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IRAs - A to Z Explanations ©

Definition of term, *IRA*: *Individual Retirement Arrangement* (in IRS publications) or *Individual Retirement Account* in federal tax law.

The Need For IRAs Is Greater Than Ever. Today, more than ever before, one of the greatest challenges facing American workers and retirees is assuring their financial security in retirement. Americans are faced with uncertainty over the adequacy of Social Security, Medicaid and Medicare and availability of regular health care. They have a deep distrust of the financial markets and investing, which is due to the tremendous upheaval of 2008-09 in the banking and overall financial industry, along with the mortgage, credit and stock market meltdowns. These all too real facts and risks mean that Americans now and in the future will be forced to rely more heavily on their own resources to support their retirement lifestyle, or just to survive.

At the same time, the world of employer-based pensions is also changing. Much less common today is the employer-sponsored defined benefit plan, the kind of plan that assures former employees a dependable income throughout their retirement years. The pension world is changing to one in which employees must make the decision to save for retirement. And, even when an employer plan is available, employees may be required to make most or all of the contributions.

Many long held retirement concepts and foundations are changing in America as well. For instance:

- The trend toward changing employment more frequently lessens an individual's opportunity to acquire great reserves in company pension or 401(k) plans.
- The investment of 401(k) money is very restricted to the employer's investment plans and options, often with poor or even devastating results.
- Many new entrepreneurs striking out on their own cannot offer retirement options to themselves or their employees until the company is more financially secure.
- Social Security is no longer seen as the answer to retirement funding.

Can IRAs Help You Save And Plan For Retirement? Individual Retirement Arrangements or Accounts (IRAs) are one of the most viable answers to the questions of how to assure a secure retirement. Both the Traditional and Roth IRA are federal government designed, regulated and tax advantaged savings plans, with a formal retirement planning feature. IRAs are directly owned by you, not an employer, and you have complete control (within government rules) of your IRA retirement planning and investment choices. IRA investment choices are not limited to the stock market, mutual funds, bank savings and insurance company annuities, as other retirement and 401(k) plans are. IRAs can also be invested in many non-traditional assets, including: Real estate, precious metals or bullion and bullion coins, private businesses, private offerings and other thinly traded investments, real estate backed mortgage investments, and much more*.

Both Traditional and Roth IRAs offer:

- Independence, IRAs can be opened and funded without any employer participation, and it is even possible to have full checkbook control over your IRA*.
- Immediate tax benefits, with contributions and/or earnings permanently tax eliminated (Roth) or tax deferred until retirement (Traditional).
- Accessibility, with funds always available, something not generally true of employer plans.
- Flexibility with annual savings amounts, because there is no minimum contribution required in any year (though there is a maximum allowed).
- Flexibility of accounts, IRA accounts can be easily moved from one custodian to another, multiple accounts can be held at one or more custodial institutions (though this provision cannot be used to exceed maximum allowable contributions)

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- Old 401(k) plan money can be easily moved to a new or existing IRA ("old 401(k)" refers to retirement plan money which remains with one or more former employers)
- Left over IRA money is inherited by your pre-designated beneficiaries, probate free, with the plan continuing to have its tax advantaged growth and an optional lifetime payout provision for the beneficiaries

* An excellent source for information on checkbook control and non-traditional investing of IRA funds can be found at www.IRAcentral.com

Setting Up An IRA, Custodial Requirements. None of the tax deferral and other tax advantages of an IRA are allowed under tax law and IRS rules unless a qualified trustee takes custody of the IRA assets. In other words, without a qualified trustee/custodian holding the assets there is no IRA. The trustee is generally referred to as "custodian" in most IRA dealings. Under tax law and IRS rules, banks and trust companies are automatically allowed to act as IRA custodians. With special IRS permission the following types of institutions may also be permitted to act as custodian: Stock brokerage firms (or broker-dealer), mutual fund companies, insurance companies, and registered investment advisors or advisory firms. Most major institutions in this latter group have qualified for special IRS permission to be an IRA custodian.

