PERSONAL INVESTMENT MANAGEMENT, INC

White Paper #4

Individual Retirement Accounts

By

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Introduction

A majority of PIM clients are, or were active participants in an employer-sponsored defined contribution plan allowing income deferrals and employer matching contributions. As account balances increase over years of systematic contributions and investment returns, the value of tax-deferred compound growth becomes clear.

Those wishing to accumulate additional retirement savings in a tax-deferred manner may do so using an Individual Retirement Account (IRA). An IRA may be considered a supplement to an employer sponsored retirement plan or in cases where no employer plan is offered, may be one of only a few alternatives.

Generally, there are two types of IRAs – Traditional IRA and Roth IRA (though there are others such as an "Inherited IRA"). Herein, we will discuss the features and requirements for Traditional and Roth IRAs and which is more appropriate in a given situation.

Traditional IRAs

Any person under age 70 ½ who has earned income (or alimony) may establish and fund a Traditional IRA. IRAs are always individual and never joint accounts and must be established with a qualified trustee or custodian such as a bank, insurance company, some investment companies or a brokerage firm. The maximum individual contribution limit for 2011 is the lesser of 100% of compensation or $5,000; if you are over age 50, you may contribute an additional $1,000 "catch-up" amount. This applies across all IRA accounts (so not $5,000 or $6,000 per account, but rather per person, per year).

With the age and income requirements met, the next issue for consideration is the deductibility of contributions from current income. For purposes of this discussion, let us distinguish as follows: Contributions that are deducted from current income for the year when the contributions were made are Deductible Contributions; contributions that were not deducted from current taxable income are Non-Deductible Contributions.

Who Can Deduct Traditional IRA Contributions?

- ✓ Not participating in an employer-sponsored qualified retirement plan (or SEP or SIMPLE IRA)
- ✓ Actively participating in an employer-sponsored plan but with adjusted gross income (AGI) below specified amounts:

Single Person

AGI < $56,000 = full deductibility
AGI from $56-66,000 = partial deductibility
AGI > $66,000 = no deductibility

Married Filing Jointly – both participating in employer-sponsored plans

Aggregate AGI < $90,000 = full deductibility for both
Aggregate AGI from $90-110,000 = partial deductibility for both
Aggregate AGI > $110,000 = no deductibility

Married Filing Jointly – one spouse participating in an employer plan, the other not

For the spouse actively participating in an employer plan

Aggregate AGI < $90,000 = full deductibility
Aggregate AGI from $90-110,000 = partial deductibility
Aggregate AGI > $110,000 = no deductibility

For the spouse not actively participating in an employer plan

Aggregate AGI < $160,000 = full deductibility
Aggregate AGI from $169-179,000 = partial deductibility
Aggregate AGI > $170,000 = no deductibility

Your ability to deduct contributions fully or not at all seems fairly straight forward. But remember that adjusted gross income is the determining factor, so working with your tax professional is highly recommended. If AGI falls within the partial deductibility ranges, the formula for determining the amount of an annual contribution that is deductible is as follows:

Allowable Contribution Limit ($5,000) X ((Upper limit of the range – AGI) / the amount of the range))

For those without a passion for algebra, here's an example using a situation in which a married couple, both under age 50, filing jointly and who both participate in employer-sponsored plans earn aggregate adjusted gross income of $100,000. According the range listed above, this couple may each make partially deductible contributions. The calculation is performed based on the maximum contribution for one person and is valid for both, individually, as follows:

$$\$5{,}000 \text{ max contribution} \times \frac{\$110{,}000 \text{ top end of the range} - \$100{,}000 \text{ adjusted gross income}}{\$20{,}000 \text{ the phase-out range}}$$

$$\$5{,}000 \times (\$10{,}000 / \$20{,}000)$$

$$\$5{,}000 \times .5 = \$2{,}500$$

Therefore, each person may make a $2,500 contribution to an IRA and deduct this amount from current income for tax purposes. This may represent the total of each person's contribution for the year, or each may make an additional <u>non-deductible</u> contribution of $2,500 for a total of $5,000 per person.

<u>Non-Deductible Traditional IRA Contributions</u>

If unable to qualify to deduct part or all IRA contributions, based on status as a participant in a qualified plan and the income "phase-out" ranges, you may still make non-deductible contributions. The advantage of non-deductible contributions is that upon distribution, this portion will not be taxed as income. See Taxation of IRA Distributions later in this document.

