

Part VII Individual Retirement Accounts

Individual Retirement Accounts are a retirement planning tool that virtually everyone should consider. The new IRA options also have made selecting an IRA a bit more complicated.

IRA Basics

The Traditional IRA is an Individual Retirement Account/Annuity that may allow contributions to be made on a tax-deductible basis. Earnings grow tax-deferred, while withdrawals of tax-deductible contributions and earnings are taxed at ordinary income tax rates.

The Roth IRA is an Individual Retirement Account/Annuity, where contributions are made on a non-deductible basis. Earnings and the withdrawal of those earnings are tax-free if the account is held for at least five years and one is 59 1/2 or older.

Anyone under age 70 1/2 with earned income can contribute up to \$3,000 per year to a Traditional IRA. However, whether one qualifies to deduct his contributions is determined by whether he or his spouse participate in an employer-sponsored retirement plan and by his adjusted gross income (AGI).

Starting in 1998, one could contribute up to \$3,000 per year to a Roth IRA as long as he or his spouse has earned income and his AGI is within established income limits. To the extent withdrawals from a Traditional IRA or Roth IRA are taxable, they may be subject to a 10% premature withdrawal penalty. However, the penalty will not apply if one is over 59 1/2 or disabled, uses the funds for qualified educational or medical expenses or for a first home purchase or take the funds as substantial periodic payments.

For those who

- have no way of participating in 401(k) plans or other self-directed, tax-deferred retirement plans
- have maximized their 401(k) savings

The next best place for their money may be an individual retirement account. IRAs may have lost some of their luster, but they can still be a key ingredient in one's retirement plan.

Traditional IRAs

Traditional IRAs are sometimes referred to as Standard IRAs, Regular IRAs, or even just as IRAs. The basic rules for a Traditional IRA are reasonably straightforward: anyone who will be younger than age 70 ½ at the end of the year can make an annual IRA contribution of up to either \$3,000 or his or her total compensation for that year, whichever is less.

Under the new IRA rules an additional annual contribution of up to \$2,000 also can be made on behalf of a spouse who has little or no personal earnings of his or her own. If a wife has compensation of \$50,000 in the current year, and her husband has no compensation, the wife can contribute \$3,000 to her own IRA, and another \$3,000 to a Spousal IRA on behalf of her husband. If this wife has only \$3,000 in compensation, and her husband still has no compensation, then the total contributions she can make cannot top \$3,000.

All of one's IRA contributions can be invested as one sees fit, with very few restrictions. Investment profits earned in one's Traditional IRA are tax deferred until they are withdrawn from the account, typically during retirement. In retirement, all withdrawals will be taxed at one's ordinary income tax rate. If one withdraws money from a Traditional IRA prior to age 59 ½ he likely will face a 10 percent penalty, with some exceptions. Traditional IRA rules become more complicated when it comes to determining whether or not one is allowed to make tax-deferred contributions.

Tax-Deferred Contributions

Some people are allowed to use their IRA contributions as deductions against current taxes, others are not. The ability to make tax-deferred contributions goes a long way toward determining whether or not a Traditional IRA is the best choice for one's retirement savings. There are two ways that one can qualify for deductible contributions. One only needs to qualify under one or the other. There is no advantage to qualifying under both.

- If one is not an active participant in any corporate pension plans
- If one's modified adjusted gross income is below certain preset limits – In 1999, the limits for full deductibility were \$51,000 for married couples filing jointly or \$31,000 for single filers.

The Roth IRA

With the Roth IRA, Congress has passed what is potentially the most significant legislation designed to stimulate savings since the original IRA was introduced in the 70's. Author of the bill and Senate Finance Committee Chairman, William Roth (R-Delaware), presented the legislation under the title "IRA Plus Accounts." House and Senate conferees changed the name to "Roth IRA" to honor him for his long-time advocacy of tax-free retirement accounts.

The Roth IRA, like a Traditional IRA, allows one to invest up to \$3,000 each year into a tax-advantaged retirement account. One cannot contribute \$2,000 in each type of IRA only \$3,000 total between the two. It is also only available beginning in 1998.

To make a contribution, one or his spouse must earn at least \$3,000 at work (\$6,000 to include non working spouse) or in profits from self-employment. No tax deduction is allowed on contributions made to a Roth IRA.

The Roth IRA is a mirror image of a Traditional IRA. Rather than the upfront tax savings on the deposit offered with the Traditional IRA, the Roth IRA allows one to save taxes at the other end. Withdrawals are tax-free when one meets a few simple requirements. The advantage over many decades is enormous because one will not pay taxes on the account growth.

