrual of returns is *exempt* from taxation, and the withdrawal is *taxed*). In back-loaded accounts, contributions are not tax deductible but accruals and withdrawals are tax-free. These accounts are also called TEE accounts (contributions *taxed*, accruals *exempt*, withdrawals *exempt*). In both types of accounts, investment returns on assets kept within the account (accruals) are untaxed.

Which is a better deal? That depends on the difference between individuals' tax rates during their working years and during retirement. Individuals with high tax rates during their working years and lower rates during retirement benefit more from front-loaded accounts, because the original contributions are deducted against high tax rates and withdrawals are taxed at lower rates. Someone who expects to be in a higher bracket in retirement would benefit more from a back-loaded account.

The example in table 1 shows that if tax rates during working years and retirement are the same, front- and back-loaded accounts yield the same result.

Consider a front-loaded account first. Say an individual faces a 25 percent tax rate when making both contributions and withdrawals, makes a before-tax contribution of $2,000, earns 5 percent per year, and withdraws all funds after 10 years. In a front-loaded account, the individual will be able to contribute the full $2,000. The account will accumulate interest, and after 10 years the balance will be $3,258. Upon withdrawal, the individual will pay $814 in taxes, leaving net retirement assets of $2,443. With a back-loaded account, an individual pays a 25 percent tax on $2,000 in income, leaving $1,500 to contribute to the account. With the same 5 percent return, the balance will grow to $2,443. Since no taxes will be paid on withdrawal, after-tax proceeds are $2,443, which is the same as in the front-loaded example.

Key Elements of the U.S. Tax System

What's the difference between front-loaded and back-loaded retirement accounts?

TABLE 1

Front- and Back-Loaded Savings Accounts with Constant Tax Rate

$2015

Plan overview		
Tax rate: 0.25		
Interest: 0.05		
Time (years): 10		
	Front-loaded	**Back-loaded**
Before tax income	2,000	2,000
Less taxes paid (25%)	0	500
Contribution	2,000	1,500
Accumulated balance in account	3,258	2,443
Less taxes paid on withdrawal (25%)	814	0
After-tax proceeds	2,443	2,443

Now check out the example in table 2, in which the tax rate decreases from 25 percent during working years to 20 percent during retirement. Here, the front-loaded account will accrue $163 more than the back-loaded account, since taxes are imposed upon withdrawal, when rates are lower. Of course, the conclusion is reversed if the tax rate is higher during retirement than during working years.

TABLE 2

Front- and Back-Loaded Accounts with Lower Tax Rate at Retirement

$2015

Plan overview		
Tax rate T0: 0.25		
Tax rate T10: 0.20		
Interest: 0.05		
Time (years): 10		
	Front-loaded	**Back-loaded**
Before tax income	2,000	2,000
Less taxes paid (25%)	0	500
Contribution	2,000	1,500
Accumulated balance in account	3,258	2,443
Less taxes paid on withdrawal (20%)	652	0
After-tax proceeds	2,606	2,443
Tax savings from front-loaded account: 163		

Key Elements of the U.S. Tax System

What's the difference between front-loaded and back-loaded retirement accounts?

That's not quite the end of the story, though. If the two accounts have the same contribution limit, an individual can shelter more savings in a back-loaded account than in a front-loaded account. For example, if an individual facing a 25 percent marginal income tax rate contributes $2,000 to a front-loaded account, he or she is really contributing $1,500 and $500 of government funds because of the tax deduction. When the funds are withdrawn, the government reclaims its share of the principal contribution, plus taxes on interest earned (table 3). In a back-loaded account, however, taxes are paid on the initial contribution and interest can be withdrawn tax-free. Note the distinction here. The value of the tax shelter per dollar saved is the same with either account. However, if the nominal contribution limits are identical, a determined saver can sock away more with a back-loaded account.

TABLE 3

Tax Savings in Front- and Back-Loaded Savings Accounts with Constant Tax Rate

$2015

Plan overview		
Tax rate: 0.25		
Interest: 0.05		
Time (years): 10		
	Front-loaded	**Back-loaded**
Contribution	2,000	2,000
Own income	-1,500	-2,000
Government tax expenditure	-500	0
Accumulated balance in account	3,258	3,258
Taxes paid on withdrawal	814	0
After-tax proceeds	2,443	3,258
Additional savings with back-loaded account: 814		

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Q. What is an automatic 401(k)?

