

Investment Knowledge

IRA and 401(k) Overview

IRAs and employer-sponsored retirement plans are popular ways to save for retirement. And for those who qualify, there are some federal tax benefits for these types of retirement savings plans.

Individual Retirement Account (IRA)

An IRA is not an investment. It's an account type that allows for tax-deferred or tax-free growth on your retirement savings contributions. You can open an IRA at a:

- Brokerage firm
- Mutual fund company
- Insurance company
- Bank or credit union

Traditional IRA

Whether your IRA contribution is tax-deductible depends on three factors:

1. Your income tax filing status
2. Your adjusted gross income (AGI), and
3. Whether you are covered by a retirement plan with your employer

For 2014, if you are covered by a retirement plan with your employer, your IRA contribution is fully-deductible if your tax filing status and AGI is one of the following:

- Single or Head of Household with an AGI less than \$60,000
- Married Filing Jointly with an AGI less than \$96,000

If your AGI falls within the following range, your contribution is partially deductible:

- Single and Head of Household with an AGI between \$60,000 and \$70,000
- Married Filing Jointly with an AGI between \$96,000 and \$116,000

If your AGI is more than the range listed above, then your contribution is not deductible.

For 2014, an IRA contributor who is not covered by a retirement plan at their place of employment and is married to someone who is, the deduction is phased out if the couple's income is between \$181,000 and \$191,000.

If both you and your spouse are not covered by an employer-sponsored retirement plan, then you can take the full deduction up to the amount of your contribution limit.

Other Attributes:

- Savings grow tax deferred
- Investments include stocks, bonds, mutual funds, Exchange-Traded Funds, CDs, and so forth
- Withdrawals may begin at 59½
- Mandatory distributions after 70½

- Taxes are paid on earnings when withdrawn
- No income restrictions
- Funds withdrawn prior to 59½ are generally subject to a 10% early withdrawal penalty and income tax
- 2014 contribution limits:
 - ◆ 49 and younger: \$5,500
 - ◆ 50 and older: \$6,500

10% Early Withdrawal Penalty Exemptions

- Permanent disability
- Death of the IRA owner
- Payment of non-reimbursed medical expenses in excess of 7.5% of AGI
- First-time home purchase (\$10,000 lifetime limit)
- Higher education costs
- Pay IRS back taxes after levy on IRA accounts
- Pay medical insurance premiums if unemployed longer than 12 weeks
- Owner attains the age of 59½

Required Minimum Distributions (RMD)

- Mandatory minimum annual withdrawals starting with the year the account owner turns 70½ or, if later, the year of retirement
- Rules apply to all employer-sponsored retirement plans and all IRA-based plans including Traditional, SEPs, Simple IRAs, etc.
- RMD is calculated for each IRA account by dividing the prior December 31st balance of the account by a life expectancy factor published by the IRS
- Excess distributions for one year cannot be applied to the RMD for future years

Roth IRA

For 2014, the AGI phase-out is:

- Single and Head of Household with an AGI between \$114,000 to \$129,000
- Married Filing Jointly with an AGI between \$181,000 to \$191,000

Other Attributes:

- Savings grow tax free
- Contributions are not tax deductible
- Investments include stocks, bonds, mutual funds, Exchange-Traded Funds, CDs, and so forth
- No mandatory distribution age
- Withdrawals 100% tax free if regulations are followed
- 2014 contribution limits:
 - ◆ 49 and younger: \$5,500
 - ◆ 50 and older: \$6,500

Traditional IRA vs. Roth IRA

Things to consider:

- Income restrictions for contributing to a Roth IRA
- Forecasting prevailing tax rates upon retirement
 - ◆ Rates higher: Roth IRA
 - ◆ Rates lower: Traditional IRA
 - ◆ Rates same: Neutral
- Tax diversify: Percentage of retirement assets in a Traditional IRA or 401k and a percentage in a Roth IRA or 401(k)
- Roth IRA: Ability to withdraw contributions (not earnings) without incurring a 10% early withdrawal penalty.

Tax Rates and Traditional vs. Roth IRAs

If tax rates remain constant, there is no difference in the net after tax future value of a Traditional IRA and a Roth IRA:

Traditional IRA

\$10,000 Initial investment
 \$19,672 Value after 10 years compounding at 7% annually
 -\$6,295 Assuming 32% combined state and federal tax
 \$13,377 Net value

Roth IRA

\$10,000 Initial investment
 - \$3,200 Assuming 32% combined state and federal tax
 \$6,800 Net investment
 \$13,377 Net value after 10 years compounding at 7% annually

401(k) / Employee Defined Contribution Plan

- Contributions made through payroll deduction
- Savings grow tax deferred
- Potential for employer matching contributions
- Investments limited to those selected by employer
- Portability
- Funds withdrawn prior to 59½ are subject to a 10% early withdrawal penalty and income tax
- Potential for loans and hardship withdrawals
- 2014 Contribution limits:
 - ◆ 49 and younger: \$17,500
 - ◆ 50 and older: \$23,000

401(k) Rollover Options

Three options when leaving your employer:

- Leave your assets in former employer's 401(k) plan
- Rollover your 401(k) to new employer's 401(k) plan
- Rollover your 401(k) into an IRA

Two options for moving 401(k) assets:

- Rollover: funds distributed to account holder and transaction is reported to IRS
- Transfer: custodian to custodian transfer and is not reported to IRS

Premature Distributions

Penalties from early distribution from 401(k) or IRA:

- 10% IRS premature distribution penalty
- Income tax on distributed amount, example:

\$10,000 Early distribution
 - \$1,000 Premature distribution penalty
 - \$3,000 Income tax
 \$6,000 Net distribution

Lost opportunity potential:
 \$10,000 10 years compounded at 8% annually*
 \$20,989 Projected value

*Rate of return is hypothetical and assumes an 8% compounded annual growth rate on \$10,000. It does not represent the expected return for any specific investment.

Early Withdrawals: Section 72(t) Distributions

- Available to participants in a 401k plan and IRA account holders
- Distributions must be "substantially equal" payments based upon the life expectancy of the participant
- Payments must continue for a period of 5 years or until the age of 59 – whichever is longer
- Three methods of calculating distribution:
 - ◆ Minimum Distribution Method
 - ◆ Fixed Amortization Method
 - ◆ Fixed Annuitization Method