Withdrawals from a Roth IRA are not taxed if:

- The investor is 59 ½ or older when he makes the withdrawal
and
- His Roth IRA was set up and the first contribution made five or more years prior to the withdrawal date

The profits earned on investments made within a Roth IRA are not taxed when they occur, same as with a Traditional IRA. With a Roth IRA, these investment profits also are not taxed when the money is withdrawn during retirement—so Roth IRA investment profits can be totally tax free, assuming certain rules are followed. This is the big difference between a deductible Traditional IRA and a Roth IRA -- one offers a tax break today, the other a tax break during retirement.

Mechanics of IRAs

The first step is to select a trustee or custodian for the account. Then one needs to fill out a few forms and select the specific investments for one's IRA. There are a wide range of potential IRA trustees, including:

- Mutual fund companies are probably the most appropriate IRA trustees for many investors. Virtually any mutual fund company will act as an IRA trustee. The right choice for one is the fund company that offers the funds in which he wishes to invest his retirement savings.
- Either a full-service broker or a discount broker can act as an IRA trustee. This allows one to invest in individual securities, such as stock or bonds, through his IRA. This is a good choice for experienced investors who like to make their own investment decisions. Mutual funds are also available through many brokers.
- Many banks, as well as credit unions and savings and loans, can act as IRA trustees. The investment options offered by such institutions often are limited to low-risk, low-return certificates of deposit or similar options.
- Many insurance companies are more than willing to act as IRA trustees, but the investment options might be limited. Usually, the investments products offered by insurance companies are annuities –Individual Retirement Annuities. Annuities feature a guaranteed payout, and thus none of the stock market's volatility, but generally also offer a lower long-term return than stocks. Since one of the advantages of owning an annuity is that they typically are already tax deferred, there might not be all that much advantage to investing in annuities through an IRA. It is generally better to use an IRA for taxable investments.

The primary consideration when selecting an IRA trustee is the type and quality of investment opportunities available through that trustee, and the fees charged by the trustee. Many trustees charge an annual fee for maintaining IRAs, typically in the neighborhood of \$10 to \$20, although potentially much more. Some trustees also charge

- IRA termination fees
- Setup fees
- Fees for trading within the account
- Other fees

It is important to inquire about fees before selecting a trustee for one's IRA.

One can establish as many IRAs as he desires or move accounts from one trustee to another. However, since most IRA trustees charge an annual fee, and since having extra IRAs does not mean that one can contribute any more money each year, it usually is more sensible to keep one's total number of IRAs low.

Maintaining an IRA

One can make contributions to the IRA each year, some years, or never again. This is based on the assumption that one has earned income in a given year, and that he is under 70 ½. While there is no requirement that one contribute each year, that is the best strategy. If one does not contribute each year, he will not be allowed to go back later and make contributions for past years that he skipped. Because there is no limit to the number of IRAs any person can own, he also could set up a new IRA each year, rather than add money to an existing IRA.

The IRS does not care if one sets up one IRA or a dozen. One may set them up at as many financial institutions as he wants. Institutions charge annual fees to maintain many small accounts and they all charge fees. This results in a drop in the investment return.

Transfers and Rollovers

If one wishes, he can change the investments within his IRA at any time or even change trustees. Doing so should cause no penalties or tax consequences. This is different from a rollover, which is a tax-free distribution to one of assets from one retirement plan to a second retirement plan. Rollovers can have tax consequences or lead to penalties if not handled properly.

- Assets taken out of one retirement plan generally must be rolled into another one within 60 days, or the transaction will be treated as a withdrawal, possibly creating penalties and taxes.
- Usually one cannot roll over any particular IRA assets into a different IRA more than one time in any given year, with some exceptions.
- Assets rolled over into an IRA do not count against his annual IRA contribution limit.

Withdraws from a Traditional IRA

In addition to the eligibility restrictions and contribution limits, limited access to one's money is the other big downside to Traditional IRAs. Usually, funds cannot be withdrawn

prior to age 59 ½ without incurring a 10 percent penalty in addition to standard income taxes. Withdrawals from a Traditional IRA must begin by age 70 ½.

