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IRAs AND 401(k)s

"The question isn't at what age I want to retire,
it's at what income."
—George Foreman

Two of the greatest opportunities for retirement investing are IRAs and 401(k)s. Yet many people fail to take advantage of these gifts from Congress. And many of the people who do avail themselves of IRAs and 401(k)s fail to utilize them as best they can. Knowledge is power. Knowing how to maximize the benefits of these saving graces can help make your retirement so much better.

For Want of a Nail (IRA Style)

According to Benjamin Franklin in *Poor Richard's Almanac,* "For the want of a nail, the shoe was lost. For the want of a shoe, the horse was lost. For the want of a horse, the rider was lost. For the want of a rider, the battle was lost. For the want of a battle, the kingdom was lost. And all for the want of a horseshoe nail." Old Ben certainly had a way with words (and the ladies, too, but that is a subject for another time).

The lesson of this particular quotation is that small details are important. They can be particularly important when dealing with Individual Retirement Accounts. One of the important details that IRA owners neglect is failing to name contingent beneficiaries for their IRAs. A contingent beneficiary is the person designated to receive what is left in the IRA at the owner's death. Neglecting this little detail can dramatically affect the income tax levied on the money distributed from an IRA. Listing your spouse as a beneficiary gives your spouse the ability to roll over your IRA, at your death, into his or her own IRA and then withdraw the IRA funds based upon his or her own IRS determined life expectancy.

Based on the IRS Uniform Lifetime Table, this is 17 years for a 70-year-old. In this instance, then, a 70-year-old surviving spouse could either extend the tax deferral of a traditional IRA or avoid the full tax of a Roth IRA for another 17 years—and that, in turn, results in some considerable tax savings. (By the way, the IRS is even optimistic about the longevity of someone who is 107 years old: The IRS Single Life Expectancy Table gives this person 1.5 more years to take out his or her IRA money.)

Stretch IRA

By naming children or even grandchildren as beneficiaries of your IRA, you enable them to extend the period over which they can withdraw the inherited IRA amounts over their projected lifetimes, as determined by the IRS tables. This could result in tremendous tax savings. For example, a ten-year-old grandchild who inherited a Roth IRA from a grandparent would have 72.8 years to withdraw the money in the inherited Roth IRA tax-free. The money remaining in the Roth IRA would continue to compound during that time.

In a move that allows someone to essentially bet on the race after it is over, you can designate your spouse as the primary beneficiary of your IRA, your children as secondary beneficiaries, and your grandchildren as tertiary beneficiaries. After your death, it then is up to your spouse to decide whether to take all or a portion of the inherited IRA, or disclaim all or a portion of the IRA. Any amount disclaimed passes to the

children or, if they disclaimed the money, to the grandchildren. Thus, the benefits of the tax avoidance can be stretched over the lifetimes of your descendants.

Key

However, if you fail to maintain an up-to-date beneficiary designation and your IRA passes to your estate, your family must take out the money over the next five years, translating into a much greater tax burden. Making the best of a bad situation, if you find yourself in this position, IRS rules do not require you to take out the IRA money equally over the five years. The only requirement is that all the money must come out of the IRA within five years. Therefore, if you inherit an IRA through an estate, you at least have the opportunity to leave the money in the IRA until the end of five years, to gain compound interest during that time.

Another Nail

Smokey the Bear always said, "Only you can prevent forest fires." (As a bit of trivia, Smokey's middle name "the" was added in the 1952 song "Smokey, the Bear" for better musical rhythm.) If Smokey had inherited his wife's IRA, he might have warned everyone, "Only spouses can roll over an IRA into their own IRA." This might seem like a small detail, but it's important. Anyone else who inherits an IRA and rolls it over into his or her own IRA risks losing all the tax avoidance and deferral benefits of a stretch IRA. This is because the IRS requires the beneficiary to set up a new IRA with the inheritance that also contains the name of the deceased IRA owner in its title. For example, the title of the new inherited IRA account could read "Smokey the Bear Jr., beneficiary of IRA of Smokey the Bear."

Game, Set, Match

Listen carefully. Gordon Gekko, the character played by Michael Douglas in the 1987 movie *Wall Street,* was wrong when he said, "Greed

is good." However, free money is good. The idea of free money might sound too good to be true, but you might have some free money available to you that you are missing. When your employer offers to match your contributions to your 401(k) plan at work, you're essentially getting free money.