To set up an IRA, or to move existing IRA or 401(k) money to another IRA, you must fill out new IRA account forms with a custodian and arrange to transfer your IRA money, stocks, mutual funds, real estate, etc. to that institution as the IRA custodian of those assets. The custodian will then hold legal title to the money or other assets. Basically that means that the custodian has signature control to deal with your money or other assets, but deal only as you direct the custodian. You have complete control in telling the custodian what you want your money invested in, when you want to take withdrawals, or when you want to move some or all your assets to a different custodian. The function and formality of an IRA account is substantially the same arrangement that you have when you open a mutual fund or stock brokerage account.

Picking a Custodian. Your choice of custodian will generally be linked with the type investing you want to engage in. If, for example, you know that you want to personally engage in regular stock trading, then you should open an IRA with a brokerage like Schwab, e-trade, Scott, T.D. Ameritrade, Vanguard Brokerage, Fidelity Brokerage or any of the scores of other brokerages which offer brokerage accounts specifically tailored for stock traders. If you know that you want to invest in one or a few mutual funds from one mutual fund family, then you should open an IRA with that mutual fund. If you want to invest in certificates of deposit, then go to a bank or a brokerage which provides CDs which are suitable for you, and open an IRA there.

If you want to invest in a variety of asset classes, including some non-traditional choices such as real estate, private placements, precious metals, loans and notes, etc., then you should open a self-directed IRA which allows and facilitates an asset variety, including the non-traditional assets. Virtually none of the banks, brokerages, mutual funds and insurance companies will allow non-traditional asset investing. Many of them won't even allow investments which they don't sell or broker. An excellent low-fee, self-directed IRA program, with the most comprehensive offering of services, investment funds, non-traditional asset programs, and expertise in the self-directed IRA industry, is offered through the IRA web site of American Estate & Trust, LC: www.IRAcentral.com.

You May Need Multiple IRAs. It is OK, actually quite common, to form multiple IRAs, so that you can have more diverse investment capabilities. You might put part of your IRA money in a stock brokerage IRA so that you can day trade with that account, and then put some more of your IRA in a self-directed IRA so that you can directly own precious metals or real estate in that account. Bear in mind, though, that you cannot use multiple IRAs to exceed the annual IRA contribution limits. The stated annual limits (see "Contribution Rules For Both Roth and Traditional IRAs" topic on page 4) are the maximum amount allowable for all your IRAs combined.

Roth IRA Basics

The Roth IRA gives you the ability to save and invest your *after*-tax dollars, let the investment grow completely tax free, and withdraw your principal and earnings tax-free if the Roth has existed for at least five years. (For certain reasons you may be subject to a 10 percent penalty on the earnings if taken before age 59 ½.) In other words, once your after-tax dollars go into the Roth, neither those dollars nor any future earnings on the dollars are ever taxed again, a very powerful feature. And, unlike the Traditional IRA, there is no 70-½ years age limit on making contributions, you may make contributions at any age. You do need to have some earned income which is equal to the amount you want to contribute, and then there is a maximum amount that you may contribute.

Contributions. The deadline to contribute to a Roth IRA for a particular tax year is generally April 15 of the following year. When this date occurs on a weekend or a legal holiday, the following business day becomes the deadline. Tax return extensions do not extend this deadline, it's always April 15th of the following year. When an individual makes a contribution to his or her Roth between January 1 and April 15, for the previous tax year, this is frequently referred to as a "carryback contribution". See the page 4 topic "Contribution Rules For Both Roth and Traditional IRAs" for contribution limits.

Withdrawals (Distributions). If you satisfy two conditions you may make tax-free and penalty-free withdrawals from your Roth IRA. First, your Roth IRA must have been open for a minimum of five years. Second, the withdrawal must be made because of the occurrence of one of the following events:

- You have reached age 59-½ (However, there is an excellent IRS provision which allows partial withdrawals to begin at almost any age and to continue for a specific time frame. This provision is called a 72(t). Click on the link, "Access IRA For Quick Cash" at IRACentral.com for more information and for access to a free 72(t) calculator.)
- Your death
- Your disability
- Your first home purchase

Distributions or withdrawals that meet the above requirements are referred to as "qualified distributions." While you may take distributions from your Roth IRA at any time, distributions which are not qualified distributions may be subject to taxes (and in some cases early distribution penalties) to the extent they exceed your combined contributions to the Roth IRA.

You are not required to take withdrawals at age 70-½ or any other age as you are with a Traditional IRA, another very powerful feature. You can leave everything in the Roth, continuing to grow tax free, and pass the Roth after your death on to your heirs also income tax free. However, the amount left in the Roth after death will be subject to estate or other death taxes if the estate is large enough to hit the taxable minimums.

