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A Primer on IRAs

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History

Individual Retirement Accounts (IRAs) were originally known as Individual Retirement Arrangements. The concept was launched in 1974 with the passage of the Employee Retirement Income Security Act (ERISA), the same legislation that created qualified plans; refer to *'Memorandum #106*. The idea was to make some sort of retirement savings vehicle available to those workers not covered by a qualified pension plan.

The first IRAs allowed annual contributions of up to 15% of pay, or a maximum of $1500, and were tax deductible for the year the contributions were made. Additionally, any earnings in the account accumulated tax free until withdrawal. In order to encourage the use of these accounts to be primarily for retirement, ERISA established a penalty of 10% on any withdrawals prior to age 59½ years. Furthermore, the IRA account holder must take Required Minimum Distributions (RMDs) at the age of 70½ years. (If for some reason these distributions are not taken, the penalty is stiff: a 50% excise tax.) The first institutions to offer IRAs were banks.

The Economic Recovery Tax Act (ERTA) of 1981 made IRAs available to anyone with earnings, even if they were already enrolled in a company-sponsored pension plan. This legislation also allowed the contribution of $250 for a spouse without earned income. Contributions were increased to either 100% of pay, or a maximum of $2,000.

The Tax Reform Act of 1986 reversed the open eligibility back to the ERISA mandate. Only those (or their spouse) not participating in a qualified plan could make tax-deductible contributions to an IRA and income restrictions were added. People who were no longer eligible, however, could make nondeductible contributions.

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The Taxpayer Relief Act of 1997 raised income limits of those covered by an employer plan and included spouses who had previously been excluded from making contributions. The biggest change, however, was the creation of the Roth IRA.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 not only increased the maximum contribution to both types of IRAs, but introduced catchup contributions for those age 50 years or older.

As you can see, Individual Retirement Accounts, like qualified plans, are always changing and developing.

Traditional IRAs

One can make both tax-deductible and nondeductible contributions to a Traditional IRA. Sometimes a single contribution is split between the two as a result of income limits. Keep very careful records if you choose to do this as a lot of confusion can result when withdrawals are made and taxes calculated. Some monies will be taxed and some will not. I have found that a simple way of avoiding this problem is to have a standalone, separate IRA for non-deductible contributions. That way I know that only the earnings portion of withdrawals from that particular account will be taxed, not the contributions portion.

The Traditional IRA has also become the depository of qualified plan distributions. Regardless of whether a participant retires or leaves a company for reasons other than retirement, a Traditional IRA provides a place where they can deposit their proceeds which can continue to grow tax deferred.

Plan assets can be "rolled over" to an IRA by one of two ways:

1. The participant can receive a check and deposit it into an IRA within 60 days before the IRS considers it a taxable distribution. At this point, the plan is required to withhold 20% for taxes.
2. Have the plan roll the assets directly into an established IRA account. (This direct method is by far the cleanest way of transferring assets without worrying if the 60-day time limit will be met.)

A Traditional IRA is also a way to pass along tax-deferred assets to beneficiaries for generations (as long as the account is not needed to pay an estate tax). This is one of the most important reasons to review and revise the beneficiaries on the account regularly. Following the death of the account owner, the rules are different for spouse and non-spouse beneficiaries:

1. If the beneficiary is the spouse, they can re-title the account as their own, roll it into an already-established IRA or other qualified plan, or consider themselves a beneficiary. Note: If the spouse is treated as a beneficiary, RMDs will begin by December 31 of the calendar year in which the account owner (i.e. the deceased) turned 70½.
2. If the beneficiary is not the spouse, he/she cannot treat it as their own, so they are unable to make any additional contributions to the account or roll any amounts into or out of the account. The account must be re-titled to read John Doe, Deceased (date of death) IRA F/B/O (for benefit of) Charles Doe, Beneficiary. The first RMD must be taken by December 31 in the year following the death. Subsequent RMDs will be based on the life expectancy of the beneficiary.

Roth IRAs

Contributions to Roth IRAs consist of after-tax monies; they grow tax free and are not taxed at distribution. A Roth IRA is well suited for individuals who think their taxes will be higher when they retire, or would prefer having a piece of their retirement funds distributed to them tax free.