<u>Timing of Distributions</u>

Distributions from an IRA may begin without penalty at age 59 ½ and must begin by April 1st of the year following the year you turn 70 ½. (Note: for employer sponsored qualified retirement plans, you may continue to contribute and are not required to begin Required Minimum Distributions (RMD) until you retire, even if beyond age 70 ½ - unless you own 5% or more of the company that sponsors the retirement plan).

<u>Exceptions for Early Distributions</u>

Distributions prior to age 59 ½ are not qualified, and unless they meet one of the following allowable exceptions for early distribution, are subject to income tax and an additional penalty of 10%. The exceptions to the 10% penalty are as follows:

- Death
- Permanent Disability
- Medical Expenses > 7.5% of Adjusted Gross Income
- Health Insurance Premiums while unemployed (must have 12 consecutive weeks of unemployment compensation)
- Qualified higher education expenses – must be post secondary and for tuition, books, fees etc
- Qualified first time home buyer, up to $10,000 (neither spouse owned a home for 2 years)
- Military Reservist Distribution
- Disaster (hurricane, earth quake, tornado etc)
- Substantially equal periodic payments

Note: there are three methods for calculating the distribution amount for the "Substantially Equal Periodic Payments" scenario. These are: RMD Method, Fixed Amortization Method and the Fixed Annuitization Method. We will not present the details of these methods here. But if considering this alternative, please note that once this process is initiated, it lasts until the later of attaining age 59 ½ or for 5 years, and once the payment amount is established, it cannot be changed.

More on "Required Minimum Distributions" (RMD)

If you delay distributions until age 70 ½, the annual RMD is calculated using government tables for life expectancy. Over age 70 ½, there is an additional penalty for failing to withdraw the required minimum. The penalty is 50% of the annual RMD that was not distributed; therefore, if the RMD is $3,000, and for whatever reason, only $2,000 was distributed, the penalty will be an additional $500 (the amount not distributed that should have been ($1,000) X the penalty ratio (50%) = $500.00.

RMD must be taken in lump sum or in payments no less frequently than annually. The required distribution amount is based on the life expectancy of the account owner using the "Uniform Table", or if the spouse of the account owner is 10 or more years younger than the account owner, the "Joint and Last Survivor" table may be used that takes into consideration the life expectancies of both and results in a lower RMD.

Options for Beneficiaries

This is a tricky subject. The disposition of an IRA following the death of the owner is based on whether or not the beneficiary is a spouse or non-spouse and whether or not the account owner died before or after age 70 ½. There are various options available depending on which configuration is considered.

If the spouse is the beneficiary, then he/she has three options: 1) take the proceeds in a Lump Sum, 2) Rollover the account into his/her own IRA and 3) Re-title the account to an "Inherited IRA".

Option #1: results in taxation of 100% of the account value as ordinary income.

Option #2: re-characterizes the assets as if they'd always belonged to the recipient spouse and therefore, RMD will be based on his/her age.

Option #3: If the deceased was < 70 ½ then the spousal beneficiary may initiate distributions as late as December 31st of the year following the year of death of the original account owner, or when the deceased would have reached 70 ½, whichever is later.

If the deceased was over 70 ½ the spousal beneficiary may use his/her own life expectancy for the determination of the RMD amount but must begin taking distributions by no later than December 31st of the year of death of the original account owner.

If the beneficiary is not the spouse of the deceased IRA account owner, then the options are fewer and less favorable. The beneficiary may take the funds in Lump Sum or may Re-Title the account to an Inherited IRA.

The first option, Lump Sum, works the same way for a non-spouse beneficiary as it does for a spouse.

The second option, Inherited IRA, again depends on the age of the deceased. If < 70 ½ then the beneficiary may either begin taking RMDs by 12/31 of the year following the year of death of the original account owner or may delay distribution for five years from the date of death. At the end of five years, distribution is made in a lump sum and is fully taxable as income.

If the original account owner was over 70 ½ at the time of his/her passing, then the beneficiary may use his/her own age/life expectancy to determine an RMD amount and must initiate distributions by no later than the first 12/31 following the date of death of the original account owner.

Importantly, any non-spouse beneficiary must use the "Single Life" table to determine the RMD, which is less advantageous if the objective is to receive the lowest possible distribution amount over the longest period of time.