According to a 2005 study done by Hewitt Associates, 22 percent of eligible employees in the United States fail to contribute enough to their 401(k) retirement plan at work to get the full company match. This should be a no-brainer. In 2006, the maximum amount that you can contribute to your 401(k) account is $15,000. However, baby boomers who are at least 50 years old are permitted to contribute an additional $5,000, for a total of $20,000 in 2006. It is important to also remember that the money you put into your company 401(k) plan is pre-tax money: You do not pay taxes on it. In addition, any money put into your 401(k) account grows untaxed; you do not pay any tax on the money until you withdraw it at retirement.

Roth 401(k)

The Roth IRA, the relatively new kid on the IRA block because it was introduced in 1998 as a way of saving for a tax-free retirement, now has a new little brother, the Roth 401(k).

In a conventional 401(k) retirement account, a worker contributes some of his or her salary into a tax-deferred retirement account. Any money that is contributed is not subject to income tax when it is put into the account. Instead, the income taxes become due when money is withdrawn from the account. Beginning in 2006, employers can offer a Roth 401(k) that allows employees to put all or some of their 401(k) contributions into a Roth 401(k) account. The amount of the worker's salary that is contributed into the Roth 401(k) is considered as taxable wages in the year in which it is contributed to the Roth 401(k). Once in the account, however, the money grows tax-free and can be withdrawn later without incurring further income tax.

As with the regular 401(k), in 2006 as much as $15,000 can be contributed annually to an employee's Roth 401k account unless the

employee is at least 50 years old; in that case, the amount increases to $20,000.

Important Loophole

In 2006, to qualify for a Roth IRA, the adjusted gross income (AGI) of unmarried individuals cannot exceed $110,000, and the adjusted gross income of married taxpayers filing jointly cannot exceed $160,000. However, unlike the regular Roth IRA that is described in detail in my book *A Guide to Elder Planning* (Pearson Education, 2003), there are no income eligibility limitations to qualify for a Roth 401(k).

All or Nothing at All

Besides being the title to a 1939 no. 1 hit by Frank Sinatra, this phrase also refers to the flexibility for workers whose employers offer Roth 401(k) accounts. When both types of 401(k) accounts are offered, the employees get to decide how much, if any, they want to contribute to either type of 401(k) account. For example, a worker over the age of 50 might choose to put $10,000 into a regular 401(k) account so that the amount would not be subject to current income taxes; he then might contribute another $10,000 to his Roth 401(k) account for future tax-free growth, and pay the income tax on that amount of compensation.

The Match Game

Many baby boomers fondly remember *The Match Game,* a daytime quiz show hosted by Gene Rayburn with the familiar voice of Johnny Olson as announcer. Baby boomers are even more fond of the matching employer contributions to their 401(k) accounts. These matching contributions are income-tax-free contributions that employers make to the 401(k) accounts of their employees. Thus, they constitute not just an incentive for employees to contribute to their 401(k) accounts, but they truly can be considered money for nothing. (However, unlike the 1985 song "Money for Nothing" by Dire Straits, you do not get chicks for free.) It is important to note that employer-matching

401(k) contributions may be made only to a regular 401(k). Employer-matching contributions may not be made to an employee's Roth 401(k) account.

For Whom Does a Roth 401(k) Make Sense?

Younger workers who will not be retiring for a long time might choose the advantages of tax-free income in the future over the benefits of deferring present income taxes. Lower-income workers also might find the benefits of future tax-free income to be worth more to them than the present tax deferral. They might anticipate that when they withdraw the money, they will be in a higher tax bracket. Workers who are not eligible for a regular Roth IRA because their adjusted gross income is too high might find that the Roth 401(k) gives them a tax-free retirement option. Finally, baby boomers who are looking at ever-increasing federal deficits might wish to opt for the Roth 401(k) as a hedge against what they might think are future income tax rate increases. And those who still cannot make up their minds can choose to do both: set up a regular 401(k) and a Roth 401(k), and split their contributions. Just remember that the total contributions to 401(k) accounts may not exceed the statutory limits.

Sunrise, Sunset

"Sunrise, Sunset" was the name of a hauntingly beautiful song from the musical *Fiddler on the Roof,* which ran for 3,242 performances on Broadway beginning on September 22, 1964.