Traditional IRA Basics

The Traditional IRA allows you in invest or contribute your *before*-tax income to an IRA, take a tax deduction for the contributions (pay no taxes on that amount of your income), and let those non-taxed dollars grow tax deferred in the IRA until you start taking them out in retirement.

Contributions. The deadline to contribute to a Roth IRA for a particular tax year is generally April 15 of the following year. When this date occurs on a weekend or a legal holiday, the following business day becomes the deadline. Tax return extensions do not extend this deadline, it's always April 15th of the following year. When an individual makes a contribution to his or her Traditional IRA between January 1 and April 15 for the previous tax year, this is frequently referred to as a "carryback contribution". See the page 4 topic "Contribution Rules For Both Roth and Traditional IRAs" for contribution limits.

Withdrawals (Distributions). Regular retirement withdrawals cannot begin until age 59-½. But there is an excellent IRS provision which allows partial withdrawals to begin at almost any age and to continue for a specific time frame. This provision is called a 72(t). (Click on the link, "Access IRA For Quick Cash" at IRACentral.com for more information and for access to a free 72(t) calculator.) If you have not begun distributions sooner, then at 70-½ years of age you are required to begin distributions or withdrawals from the Traditional IRA (this latter rule is not applicable to the Roth).

Regardless of any earlier withdrawals you may have taken, at age 70-½ there is a minimum amount you must begin taking each year from whatever the IRA balance is. This is termed "required minimum distribution" or RMD. The RMD is calculated as if you turned your Traditional IRA into a lifetime annuity. That is, the calculation is designed to spread your total IRA balance out in yearly payments so that theoretically you will have paid your entire IRA out to yourself when you reach your IRS life expectancy. The IRS life expectancy of a 60 year old is 25.2 years, for a 65 year old it is 21 years, and for a 70 year old it is 17 years (from IRS Publication 590). These life expectancies apply to both men and women. There is an excellent and free RMD calculator on www.IRACentral.com, click on the "IRA Retirement and Calculators" link, then click on the "Required Minimum Distributions For Current Year" calculator.

Contribution Rules For Both Roth and Traditional IRAs

Single tax filers may contribute up to the maximum allowable per year if their modified adjusted gross income (MAGI) is less than $99,000. Contribution amounts are reduced for single tax filer's with MAGI between $99,000 and $114,000. Married couples filing jointly may each contribute up to the maximum allowable if their MAGI is less than $156,000. Contribution amounts for joint filers are reduced for MAGI's between $156,000 and $166,000. Roth IRA contributions may not be made by single tax filer's with MAGI of more than $114,000, or couples with MAGI of more than $166,000.

Roth and Traditional contribution limits <u>for 2008 and beyond</u> are:

$5,000 for single tax filers and $10,000 for married filers.

Individuals who are 50 years of age before the end of the taxable year may be eligible to contribute an additional amount of $1,000 to a Traditional or Roth IRA as a “catch-up” contribution. For married couples the amount is $1,000 where only one spouse is age 50 or over, and $2,000 if both spouses are age 50+.

Beginning in 2009, the maximum contribution amount is indexed upward for cost-of-living adjustments (COLA) in $500 increments.

Roth or Traditional IRA, Which? Whether you are setting up a new IRA or managing an existing Traditional IRA, the question of implementing or converting to a Roth IRA should always be explored. To go into this requires a somewhat lengthy topic, about a page and a half, so we chose to publish this information in a separate article entitled, *Roth or Traditional IRA, Which?*. Go to www.IRAcentral.com, click on “Articles” and look for this article.

IRAs and Simplified Employee Pension Plans (SEP-IRA). The SEP-IRA is a federal law provision which allows employers to contribute to their employees’ IRAs, as a substitute or supplement for a company retirement plan. Since this article is dedicated to individuals and their IRAs, we have published SEP-IRA information in a separate article entitled, *IRAs and Simplified Employee Pension Plans (SEP-IRA)*. Go to www.IRAcentral.com, click on “Articles” and look for this article.

Free Calculators. The free IRA calculators on www.IRAcentral.com can be very helpful for many IRA questions and decisions. Go to the web site and click on “IRA and Retirement Calculators” to see the list.

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