Under special circumstances, early withdrawals from Traditional IRAs are possible without incurring the usual 10 percent penalty, although taxes still will have to be paid on such withdrawals at one's standard federal and state income tax rates. These exceptional situations include:

- ***Buying a first home.*** This applies only if the house has been purchased within the past 120 days, and only if it is owned by either the IRA owner, a spouse, a child, a grandchild, or a parent, or other ancestor. This includes the cost of buying, building, or rebuilding a home, or settlement, financing or closing costs. Penalty-free withdrawals for this purpose cannot exceed \$10,000 over the life of any IRA owner. If both husband and wife each own IRAs, then each can withdraw up to \$10,000, for a total of \$20,000 toward a first home.
- ***Paying higher education expenses.*** The student must be the IRA owner, or a spouse, child, or grandchild.
- ***Paying excessive medical expenses.*** This applies only to the portion of one's unreimbursed medical bills that exceeds 7.5 percent of his gross income. This exception is meant only for real medical catastrophes.
- ***Paying medical insurance premiums*** – if one is unemployed. The insurance can be for the IRA owner, a spouse, or dependents.
- ***Cases of severe and extended or permanent disability*** to the IRA owner
- ***The death of the IRA owner.*** If one dies, his IRA's beneficiaries will not have to pay a penalty on the money distributed to them from his IRA regardless of his age at death.
- ***If one agrees to receive "substantially equal payments"*** from his IRA calculated to last for the rest of his life. This system will not allow one to withdraw a large amount of money from his IRA right away. He must use a distribution formula approved by the IRS.

Borrowing From an IRA

It is generally not possible to borrow money from an IRA prior to retirement age without incurring the early withdrawal penalty. In an emergency it might be possible to gain access to one's money for up to 60 days. This can be done by taking advantage of the IRS rule that provides up to 60 days to deposit the money in a new tax-deferred account without penalty when conducting an IRA rollover. One has about two months to use the money for other purposes.

The main drawbacks to borrowing from an IRA are:

- If one does not get the money back into another IRA or other qualifying tax-deferred account within 60 days, the IRS will treat it as a withdrawal, and the funds will be subject to a 10 percent penalty and taxation at his income tax rate. One also loses his opportunity for future tax-deferred growth of these funds. If he were already so short of cash that he needed to borrow money from his IRA in this way, paying those taxes and penalties could be a major problem.
- The money is not earning any investment profits while it is not invested
- The money in any given IRA is eligible to be rolled over only once during any 365-day period, with certain exceptions.
- As with any other rollover, 20 percent of the amount that one attempts to roll over must be withheld. He will get access to less money than he attempts to roll over, and if he does not have extra cash to cover the withholding when he attempts to complete the rollover, the 20 percent portion withheld will be subject to taxes and penalties, as described above.

Roth IRA Eligibility

Expanded eligibility is a major benefit of the Roth IRA. They are available to a far larger percentage of the population than deductible. Traditional IRAs are—but they are not available to everyone. As of 1999, single taxpayers were eligible to make a full contribution to a Roth IRA only if they had a modified adjusted gross income of \$95,000 or less for the year. Those with modified AGIs between \$95,000 and \$110,000 are eligible for a reduced contribution of less than \$2,000. Married couples filing jointly are eligible for full contributions if their 1999 modified AGI is \$150,000 or less, and a reduced contribution if their modified AGI falls between \$150,000 and \$160,000. Married couples filing separately will be eligible for a contribution only if their modified AGIs are below \$10,000 (and then only a partial contribution) or if they lived apart for the entire year, in which case they can follow the rules for singles.

As with a Traditional IRA, contributions to a Roth IRA cannot be more than 100 percent of one's compensation for the year. If his compensation was less than \$3,000, a full \$3,000 contribution will not be possible. The exception to this would be the Spousal IRA. If one's spouse has little or no compensation, he might qualify to make a Roth IRA contribution on his or her behalf. Contributions to Roth IRAs can be made from the beginning of a year until the date one's taxes are due for that year.

Withdrawing from a Roth IRA

One of the most significant advantages of a Roth IRA over a Traditional IRA is that contributions can be withdrawn at any time tax-free and penalty-free even before the age of 59½. The order of withdrawals is that contributions come out first, then earnings. It is the earnings inside the Roth IRA that are subject to taxes and penalties. Roth Conversion accounts have different rules and penalties on withdrawals so they need to be kept separate from Contributory Roth IRA accounts.