Taxation of IRA Distributions

If the IRA in question was funded with only contributions that were deducted from current income in the year of the contributions, then all distributions are taxed as ordinary income for the year of the distribution. Since contributions were deducted from current income for each year a contribution was made, the total IRA account is subject to income tax upon distribution.

If the IRA in question received only contributions that were not deducted from earned income at the time, it is a different story. The dollars comprising these contributions were taxed when originally earned (and were never deducted from current income) so are not required to be taxed again. In this case, the total IRA account balance is considered to consist of two parts – your contributions and investment gains/returns. Only investment gains/returns are taxed as ordinary income, and each distribution will consist of part taxable gain and part return of contributed basis. In order to distinguish between contributions and gains, careful records must be kept to document contributions. IRS form 8606 is used for this purpose.

It is possible that over time, a Traditional IRA may receive contributions of both types, deductible and non-deductible, as a person's / married couple's earnings appreciate etc. If for no other reason than record-keeping, it is advisable to keep deductible and non-deductible contributions separate (read: in separate IRA accounts). But if it's too late to segregate contributions by tax status, all is not lost. The same logic applies to the taxation of distributions from an account with both types of contributions. But you must know and have documentation of your non-deducible contributions.

Summary of Traditional IRAs

The two basic qualifications for having a Traditional IRA are earned income and being under age 70 ½. The deductibility of contributions and related taxation of distributions are the real issues for consideration and relate to two things: status as an active contributor to an employer-sponsored plan,

and income. It is also helpful to be aware of the conditions that may allow premature distributions without penalty and of the options available to beneficiaries.

Roth IRAs

General Features and Requirements

Roth IRAs were created by the Taxpayer Relief Act of 1997. The primary feature is the tax free nature of distributions to the account owner and beneficiary. Since distributions are entirely tax free, contributions are not deductible from current income under any circumstances.

Roth IRAs are not subject to Required Minimum Distributions, and as long as you have earned income below the phase-out threshold, you may continue to contribute beyond age 70 ½.

Eligibility is based in earned income only. The phase-out ranges for 2011 are as follows:

Single:	$107,000 - $122,000
Married Filing Jointly:	$169,000 - $179,000

If you are single and earn under $107,000, you may contribute the maximum $5,000 to a Roth IRA; if you earn $122,000 or greater, you may not contribute to a Roth. If your earnings are somewhere between the ranges, you may contribute some amount to a Roth IRA. For married persons filing jointly, use $169,000 as the low end of the range and $179,000 as the high end. If earnings fall within the phase out range, then apply the same mathematical formula illustrated earlier to determine the amount you may contribute.

Distributions are considered qualified (no 10% penalty) if after age 59 ½ AND after a five-year holding period has been met. The holding period is unique to Roth IRAs and begins on January 1st of the year for which the contribution is made (even if the contribution was made late in the year). The exceptions to these qualification rules are the same as for Traditional IRAs, as detailed earlier in this document.

Should a distribution occur that is non-qualified (under 59 ½ and/or within the five-year holding period) and is not an allowable exception, then the tax treatment of the distribution will follow a specific order that is unique to Roth IRAs. That is – all distributions are considered to be returns of contributed capital first and until exhausted. These distributions are not subject to income tax or 10% penalty. If distributions continue beyond the amount of contributed capital, these will consist of investment returns that are subject to income tax and 10% penalty. NOTE: this is not the method used for distributions of non-deductible contributions to a Traditional IRA discussed earlier, where all distributions are considered part contributions and part returns.

Roth Conversions

Assets in a Traditional IRA (and certain other retirement accounts that will not be discussed here) are able to be transferred into a Roth IRA. As just discussed, past contributions to a Traditional IRA have either been deducted from current income in the year of contribution or were non-deductible contributions.

Before providing examples of how this is done, let's discuss why. The obvious, primary advantages of a Roth IRA are the tax-free nature of qualified distributions and no RMD (required minimum distributions). One disadvantage of a Roth IRA is that not everyone can have one – based on income as discussed above. So, how does one earning income in excess of the limitations access a Roth IRA to take advantage of tax-free distributions? The answer is by converting IRA assets to a Roth IRA and paying taxes on the converted amount as current income in the year of the conversion.

