THE TRUTH ABOUT

# PROTECTING YOUR IRAs AND 401(k)s

"Earn more benefits and keep them rock-solid safe..."

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*"I'm here from the government, and I am here to help you." For some people that phrase instills confidence that the government of the people, for the people, and by the people has come to the rescue of its citizenry and will be providing assistance in some important matter. For other people that phrase instills a fear that when the government gets involved, things tend to get overly complicated and complex. When it comes to retirement planning, both mindsets are right.*

Although sometimes it may seem like the purpose of tax laws is to merely take as much of our hard earned money as possible, tax laws are also written to encourage certain activities and discourage others. The tax deduction for mortgage interest is an example of Congress' attempt to encourage and facilitate home ownership. And so it is with retirement planning.

In an effort to encourage us to save for our own retirement rather than be dependent upon the government and programs like Social Security, Congress has passed laws providing opportunities for us to save for our own retirement while also reducing our income tax burden—a definite win-win situation for us. Perhaps the most popular and most effective ways of saving for your retirement are through IRAs and 401(k)s. More than 3 ½ trillion dollars are invested in IRAs while 401(k)s hold investments worth another 3 trillion dollars.

When it comes to planning for your retirement, IRAs and 401(k)s offer tremendous opportunities, but also pitfalls and traps for the unwary. As with any government-created program, there is a veritable avalanche of rules that can be viewed by pessimists as being stifling complications filled with financial danger. To the optimist, however, these rules provide opportunities for you to adopt IRA and 401(k) strategies specifically tailored to yours and your family's needs—not just for now, but for the next generation.

That is where this book comes in. This book may not turn you into an optimist if that is not your predisposition, but it will provide you with the truth about all the ins and outs, the regulations, and

the loopholes involved with IRAs and 401(k)s. It will help you identify both the pitfalls and the opportunities. It will help you help yourself toward a secure retirement.

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

# TRUTH 1

# IRA

Although it may seem like the purpose of tax laws is merely to confiscate as much of our money as possible, tax laws are written by legislators to encourage and discourage particular activities. The tax deduction for mortgage interest is an example of Congress' attempt to encourage and facilitate homeownership. And so it is with retirement planning.

In an effort to encourage us to save for our own retirement rather than depend on the government and programs like Social Security, Congress has passed laws providing opportunities for us to save for our own retirement in a tax-advantaged way. Perhaps the two best ways to do this for most people are the IRA and the 401(k). When it comes to retirement planning, the IRA offers tremendous opportunities. As always, there is a veritable avalanche of rules that can be viewed by pessimists as stifling complications. However, to the optimist, these rules present opportunities to help you adapt an IRA strategy that will work best for you and your family.

IRA is an acronym for Individual Retirement Account. It comes in the form of the traditional IRA (if anything that has only been around since 1974 can be referred to as traditional) and the Roth IRA, named after its primary Congressional proponent, Delaware Senator William Roth. The traditional IRA was originally intended to provide a means for people who were not covered by company pensions to be able to save for their own retirement in a tax-advantaged manner. In 1981, Congress broadened the availability of IRAs to all workers regardless of whether they were covered by a company pension.

When it comes to retirement planning, the IRA offers tremendous opportunities.

The Roth IRA became law in 1997. Two years prior to its enactment, a similar proposal entitled the American Dream Savings Account was passed by Congress but vetoed by then-President Clinton. Apparently, they did not share the same dream. The Roth IRA was the crowning achievement of the legislative career of Senator William Roth, who a scant three years after the passage of the legislation was sent into his own retirement when he lost his bid for reelection to the Senate.

With a traditional IRA, contributions to the IRA are often tax deductible and accumulate income on a tax-deferred basis. With a Roth IRA, you pay income tax on the money you put into the IRA. However, the money grows untaxed, and you are able to take money out of a Roth IRA free of all income taxes.

## Traditional IRA

A traditional IRA is a retirement account into which the law permits you to make, in many cases, tax-deductible contributions on an annual basis of as much as $5,000. For those of you reaching the age of 50, not only do you get a birthday card from AARP (and how do they always manage to know when everyone's 50th birthday is?), but also you are permitted by law to contribute an extra $1,000 to your IRA, for an annual total of $6,000. Beginning in 2009, the amount of the annual contributions are adjusted annually for inflation, in $500 increments.

Perhaps the major requirement for eligibility for any IRA is earned income. However, there are limitations on the amount of income you may have to qualify for a Roth IRA. There is no limitation on the amount of income you are permitted to earn to be eligible for a traditional IRA. In addition, you must be under the age of 70 1/2 to contribute to an IRA, but more on that later.