There are limits on modified adjusted gross income (MAGI), above which one is not eligible to contribute to a Roth IRA. While the MAGI limit can change from year to year, Roth IRAs have the same contribution and catch-up rules as Traditional IRAs. Note: If one contributes to both types of IRAs, the overall limit applies. For 2013, both accounts would have to total $5500 in any combination; $6500 if you are 50 or older.

While RMDs do not apply to Roth IRAs, there are certain rules for distributions:

1. At age 59½, a qualified distribution can be made after five years have elapsed since the first contribution to the account.
2. A qualified distribution can be made as the result of disability.
3. A qualified distribution can be made to a beneficiary after the account holder's death. When an account holder dies and the beneficiary is the spouse, the spouse can combine it with another Roth IRA and treat it as their own. If the beneficiary is not a spouse, the inherited Roth IRA can be distributed tax free in one of two ways:

• The entire amount can be distributed over a period of five years ending December 31 of the fifth year.

• Take RMDs based on the beneficiary's life expectancy. (The beneficiary can, in turn, pass it on to another beneficiary, making it a great way of providing untaxed benefits to several generations.)

Traditional IRAs or 401(k) distributions can be converted to a Roth IRA. When tax deductible contributions or earnings are converted, the amount is added to the account holder's gross income and taxed accordingly. In order to minimize the tax, a conversion can be done over a period of several years. We suggest meeting with a tax professional prior to doing a conversion to make sure it is in the account holder's best interest. Note: Roth 401(k) accounts can be rolled into an established or new Roth IRA, but special rules apply.

Conclusion

IRAs are a very important tool in saving for retirement. They are a great way to encourage young people with a part-time job to get in the habit of putting some money away for retirement. In general, anyone with earned income can open an IRA account. Note: Some institutions impose age restrictions.

As with qualified plans, they are a dynamic creation where rules, eligibility limits, and contribution limits can change with new legislation.

More detailed information regarding IRAs can be found in IRS Publication 590 available at www.irs.gov. If you have any specific questions regarding IRA accounts, please feel free to contact our Client Service Department at (877) 935-5520 extension 4.

2013 IRA Contributions

Traditional and Roth IRA contribution limits for 2013 are the lesser of $5,500 ($6,500 if you are age 50 years or older), or 100% of your earned income.

Traditional IRA MAGI Limits

Individuals filing as single or head of household who are covered by a retirement plan at work may deduct contributions to a Traditional IRA:

• Fully—if their Modified Adjusted Gross Income (MAGI) is less than $59,000; ($95,000 if filing a joint return); or

• Partially—if their MAGI is between $59,000 and $69,000; ($95,000 and $115,000, if filing a joint return).

Individuals filing as single or head of household who are covered by a retirement plan at work with a MAGI of $69,000 or more ($115,000 or more if filing a joint return) cannot deduct contributions to a Traditional IRA.

Individuals either living with a spouse or filing a joint return who are not covered by a retirement plan at work— but whose spouse is—can deduct contributions to a Traditional IRA:

- Fully—if their MAGI is less than $178,000; or
- Partially—if their MAGI is between $178,000 and $188,000.

Individuals either living with a spouse or filing a joint return who are not covered by a retirement plan at work—but whose spouse is—with a MAGI of $188,000 or more cannot deduct contributions to a Traditional IRA.

Roth IRA MAGI Limits

Individuals filing as single or head of household may fund a Roth IRA:

- Fully—if their MAGI is less than $112,000; ($178,000 if filing a joint return); or
- Partially—if their MAGI is between $112,000 and $127,000; ($178,000 and $188,000, if filing a joint return).

Individuals filing as single or head of household with a MAGI of $127,000 or more ($188,000 or more, if filing a joint return) cannot make a Roth IRA contribution.

The comments made in this commentary are opinions and are not intended to be investment advice or a forecast of future returns. Any tax or legal information provided is merely a summary of our understanding and interpretation of some of the current income tax regulations and is not exhaustive. Investors must consult their tax adviser or legal counsel for advice and information concerning their particular situation.

The "FRIDAY FOCUS" on Retirement series includes:

'**Memorandum #105:** *History of Pensions*

'**Memorandum #106:** *Pension Plans—Types and Characteristics*

'**Memorandum #107:** *A Primer on IRAs*

'**Memorandum #108:** *Participant and Sponsor Challenges*

'**Memorandum #109:** *Planning for a Successful Retirement*