A. An automatic 401(k) enrolls workers automatically, assigning them a default contribution rate and allocation of funds that they are free to change later.

An automatic 401(k) is one that automatically enrolls workers in the plan, rather than requiring them to sign up. Eligible workers are assigned a default contribution rate—often 3 percent of wages—and a default allocation of funds contributed to the retirement account. As with traditional 401(k)s, workers are still in control; they can change the default contribution rate and allocation or opt out entirely. The main difference: with an automatic 401(k), inaction on the worker's part will automatically result in the worker saving for retirement.

This difference is, as a practical matter, significant. With traditional 401(k) plans, workers must decide whether to sign up, how much to contribute, how to allocate their investment funds, how often to rebalance their portfolios, what to do with the accumulated funds when they change jobs, and when and in what form to withdraw the funds during retirement. These decisions are difficult, and many workers, daunted by the complexity, either make inappropriate choices or never sign up at all.

With an automatic 401(k), sometimes called an "opt-out plan," unless workers make the active decision not to participate, each stage of the savings and investment allocation process is automatically set at a pro-saving default. Workers can choose to override any of these choices, but the inertia that discourages so many from opting into a traditional 401(k) is now likely to keep them on the default path.

Figure 1 shows that automatic enrollment raises 401(k) participation rates among new hires. This is especially true for women, minority groups, and low earners.

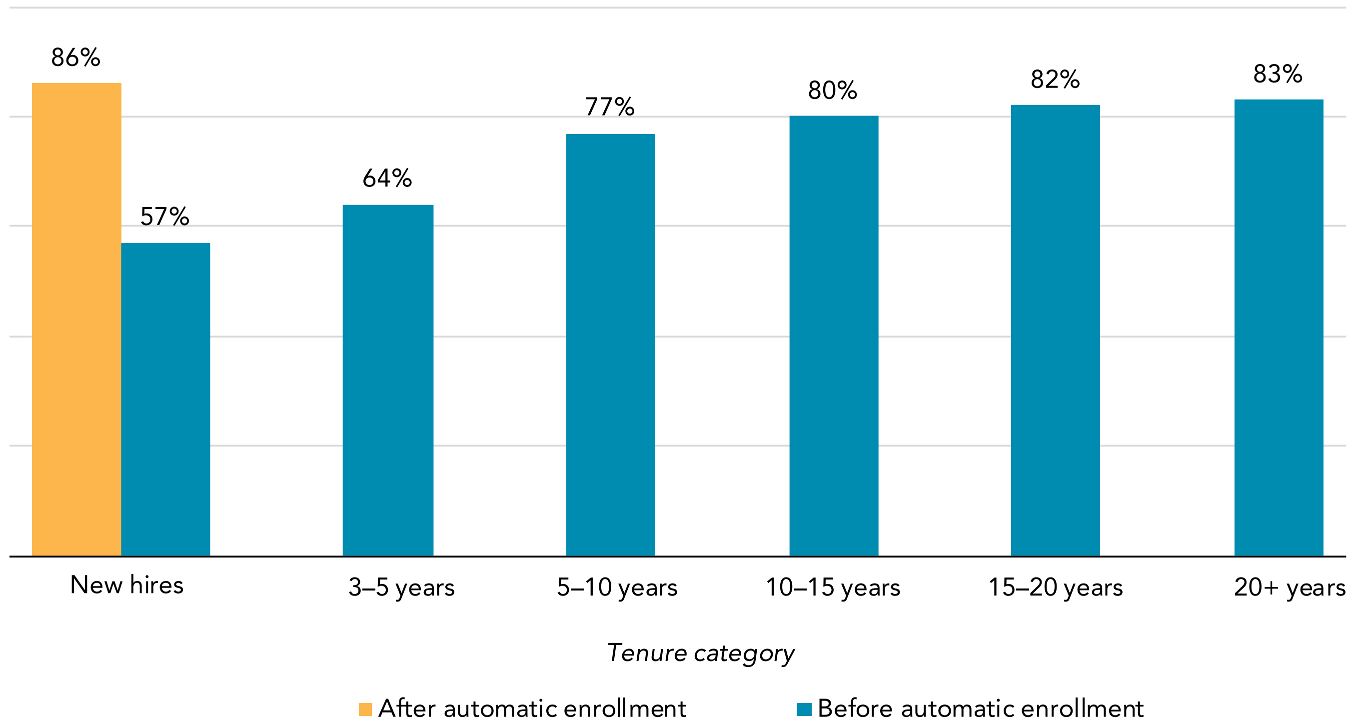
The automatic escalation of default contributions over time raises overall contributions to 401(k)s relatively painlessly, as employees become accustomed to deferring receipt of a portion of their pay. The gradual escalation also helps ensure that inertia does not keep employees at a default contribution rate lower than the rate they might have chosen without the default.

