Individual Retirement Accounts

Your retirement savings aren't tax sheltered?

Tell me more about these "long-term plans" of yours.

Updated Aug. 2014
Squared Away

- Educational website
  - Financial Security Project at Boston College.
- Learn About IRAs, 401(k)s, & 403(b)s
  - [http://squaredaway.bc.edu/learn-more/learn-more-about-401ks-and-iras](http://squaredaway.bc.edu/learn-more/learn-more-about-401ks-and-iras)
What is an IRA?

• Tax-advantaged investment for *retirement*
• *Individual* investment account (not joint)
• Not itself an investment
  – an account in which to **hold** investments
    • Think of a cookie jar
    • What kind of cookies will you put in the jar?
      • *Not* limited to one kind of cookie
  – IRA is tax-advantaged “container”
• Earnings accumulate **tax-deferred**
• Penalties for withdrawals before age 59 1/2
Who Can Contribute?

• Worker with earned income
  – No age minimum
    • kids can have an IRA

• Earner’s Spouse
  – Spousal IRA for non-employed spouse
  – S/he deserves an IRA!
IRA Contribution Limits

• $5,500/year
• Add $1,000 for age 50 & older: $6,500
Two Types of IRAs

- **Traditional**
  - Contributions may be tax-deductible
  - Withdrawals are taxed at MTB

- **Roth**
  - Contributions *not* tax-deductible
  - Withdrawals after age 59 1/2 are **tax free!!**
Traditional IRA deduction limits for workers *covered by employer plan*

**Single taxpayers**
- Modified AGI $60,000 or less: full deduction
- MAGI $70,001+: no deduction
- MAGI $60,001-70,000: partial deduction

**Married filing jointly**
- MAGI: $96,000 or less: full deduction
- MAGI: $116,001+: no deduction
- MAGI $96,001-116,000: partial deduction
Distributions from Traditional IRAs

- Taxes owed on withdrawals
- Penalty-free withdrawals after age 59 ½
- Withdrawals must begin by age 70 ½
  - withdrawals must be made at a rate to exhaust $ over your remaining life expectancy
  - IRS provides tables to guide withdrawals
Roth IRAs

- Contribute *after-tax* money
- Funds grow *tax-free*
- Withdrawals after age 59.5 are *tax-free*
- Income limits on who can contribute
  - To prevent wealthy from using Roth to pass money to heirs *tax-free*
2014 Roth IRA Income Limits

Single taxpayer
- AGI <$114,000: full amount
- AGI > $129,000: zero
- $114,000-129,000: reduced amount

Married, filing jointly
- AGI <$181,000: full amount
- AGI > $191,000: zero
- $181,000-$191,000: reduced amount
IRA Early Withdrawals
(before age 59.5)

- Owe income taxes
- Avoid 10% early withdrawal penalty (after 5 years) if $ used to:
  - Buy first home
  - Pay medical expenses >7.5% of AGI
  - Pay health insurance if unemployed > 12 wks
  - Higher education expenses
    - Self, spouse, child, grandchild
  - Permanent disability of IRA owner
Roth IRA Early Withdrawals

Tax-free & penalty-free withdrawals of earnings are allowed before 59.5:
- if you become disabled
- for buying first home
- for children’s (or your own) education expenses
  - But 529 college savings is better option (UESP.org)
- As long as the earnings are from funds invested for at least 5 years
Roth IRA as emergency fund

Roth contributions are made after-tax

- You already paid federal, state, FICA taxes
- Contributions (NOT growth) can be withdrawn tax-free (if account open 5 years or more)
- Use for true emergencies
- Supplement ‘cash’ emergency fund
  - Online savings earning (~ 0.75-0.90%)
  - Roth invested in balanced mutual fund ~ 6-8%
Traditional or Roth?

- Young? Invest in a Roth
- Older?
  - Depends on your marginal tax bracket (MTB)
  - Search web for calculators
- All: Roth provides *tax diversification* in retirement
  - Withdrawals from employer plans are *taxable*
  - Need more $ but want to avoid higher MTB?
    - Withdraw additional funds from Roth
Getting Started

If no other retirement plan

– Choose a stock or balanced (stock + bond) mutual fund
  • Growth potential
  • Broad diversification

• You can start an IRA with just $100!
  – See www.usu.edu/fpw “Past presentations”
    (http://www.usu.edu/fpw/schedule/powerpoints.htm)
    Scroll down to: Mutual Funds
  • Mutual Funds May 2013
Complement Employer Plan

- Determine your asset allocation
- Review employer options
- What investment categories are missing?
  - International investments?
  - Small cap stocks?
  - Real estate?
  - Choose missing asset category for IRA
Q on IRAs?

If Americans hate to pay taxes, why do so few invest in IRAs?
Employer Sponsored Defined Contribution Plans

• **401(k) Plan**
  – employees of **for-profit** corporations
  – may contribute up to 15% of earnings

• **403(b) Plan**
  – employees of **nonprofit** organizations
  – same contribution limits

• **457 State & local government employees**

• **Federal government: Thrift Savings Plan**
Defined- Contribution Plans

- Noncontributory Plans (rare)
  - Employer makes all the contributions (USU)

- Contributory Plan (most common)
  - Employee contributes % of each paycheck
  - Employer *may* “match” employee contributions
    - Match 50 cents to $1 for employee contribution (typically up to 4-6% of salary)
    - Target % of income: 15% (employer + employee)
Employer Sponsored Plans for Small Businesses

- Savings Incentive Match Plan for Employees (SIMPLE) IRA
  - Business with 100 or fewer employees

- Simplified Employee Pensions (SEP)
  - Small business with a few employees
2014 Contribution Limits

- **Employee**
  - $17,500 (indexed for inflation)

- **Catch-up contribution for workers 50+**
  - $5,500 (so $23,000 max.)