To withdraw earnings without penalty and tax assessments, one needs to be over age 59½ and have established his Roth IRA for at least five tax years. There are two special exceptions for withdrawals before age 59½:

- first-time home purchase - up to \$10,000 life-time
- post secondary education expenses - up to 100% of qualified expenses per year

The early withdrawal penalty is waived on earnings for both types of special withdrawals but the earnings are treated differently for income taxes. Withdrawals of earnings for educational expenses are taxable, whereas withdrawals for a first-time home purchase are tax-free.

A 1998 Roth IRA contribution made by April 15, 1999, would be open less than five calendar years, but would meet the five tax-year holding period on January 1, 2003. Subsequent annual Roth IRA contributions are governed by the establishment of the original Roth IRA. Contributions made after the original account is open five tax-years have no holding period.

The Roth IRA advantage of being able to withdraw contributions without paying taxes and penalties at anytime before age 59½ is a double-edged sword. It is a great way to save for a down-payment on a house or children's education, however, one can short-change his retirement nest egg with frequent withdrawals. The \$3,000 per year limit on contributions would prevent a \$10,000 withdrawal from being redeposited in one lump sum. It would take five years at \$2,000 per year to make up for the original \$10,000 withdrawal at a loss of earnings and in lieu of those additional five years of contributions. It is smart to maximize one's 401(k) payroll retirement savings at work in addition to contributing to a Roth IRA.

Choosing Between Traditional or Roth IRAs

There are at least three important factors to consider when deciding whether to invest in a Traditional or Roth IRA.

- How will one's tax bracket during retirement compare with his tax bracket now? If one's tax bracket in retirement will be the same or higher than his tax bracket this year, the Roth IRA will be the better choice. If he will be in a lower tax bracket, a deductible traditional IRA would probably be a better choice. The deductible Traditional IRA provides a break from current taxes, but a Roth IRA provides a break from taxes during retirement.
- How far is one from retirement? The longer one's investments have to grow within the IRA, the greater the advantage of the Roth IRA.
- Would one like to postpone IRA withdrawals beyond age 70 ½, or leave his IRA to **his** beneficiaries? If so, the Roth IRA is the best choice, because it does not require distributions at any age.

Changing a Traditional IRA to a Roth IRA

If one's modified AGI is \$100,000 or less, and he is not married filing separately this year, then he has the option of converting any Traditional IRA he might own into a Roth IRA. He will have to pay income taxes on the money rolled over during the year of the rollover which might lead to a large one-year tax bill, but he will not have to pay a penalty if the rollover is handled properly. This rollover can be:

- distributed to him and rolled over within 60 days to the new IRA
- sent directly from one trustee to another
- a "same trustee transfer"

The decision to roll a Traditional IRA over into a Roth is similar to the choice between making contributions to a Roth IRA or a Traditional IRA. There are four important factors to consider:

- One's tax bracket this year versus in retirement – A Roth IRA conversion probably only makes sense if one expects his retirement tax bracket to be the same or higher than his tax bracket in the year of the conversion. If his tax bracket will drop considerably in his retirement, a Roth conversion could be a bad move.

- One's ability to pay the resulting taxes without dipping into retirement accounts – if one converts a deductible Traditional IRA to a Roth IRA, he will have to pay income taxes on any money from the Traditional IRA that previously had been tax deferred. Depending on the size of the IRA and whether or not a significant percentage of it is made up of nondeductible contributions, that could be a high tax bill.
- The length of time until one wants to withdraw money from his IRA – if he will need to tap his IRA in the near future – five years or less – a conversion is probably not wise. Roth IRAs offer tax-free investment earnings, but those earnings take time to build up. Roth IRAs also have tax penalties for removing certain money less than five years after the account has been established.
- Whether one wants to postpone IRA withdrawals beyond age 70 ½ or leave his IRA to his beneficiaries – Roth IRAs do not require distributions at any age. By converting to a Roth IRA, he can pay taxes on his own IRA savings and pass his Roth IRA to his beneficiaries with no future income taxes due.

An IRA or a 401(k)

Contributions to 401(k) do not count against the annual \$2,000 IRA contribution limit. If one is eligible to participate in a 401(k), it might effect his eligibility for a deductible Traditional IRA, but it will have no effect on his eligibility for a Roth IRA. Everyone does not have enough room in his budget to contribute the maximum to both a 401(k) and an IRA each year. Here are guidelines to follow:

- If one's employer offers a match on his 401(k) contributions, he should take advantage up to the full amount that is matched before considering an IRA contribution
- Beyond the issue of matching, one should consider whether a Roth IRA or a Traditional IRA makes more sense for him. If the answer is a Roth, than a Roth will almost certainly be better than an unmatched 401(k) as well
- If a Traditional IRA makes more sense for one than a Roth, then it becomes a matter of choosing between a Traditional IRA and an unmatched 401(k). These are very similar in terms of advantages and disadvantages, but there are some points of differentiation:
 - 401(k)s often allow loans, IRAs do not (with exceptions). While borrowing from a retirement plan is rarely a good idea, it is sometimes necessary. If this is a consideration, one should lean towards the 401(k).
 - If one works past age 70 ½ he might be able to postpone withdrawals from a 401(k) until he retires. With a Traditional IRA, withdrawals must begin by age 70 ½, retire or not.