Conversion of Deductible Contributions: Since contributions to an IRA that were deducted from current income in the year of the contribution have never been taxed, and since contributions to a Roth IRA must be after-tax contributions, converting Traditional IRA assets to a Roth IRA is a taxable event. The amount converted is considered current income in the year of the conversion and taxed as such. Therefore, the cost of the conversion in real dollars is the amount of income tax one will pay on the converted dollars. Be cognizant that the additional taxable income may result in elevation to a higher marginal tax bracket – so not just more taxes, but all income taxed at a higher rate.

Conversion of Non-Deductible Contributions: We discussed earlier that non-deductible contributions to a Traditional IRA can be made by practically anyone. If you have a Traditional IRA that over time has been the recipient of both deductible and non-deductible contributions, then only the deductible contributions are taxable as current income upon a conversion to a Roth IRA. The taxable amount is a ratio of non-deductible to deductible contributions, and each converted amount will consist of some of both. In other words, you can't only convert amounts you know to have been non-deductible when contributed. We discussed earlier the importance of tracking the amounts/dates etc. of non-deductible Traditional IRA contributions; this is a good example of why detailed records are important

How To: CONSULT YOUR TAX PROFESSIONAL. Given the tax implications of this strategy, it is critical that you consult a qualified tax professional to project any potential tax liability and to determine specifically the ratio of deductible to non-deductible contributions you may have made to Traditional IRAs in past years. If you don't currently work with a tax professional or are reconsidering your current arrangement, contact PIM for a referral.

After you have spoken with a tax professional to confirm the wisdom of the Roth Conversion strategy for your unique circumstances, the conversion may be executed one of three ways: 1) take a distribution from your IRA(s) in the amount you wish to convert and within 60 days, establish and deposit the full amount into a new Roth IRA, 2) transfer the funds from your existing IRA(s) into a Roth IRA with the

same or at another custodian or 3) have your existing custodian change the designation of an existing IRA to Roth IRA.

Rules: Old and New: The taxes resulting from the conversation of Traditional IRA assets to a Roth IRA during 2010 could be spread out over the 2011 and 2012 tax years. This convenience was available only for conversions taking place during 2010. Now, taxes on conversions are attributable to the year in which the conversion took place and are due by the normal income tax filing deadline of April 15th (plus any extensions). In past, the ability to do a Roth conversion was limited to those earning less than $100,000. Now there is no income limitation at all, so anyone can do a Roth conversion. Remember that for converted amounts, the Roth IRA 5-year holding period applies.

Re-characterization: Now that you know what you can do, how to do it and what it costs (tax implications), the last subject to consider is what happens if you change your mind or if the conditions that made this a good strategy for you have changed? What could change, you ask?

Suppose you converted $100,000 from a Traditional IRA into a Roth IRA on March 1st, 2011. Your taxable income for 2011 will be increased by $100,000, assuming 100% of the converted amount was deducted from current income in the year(s) when originally contributed to the Traditional IRA. Now it's November 1st, 2011 and due to a global credit crisis and severe domestic stock market correction, your Roth account value is $45,000. You are faced with paying income taxes on $100,000 for an account that is now worth 55% less than it was 8 months earlier. You may reverse the transaction, called "Re-Characterization" such that what's left of your original $100,000 goes back into a Traditional IRA, and your will not be subject to the income taxes resulting from the original conversion.

Closing Comments

There are many ways that wealth is created. Concentrated positions, for example; this is either a narrow focus on establishing and growing a closely-held small business over many years or maybe a large wager on an individual stock (would not mind having been the first retail investor to own Microsoft or Starbucks). Sometimes wealth is inherited. But for the vast majority of us, wealth is created through the slow, steady, patient, systematic saving of smaller amounts of money over a long period of time.

The beauty of tax-deferred retirement accounts like IRAs and Roth IRAs is the cumulative effect of tax-deferred compound earnings over many years. Systematic savings requires living below our means, or as it is sometimes called, deferring gratification. But it doesn't mean foregoing gratification indefinitely. As a general matter, we highly encourage the establishment of as much tax-deferred savings as you can handle and as the law will allow. If you think you might like to do more, please contact your PIM representative for a confidential discussion of the options.

Disclaimer

PIM does not provide specific tax advice or legal advice. The Internal Revenue Code dictates the rules governing the account types and strategies discussed herein. Please consult your legal or tax professional for an analysis of your current circumstances and the possible implications of the options at your disposal.