If you are married and neither you nor your spouse has a retirement plan at work, your contributions to your traditional IRAs will be fully tax deductible in that year. Even if you do have a retirement plan at work, you may be able to deduct some or even all of your IRA contributions if your taxable income meets certain guidelines. For 2008, the guidelines were particularly restrictive for married people filing separate income tax returns. Couples are allowed to have no more than $10,000 of adjusted gross income to get even a partial tax deduction for their contributions to traditional IRAs. Single or head of

If you are married and neither you nor your spouse has a retirement plan at work, your contributions to your traditional IRAs will be fully tax deductible in that year.

household filers could fully deduct their contributions to a traditional IRA if their adjusted gross income was less than $53,000. They were able to receive a partial deduction for their contributions if their adjusted gross income was between $53,000 and 63,000. Married couples filing a joint income tax return get the most bang for their bucks from Uncle Sam, who permitted them to fully deduct their IRA contributions so long as their adjusted gross income was less than $85,000. They could receive a partial deduction if their adjusted gross income was between $85,000 and 105,000. Husbands and wives are each permitted to have their own individual IRA accounts even if only one spouse is working outside the home.

To make things even more complicated (and isn't that the apparent job of government?), if one member of a married couple is an active participant in a pension plan at work, the other spouse may still deduct all of his contribution to a traditional IRA so long as the couple's combined adjusted gross income was less than $159,000 in 2008. A partial deduction for the contributions to a traditional IRA by the spouse not covered by a pension plan at work was allowed when the couple's combined adjusted gross income was between $159,000 and $169,000. At $169,000 of combined income, no deduction was permitted for a contribution to a traditional IRA for the spouse not covered by a pension at work.

## Roth IRA

In a rare instance of consistency and simplicity, the contribution limits to a Roth IRA are the same as those for a traditional IRA. However, unlike a traditional IRA, which can be established by anyone with sufficient earned income, eligibility for a Roth IRA depends on your income. For example, if a single person has more than $114,000 of adjusted gross income or a married couple filing jointly has more than $169,000, they would not be eligible for a Roth IRA. No deduction of any amount is allowed for contributions to a Roth IRA. And unlike a traditional IRA, you can make contributions to a Roth IRA at any age.

# TRUTH 2

## Let’s get it started (IRA style)

Starting an IRA isn't generally something that's considered a lot of fun, so let's increase the enjoyment of the experience by giving it a little background music. Think "Let's Get It Started" as sung by the Black Eyed Peas. Hum or sing along as you think about what you need to do to take the first steps toward a secure retirement.

The first thing you need to do is to decide what kind of IRA you are going to establish. Will it be a Roth IRA or a traditional IRA? You can check your eligibility and compare the advantages of each of these IRAs elsewhere in this book.

Once you have decided what kind of IRA you are going to set up, you should decide how much money you are going to contribute to your IRA of choice. It is important to remember that although the law limits the maximum amount of money you can contribute to an IRA, it does not set a minimum amount. I certainly advise people who can afford to do so to contribute as much as law allows them to their IRAs each year. However, something is better than nothing, and it's a positive step just to get into the habit of contributing to an IRA. So if you aren't going to contribute the maximum amount permitted by law, at least commit to making some contribution to an IRA. In fact, although banks are generally not thought of as a great place to have an IRA because the investment choices are limited, they may be a good place to get your feet wet when it comes to starting an IRA. Most banks can set up IRAs with minimal contributions as well as minimal or even, in some cases, no fees.

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But where else is a good place to start an IRA?

A mutual fund company, such as Vanguard and Fidelity, is an excellent choice as the trustee of your IRA. Mutual fund companies offer an array of investment choices, and you are sure to find a mixture of investments you'll be comfortable with. You may want to put all your IRA eggs into one basket such as a Target Mutual Fund, or you may want to spread out your IRA investment among a few

different mutual funds within the same mutual fund company. The latter offers you a diverse asset allocation that can be quite helpful in planning for a safe and secure retirement.

If you want even more flexibility in picking your IRA investments, you may want to consider using the services of a brokerage firm, such as Charles Schwab, as the trustee of your IRA. With a brokerage firm, you can not only use mutual funds as the basis for your IRA investments, but you also can design your own portfolio of individual stocks and other investments for your IRA.

## Fees

The same rule applies to IRAs as it does to every investment. It isn't what you make that's important; it's what you keep. Particularly with a long-term investment such as an IRA that grows either tax deferred in the case of a traditional IRA or tax free in the case of a Roth IRA, the money you lose to excessive fees is money that isn't growing and compounding for your future retirement. Fees are important. Make sure that you know all the fees involved with the particular investments and trustees that you choose.

Mutual funds have a variety of sales charges and other account maintenance charges. These are in addition to the charges you pay the trustee for managing your account. You also may have to pay an initial start-up fee when you set up your IRA and, of course, there are annual maintenance fees and fees for activities, such as sales of shares of stock that may make up your IRA's investment portfolio. Make sure that you understand all the potential fees involved with a particular trustee and a particular type of investment you're considering for your IRA.

## Beneficiary designation

When you set up your IRA, you need to complete a beneficiary designation form to indicate your choice as to whom you want to receive your IRA if you die prior to having withdrawn all the money in your IRA. This is an important

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decision with many ramifications. You need to keep your beneficiary designation up to date because life is always changing. Deaths, births, and divorces are examples of some of the changes that may affect who you want in your beneficiary designation. A mistake in your beneficiary designation can result in your IRA passing at your death to people whom you wouldn't want to receive it or people whom you do want to receive your IRA having to pay substantially higher income taxes on the money they inherit.