Key Elements of the U.S. Tax System

What is an automatic 401(k)?

FIGURE 1

Participation Rates in 401(k) by Tenure: Pre- and Post-auto 401(k)



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Q. How might low- and middle-income households be encouraged to save?

A. Expanding access to savings vehicles and scaling back deductions to provide low- and middle-income households with better incentives could make a difference.

Low- and middle-income families receive significant income support through tax breaks, notably through refundable credits such as the earned income tax credit and the child tax credit. But when it comes to building wealth—defined as what you own minus what you owe—the federal tax code offers such families far less.

Wealth is important: It keeps people afloat during financial emergencies like job loss or unexpected expenses. It provides a foundation for a secure retirement. And it opens doors to upward mobility, such as a down payment on a first home or college tuition.

The main wealth-building vehicles for most people in the United States are homeownership (through building equity and, hopefully, appreciation) and retirement savings accounts. Perversely, large tax subsidies for these assets mostly benefit the already wealthy. Most tax benefits for the mortgage interest deduction, state and local property tax deductions, and 401(k)s and similar retirement plans accrue to the highest-income taxpayers. That's because these tax subsidies are structured as deductions and exclusions, which provide households in higher tax brackets with bigger subsidies. Further, lower-income households are less likely to have enough deductions to make itemizing on their tax returns worthwhile, and itemization is required to claim major homeownership tax breaks. Lower-income workers, particularly those in part-time or temporary employment, have less access to and are less likely to participate in employer-based retirement plans.

At the same time, many low- and middle-income taxpayers simply do not participate in the regular and automatic saving vehicles through which much wealth is accumulated, such as paying off a mortgage and making regular deposits to retirement accounts.

A variety of changes would reduce the bias toward higher-income households by replacing existing subsidies with better-targeted incentives. Almost all these proposals favor some movement toward tax credits and away from deductions, and many use insights from behavioral economics to get more bang for a tax buck forgone.

How might low- and middle-income households be encouraged to save?

HOMEOWNERSHIP

Credits to encourage homeownership can take different forms. They can provide an up-front credit for first-time homebuyers of primary residences, similar to the temporary credit employed as a stimulus measure from 2008 to 2009. (An early version of this credit served as an interest-free loan to be paid back to the Internal Revenue Service.) Alternatively, homeowners could receive smaller annual credits proportional to their home equity, up to a designated maximum. Another approach is to provide a credit against property taxes to defray a significant cost of homeownership. Reforms that reward building equity instead of subsidizing mortgage interest (which a badly designed credit could also do) would encourage saving instead of acquiring debt.

RETIREMENT

A saver's credit is available to moderate-income taxpayers who contribute to qualified retirement plans. However, the credit is nonrefundable and phases out quickly at higher incomes, making few people eligible for the maximum amount. Some economists have proposed expanding the credit and making it refundable, so that workers with no net income tax liability could claim it.

More expansive proposals include reshaping the complicated pension landscape to simplify plans and increase access to employer-based retirement accounts with automatic enrollment. Contribution limits to tax-favored accounts would be lowered, and the government would instead match low- and moderate-income workers' contributions. Any credits or matching employer contributions could not be accessed until retirement. Pension antidiscrimination rules could be revised to favor plans that support more full- and part-time employees.

SAVINGS AND ACCOUNT OWNERSHIP

Many low- and middle-income workers receive large refunds from refundable tax credits. A "saver's bonus" could encourage taxpayers to save a portion of their refunds in qualified savings accounts. Taxpayers are already able to contribute to individual retirement accounts until the tax-filing deadline and apply any deductions or saver's credits against their tax year's liability. Some tax preparers and tax preparation software remind taxpayers that they can do this and make clear how much tax they would save if they do. Tax time could also be used to link taxpayers to savings vehicles, such as children's savings accounts or prepaid cards with savings features for taxpayers without bank accounts.

Key Elements of the U.S. Tax System

How might low- and middle-income households be encouraged to save?

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