- **SIMPLE**: $12,000 + $2,500 catch-up 50+

- **SEP**: 25% of compensation or $52,000
What Happens When Changing Employers?

Worker has options:

- Leave retirement $ with former employer
- Transfer funds to new employer’s plan
- Move funds into a **ROLLOVER IRA**

Don’t spend the money!

- Unless unemployed & desperate
Calculate Cost of $5,000 Early Withdrawal

- Changing jobs & want to cash out your 401(k)?
- How much will you really get to spend?
- How much does the cash out cost you?
Early Withdrawals (lump-sum distributions) Ex. $5,000

- 10% Penalty (to IRS): $500

- Pay taxes at marginal tax rate
  - Ex. 15% = $750
  - $5,000 shrinks to $3750

- Lose out on long term growth***
  - $5,000 @ 6% for 20 years = $16,035
  - $5,000 @ 6% for 30 years = $28,717
Borrowing from Retirement Plan

- You **may not** borrow from IRA
  - You **may** withdraw $ early for selected reasons

- IRS allows 401(k) & 403(b) loans
  - Not all employers allow borrowing
    - Smaller companies may not allow loans
      - paperwork & administration costs
  - 403(b) plans less likely to allow loans
401(k) Loan Provisions

• Borrow up to half your **vested** balance
  – Maximum loan: $50,000
  – Typical minimum of $1,000

• Must pay money back **with interest**
  – within 5 years
  – Up to 10 years for home purchase

• If loan is **not** repaid
  – owe income tax @ MTR &
  – 10% early withdrawal penalty (to IRS)
Benefits of Borrowing

• It’s better than cashing out
• No credit check (account is the collateral)
• Convenient repayment
  – Automatic payroll deduction
Reasonable interest rates
  – Prime + 1% is common rate
  – Typically fixed rate
Cons of Borrowing

- Processing fee (URS charges $60)
- Repay *pretax* money with *after-tax* $
  - Ex: 28% tax bracket
    - Must earn $1.39 to replace $1 withdrawn
- If you have a loan & leave employer
  - must repay loan *immediately* or
  - 10% penalty & taxed at MTR
  - Give up tax-deferred compounding of $
    (time value of money)
- Reduces retirement security
Hot off the press

*J of Financial Planning* study (Tang & Lu, 2014)

- 401(k) loans can be cheaper than credit cards, high-cost loans & in some cases, home-equity lines of credit

Borrowers most likely to benefit:
- those with low 401(k) investment returns
- those with high marginal tax rates

Retirement Savings Contribution Credit (a.k.a. Savers Credit)

- For low & moderate income taxpayers
- For retirement investing
- **Tax credit** of *up to* $0.50 for each $1.00 *up to* $2,000 you contribute to IRA or employer plan
- Maximum tax credit is $1,000
## Retirement Contribution Credit

<table>
<thead>
<tr>
<th>Married Couples Filing Jointly</th>
<th>Heads of Households</th>
<th>Single Filers</th>
<th>Percent of Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $36,000</td>
<td>Up to $27,000</td>
<td>Up to $18,000</td>
<td>50%</td>
</tr>
<tr>
<td>$36,001–$39,000</td>
<td>$27,001–$29,250</td>
<td>$18,001–$19,500</td>
<td>20%</td>
</tr>
<tr>
<td>$39,001–$60,000</td>
<td>$29,251–$45,000</td>
<td>$19,500–$30,000</td>
<td>10%</td>
</tr>
<tr>
<td>Over $60,000</td>
<td>Over $45,000</td>
<td>Over $30,000</td>
<td>0%</td>
</tr>
</tbody>
</table>

Why Contribute?

- How much do you need to live on in retirement?
- Will your 401(k), 403(b) be enough?
- Can borrow from 401(k) but not IRA
- How could saving *just a little bit* each month possibly help?
Power of Monthly Investments

- $50 @ 8% for 15 years = $17,417
- $50 @ 8% for 25 years = $47,868
- $50 @ 8% for 35 years = $115,459

- $100 @ 8% for 15 years = $34,834
- $100 @ 8% for 25 years = $95,737
- $100 @ 8% for 35 years = $230,918
Find out your Marginal Tax Bracket

• Use income tax tables for last year’s return
  – Find amount of taxable income
  – Amount of tax owed?

• To find MTB add $100 to taxable income
  – Amount of tax?

$ difference in tax owed = MTB (10, 15, 25%, etc.)

• Use MTB table (use *taxable* not gross income)
“We take cash, credit or whatever’s left of your 401(k).”
5 Things **not** to think or do

• “I’ll never be able to retire, anyway.” Don’t put off saving for retirement because it seems so far away
• “I can’t afford to increase my retirement contributions.”
  – Can’t do 15%? something is better than nothing.
  – Increase it 1% every 6 months or year.
Things not to do Continued

• “I don’t need to worry about retirement now.”
  – Even if retirement is far in future, now is time to invest.
  – “I’m responsible?!?”
    • Few pensions means you’re responsible for funding retirement
• “Oh, the plan has costs?”
  – Compare fees!
• “Five things retirement plan participants get wrong.” by Jill Cornfield
FPW Past Presentations

See www.usu.edu/fpw “Past presentations” (http://www.usu.edu/fpw/schedule/powerpoints.htm)
  – Retirement
  – National Savings Rate Guidelines…