## Funding your IRA

It isn't necessary to fund your IRA by the end of the calendar year, although the sooner you fund it, the sooner it starts achieving tax-deferred or tax-free growth. The law permits you to make your annual contribution to your IRA as late as when your income tax return is due on April 15. Remember, however, that as generous as Uncle Sam is in allowing you to make your previous year's IRA contribution as late as three and one-half months after the end of the year that you're making the contribution for, you aren't allowed additional time to make your contribution even if you obtain an extension of the filing date for your income tax return.

# TRUTH

# 3

## 59 1/2 and 70 1/2

Throughout the laws pertaining to withdrawals from annuities, traditional IRAs, and 401(k)s are found the recurring numbers 59 1/2 and 70 1/2. These numbers seem to take on almost mythical proportions. Most of us assume that there are logical reasons behind these numbers and assume, in particular, that the mystical 1/2 years contained in each of these numbers must have tremendous significance. However, to assume this is to give Congress much more credit than it deserves.

The age of 59 1/2 is the age at which you can withdraw money from retirement accounts without penalties.

The age of 59 1/2 is the age at which you can withdraw money from retirement accounts without penalties. It's certainly understandable to have some kind of age prior to which there's a penalty for early withdrawal from a retirement account, because when Congress enacted the laws giving taxpayers tax breaks and inducements to save for their own retirement through these programs, allowing people to have total access at any time to these funds that are intended for retirement would just defeat the whole purpose of encouraging such savings. But why 59? And why the extra half a year to make it 59 1/2? The answer goes back to the creation of the Keogh Plan. The Keogh Plan was one of the earliest Congressional attempts to encourage people to save for their own retirement. It was named after one of its sponsors, New York Congressman Eugene Keogh. In 1962, Congress was debating the Keogh Plan's imposition of penalties before a designated "normal" retirement age and the maximum age for people to withdraw money from their tax-deferred retirement accounts so that the government could receive tax payments on the withdrawals. House and Senate committee reports indicated that the age of 60, which was a common retirement age in 1962 was, as determined by insurance company actuaries, to be actually 59 1/2 years in insurance years. No mention was made of the retirement age of 60 being 8.5714285 in dog years, but that may just be a Congressional oversight. It seemed a natural fit for Congress to conform the new retirement plan legislation with the existing policy

structures then used by insurance companies, including the half-year "insurance age" designations. Thus, 59 ½ was born.

As for age 70 1/2 being the outside age at which withdrawals must be commenced from annuities, traditional IRAs, and 401(k)s to avoid tax penalties, the age of 70 has had a long history in retirement planning. In 1889, the age of 70 was used in Germany as the retirement age in the first national old-age retirement system. During the 1930s, prior to the Social Security system being enacted, about half of the state pension systems then in effect used the age of 70 as retirement age. Although for consistency's sake you might think that 70 1/2 is the insurance age equivalent to age 70, this is not correct. The 70 1/2 may have come just in an effort to make things appear consistent with the early withdrawal penalty age of 59 1/2, or it may have been chosen in response to a 1960 report of the Social Security Administration that indicated that the average life expectancy of men who would be contributing to self-employed retirement plans like the Keogh Plan was 70.45 years.

Of course, making things even more complicated are the confusing rules that indicate how the 70 1/2 mandatory withdrawal age is applied. According to the rules, you are not actually required to take out your first minimum withdrawals from your annuity, traditional IRA, or 401(k) in the year in which you turn the magic age of 70 1/2. Ironically, you are not actually required to take out your first minimum withdrawal until April 1 of the year after you turn 70 1/2. However, if you do decide to postpone your withdrawal of your first minimum withdrawal amount until that next year in an effort to further defer the payment of income taxes on the amount to be withdrawn, you put yourself in the position of having to also take out a minimum withdrawal amount for the year following the year in which you turn 70 1/2, thereby requiring you to take out two years' worth of minimum annual withdrawals in one year, which may result in a significantly larger tax hit in that year.

But what happens if you do not start taking your minimum required withdrawals in a timely fashion? Such procrastination can result in a serious penalty. Your failure to take out the minimum required distribution in a timely fashion brings with it a penalty equal to 50% of the required distribution that you did not take. The IRS has been waiting somewhat patiently to get its hands on tax money from your

retirement accounts. It does not take kindly to people stretching the envelope and trying to extend the time during which they pay no taxes on their retirement accounts.

Failure to take out the minimum required distribution in a timely fashion brings with it a penalty equal to 50% of the required distribution that you did not take.

If you find that you did not take your minimum required distribution on time, you can always try to use the "dog ate my homework" defense and argue that your failure to take the proper distribution was due to a "reasonable error" on your part and that you are correcting the problem and taking the required distribution now. Doing this requires you to file an IRS Form 5329 as well as pay the 50% excess accumulation tax. Include a letter of explanation (unlike the homework example, a note from your mother will not suffice), hope for the best, and if the IRS is in a charitable mood, it may refund your excess tax penalty.