- IRAs offer virtually unlimited investment choices; 401(k) investment options can be extremely limited. If one's 401(k) does not offer investments that he likes he should choose the IRA.
- IRAs allow withdrawals for selected purposes—including the purchase of a first home or college costs—free from penalties. This is not the case with 401(k)s even though loans for those purposes may be available.

Non-Deductible IRAs

In 1986 Congress did a real disservice to the American public. It changed the rules on the deductibility of the IRA. This added a great deal of confusion which caused many people to stop IRAs. This is a big problem because it reduced savings. Americans are notoriously low savers which influences our ability to grow economically as a nation and also provide for our retirement.

The first \$2,000 contribution has more of an impact on one's final account totals than any other contribution. Putting off an IRA contribution, or delaying the start of a savings plan can shrink one's eventual retirement account as much as 10 - 30% of what he could have had if he had just started 1 year earlier. Therefore it's never too late to start. Remember, even after retirement, one has 20 or more years.

A non-deductible IRA has many of the beneficial characteristics of an annuity. Both allow tax deferred growth, and the withdrawals are partially tax-free based on the ratio of the original after-tax contributions to the amount of deferred growth build-up. A non-deductible IRA, is a self-directed "annuity" with more control over the account and investments with the ability to select stocks, bonds, mutual funds, and other investments.

How would a \$5,000 withdrawal from a non-deductible IRA be taxed? Assuming that there were \$10,000 in non-deductible contributions and \$10,000 in deferred growth, the ratio of tax free to taxable payments would be 50%. Therefore \$2,500 would be tax-free and \$2,500 subject to tax and/or early withdrawal penalties if applicable.

Non-deductible IRAs can be useful for people who may consider withdrawals prior to retirement for purchasing a home or kids' college education as the tax and penalties for withdrawal are significantly less for a standard IRA.

Many individuals are confused on what's deductible and what's not. If one or his spouse works for a company that does not have a retirement plan, then there is no income limit. One can earn \$200,000 and still be able to deduct the IRA.

The real confusion comes when one or both of the spouses is an active participant in the company's plan. Then the deductibility is based on their adjusted gross income. The IRS says one can elect a non-deductible IRA even if he is eligible for a partial or full deduction.

Post Mortem Planning for Inherited IRAs

Post Mortem Planning is like a "make up test" so one can get a better grade. Except it is done by the heirs and relates to when taxes are due - now or later and who eventually gets it. Knowing what to do before the "exam" will help give one's spouse, children and other heirs more options to extend the tax deferral for decades. Post Mortem Planning takes advantage of these options to ensure the maximum tax deferral is actually realized. Mistakes are easy to make so it takes multi-generational planning to gain the best results.

The beneficiary that was designated on the IRA application or 401(k) beneficiary form controls who inherits these accounts – Lets assume the decedent did their homework and the correct beneficiary inherits the IRA. The spouse, children or other individuals inheriting an IRA must take action in a timely manner to maximize this tax deferral potential.

For a decedent that dies before age 70½ the IRA must be terminated and all income taxes paid by Dec. 31st of the 5th year following the year the person died. An election out of the 5 year rule is possible for a properly designated spouse, child or other individuals. The election must be written and be received by the IRA custodian by Dec. 31st one (1) year following the death of the decedent. For a 38 year old inheriting an IRA, this election will give 44.4 years of tax deferral with minimum distributions. The difference in money one's heirs eventually have between 5 or 44.4 years of tax deferral can be substantial. If one fails to make a written election in time, the IRA will be terminated in 5 years.

Special Spousal Election. If a spouse has been properly designated, the decedents tax deferred account can be rolled over (only spouse has this option) and delay minimum distributions until age 70 1/2. This offers one great planning opportunities here, including not rolling over so a young spouse has access to funds without early withdrawal penalty. Failure to make a timely written election will cause the IRA to be terminated in 5 years.