Sunset might be beautiful when depicted in a song, but when it refers to the practice of Congress writing laws that quietly wipe out tax advantages previously granted, it is the name of a practice that would make Enron accountants blush. The federal government needs a certain amount of money to operate. When a tax break is granted to the public, Congress often puts a time limit on the availability of that particular tax break. By doing so, Congress can anticipate that future revenues needed to run the government will be restored at the end of a certain period. "Sunsetting" is the term for terminating such a law with a

limited shelf life. Of course, this tactic is highly misleading: If there is a large enough public protest over the end of a particular tax break, Congress will make it permanent. That, in turn, could mean that Congress will not have enough money to operate future necessary programs without performing other accounting manipulations that are not drastically dissimilar to the misrepresentative accounting that sent several Enron officials to prison.

A good example of a law with sunset provisions is the federal estate tax. This law provides for the regular increasing of the amounts of assets that are exempt from federal estate taxes through the year 2009 when the exemption amount reaches a peak of 3.5 million dollars. Then in the year 2010, the estate tax will be totally abolished so that no one who dies in that year, regardless of the amount of assets contained in his or her estate, will be responsible for paying a federal estate tax. But then comes December 31, 2010, a day called by some people *Throw Mama From the Train* Day, referring to the 1987 movie directed by Danny DeVito and starring Billy Crystal. Under current law, that is the last day that estates will go untaxed because, on that day, the federal estate tax abolition sunsets. On January 1, 2011, not only does the federal estate tax return, but it does so at the reduced million-dollar exemption level of the year 2002. No one actually expects that scenario to occur, least of all the Congressmen who voted for such a sunset law. Most likely, they will play out the sunset game and either permanently abolish the estate tax (less likely) or pass a new law setting a permanent (or, at least, as permanent as any tax legislation can be) exemption amount.

I tell you all of this interesting information about sunset laws not just for your edification, but also because the Roth 401(k) law has a similar sunset provision. Like the federal estate tax, the Roth 401(k) is set to sunset on December 31, 2010, unless Congress takes further action. However, even if Congress were to permit the Roth 401(k) law to just fade away, such action would only prevent people from putting further money into a Roth 401(k). Funds already put into a Roth 401(k) could most likely be rolled over into a regular Roth IRA and would continue to provide benefits to those people who took advantage of this retirement tax break during the 5 years it was available.

Temptation

Temptation: good when you are talking about the Temptations, one of the greatest of the Motown groups. Temptation: bad when it causes you to take your money out of your 401(k) when you go to a new job, thereby turning an advantage of the 401(k) into a disadvantage. The law permits people to take a 401(k) account with them from one employer to another throughout their working careers. The law also allows three other choices.

The first option, which is less of a choice than just failure to make a decision (which, thereafter, becomes a decision), is merely leaving your 401(k) account with your former employer's plan. This is not necessarily a bad decision, but it does expose you to unnecessary additional management fees if you have 401(k) accounts with multiple employers.

A second option is to roll over your 401(k) from your previous employer into the plan of your next employer. This alternative can be used if you already have another job lined up when you leave your previous job. A key determining factor in deciding to choose this option is the choice of investments in your new employer's 401(k) plan. If the choices do not seem particularly attractive, you might want to take advantage of your third option: rolling over your 401(k) account from your previous employer into your own self-directed IRA.

Rolling over an employer-sponsored 401(k) into an IRA, traditional or Roth, makes a lot of sense for most people. People who leave a job for whatever reason have a right to either leave their retirement money in the company-sponsored 401(k) or have it rolled into an IRA that they themselves control. This enables former employees to invest their retirement money in whatever investments are allowed under IRA rules. The investment choices available to a former employee in a self-directed IRA are far broader than those available when a former employee leaves the money in the company's 401(k) plan. And whether you keep it in the company 401(k) plan or roll over the money into your own IRA, income tax deferral (or complete avoidance, in the case of a company-sponsored Roth 401[k] plan) is fully available to the former employee. There is one major consideration in deciding whether to leave the money in the company 401(k) or take it out and put it into an IRA, however: only workers who take out the money and roll it into

their own IRAs can stretch an IRA through multiple generations, as described previously.

Then there is that temptation to just take the money and spend it. This is a lose, lose, lose proposition. You lose the benefit of having the money grow tax deferred in a 401(k) plan. You lose by paying income tax on the money you take out. And you lose by paying a 10 percent penalty for early withdrawal of your 401(k) account unless you are at least 59½ or come within one of the narrow statutory exceptions. Unfortunately, according to a Hewitt Associates study done in 2005, 45 percent of workers cash in their 401(k) accounts when they leave the company.

Know When to Leave

So when does it make sense to leave the money in your company's 401(k) plan? If you want to have the ability to borrow money from your retirement plan, an IRA does not offer that option, whereas a 401(k) does. However, borrowing from a 401(k) is generally not the best choice because even though you are essentially borrowing from yourself, you miss the tax-deferred compounding that is the main reason you have a 401(k) to begin with. In addition, if you leave your job, voluntarily or involuntarily, you must pay back the loan within 60 days—with interest. Otherwise, you must pay not only income tax on the loan amount, but a 10 percent early withdrawal penalty, to boot. Somehow, it does not seem worth the risk.

It might also make sense to leave the money with your employer's 401(k) plan if the fees are considerably less than what you would be responsible for paying with your own self-directed IRA. However, it is important to again do your homework to make sure that the lower costs of your company's 401(k) plan are not limited to participants in the plan who are current employees of the company. Some plans have higher fees for participants in the company 401(k) plan who are no longer employees.

When Should You Take the Money Out and Pay the Taxes?

When you leave your job, you also have the option of neither rolling the money into your own IRA nor leaving it in the company 401(k); you can also just take the money and run. However, although you might run with the money, you cannot hide it from the IRS. When you take a distribution of your 401(k) funds upon leaving the company without rolling the money into an IRA, you are responsible for paying income taxes on the money you withdraw. In addition, you are responsible for paying penalties on the money you withdraw if you are under the age of 59½.

Fortunately, buried within the Internal Revenue Code is a little-known loophole that permits former employees who had their company stock in their 401(k) accounts to transfer that stock into a regular investment account. This is considered an "in-kind distribution" that subjects the former employee to income taxes only on the value of the company stock at the time he or she bought it. This means, for example, that if the stock was worth $5,000 at the time the former employee initially purchased the company stock for the 401(k) and the stock is now worth $50,000, the former employee would pay income taxes only on $5,000 when he takes the money out of the company 401(k) plan. The remainder of the value of the stock could continue to grow. Then when the former employee sold the stock, income taxes would be limited to the lower capital gains rates.

Upside of Anger and Downside of 401(k) Accounts

The Upside of Anger was a terrific movie in 2005 starring Joan Allen and Kevin Costner. Of course, generally we do not think of an upside to anger. Nor do we think of a downside to 401(k) accounts, but there are some as reflected in a number of class actions by employees against employers sponsoring their 401(k) accounts. The biggest problem with 401(k) accounts occurs when the company invests its employees' 401(k) money either exclusively or largely in the company's own stock.

This was the unfortunate situation in which employees in the now-bankrupt Enron and WorldCom found themselves. The problem arises when workers choose from their investment options to put their 401(k) money in their own company's stock, something they know (or think they know, as in the case of Enron and WorldCom). The problem also occurs when a company matches contributions with stock in the company. Often this stock, provided as an employer-matching contribution, has restrictions. In the Enron situation, the matching stock could not be sold until the employee was at least 55 years old.

Even if you work for a good company, failing to diversify your investments puts you at greater risk of a financial downfall if the value of your company's stock goes down; this is true regardless of whether criminal behavior is involved, as in the case of Enron. Remember, just by receiving your salary from your employer, your finances already are tremendously tied to that employer. Spread out the risk. The old adage is correct: "Don't put all your eggs in one basket." Unfortunately, according to a 2005 study by Hewitt Associates, 27 percent of employees hold at least half of their 401(k) investments in their employer's stock.

Another problem that can turn up with some 401(k) plans is a limited number of mutual funds for investing 401(k) money. In addition, in some instances, these mutual funds either have been saddled with particularly high fees that eat into earnings or are poor performers when compared to other funds. The solution to these problems is found in making employees more aware of the choices that are available through the company's 401(k) plan and lobbying company officials for changes in the plan if it is not as investor-friendly as it can be.

What You Don't Know Can Hurt You

According to a 2005 study done by Hewitt Associates of "low savers"—that is, employees who either did not contribute anything to their 401(k) plan or did not contribute enough to meet the requirement for a full company match—a majority of these employees do not have even a basic understanding of how their company 401(k) plan works. In addition, 73 percent do not know the rate at which their company matches employee 401(k) contributions. Most disturbing of all,

54 percent of these low savers do not even know whether their employers offer a matching contribution.

In his song "Kodachrome," released in 1973, Paul Simon sang that his "lack of education did not hurt me none." When it comes to being able to take advantage of your company's 401(k) program, however, ignorance can cost you dearly in lost savings over the years.