Personal Finance: Another Perspective

Retirement 4: Individual Retirement and Small Business Plans

Updated 2020/03/17

Objectives

A. Understand Individual Retirement Accounts (IRAs)

B. Explain when it is beneficial to convert a traditional IRA to a Roth IRA

C. Understand small business and self-employed retirement plans

D. Understand Plans and Strategies for small business and individual retirement plans

Case Study

Data:

- Steve is considering a traditional IRA. He is married and he and his wife both have an Employer Sponsored 401k retirement plan at work. His modified adjusted gross income is $123,000 this year.

Application:

- a. Can Steve fully contribute to a traditional IRA and get the tax deduction? Why or why not?
- b. Can he contribute to any other IRAs?
- c. If neither Steve nor his wife have an employer sponsored retirement plan at work, could he still contribute to a traditional IRA and get the tax deduction?

A. Understand Individual Retirement Accounts

- With the Taxpayer Relief act of 1997, there are three *major* types of Individual Retirement Accounts
  - Traditional IRA
  - Roth IRA
  - Education IRA, which is also called a Coverdell Education Savings Account (ESA)

Individual Retirement Accounts (continued)

- Additional types of IRAs:
  - Spousal IRA: An IRA for a spouse
  - Non-deductible IRA: An IRA w/after tax contributions
  - Individual Retirement Annuity: An annuity IRA
  - Employer and Employee Association Trust Account: An IRA set up by employers, unions, associations
  - Rollover IRA: A IRA set up to receive a 401k distribution
  - Inherited IRA: An IRA acquired by a beneficiary
  - Simplified Employee Pension (SEP-IRA): An IRA set up by a small business employer for the firm's employees
  - SIMPLE: A traditional IRA set up by a small business employer for the firm's employees

1. The Traditional IRA

- What is a traditional IRA?
  - An individual retirement account in which an individual can contribute up to $6,000 annually in 2020 which is tax-deferred
  - Eligibility and amounts depend on the contributors income level and whether they have other retirement plans
- Who can contribute to a traditional IRA and what is the maximum contribution?
  - Must be younger than 70½, have earned income or be the spouse of someone with earned income
  - Maximum contribution is $6,000 per year ($7,000 if over age 50 due to $1,000 catch up provision)

Traditional IRA (continued)

- Benefits of a traditional IRA
  - The contribution is tax deductible and earnings grow tax-deferred
  - May deduct the full $6,000 contribution in 2020 on your income tax return if you are not in an employer sponsored plan (ESP) or you are in ESP but AGI is less than IRS determined maximums
  - Spouses not in an Employer Sponsored Plan may make deductible contributions up to $6,000 if joint AGI is $196,000 or less in 2020

Traditional IRA (continued)

- When can withdrawals be made?
  - After 59½ for any purpose
  - Prior to 59½ withdrawals are subject to federal penalties (10%) and ordinary income taxes unless money is used for:
    - Qualified education expenses, First time home purchase (up to $10,000), Death or disability, Annuity payments, or Medical expenses > than 7.5% of AGI
      - These still require the payment of taxes on withdrawals though
  - Federal law requires that you begin withdrawals by April 1st of the year after you reach 70½

Traditional IRA (continued)

- Deductibility
  - Individuals who are "active participants" in Employer Sponsored retirement plans (an ESRP is a 401k, Roth 401k, 403b, etc.) can only deduct contributions if their modified AGI is less than the phase-out range
    - If they are within (above) the phase-out range, there is only partial (no) deductibility
  - Non- "active participants" in Employee Sponsored retirement plans can receive the full deduction regardless of MAGI
    - If neither spouse is an active participant, then all contributions are deductible regardless of MAGI

Traditional Deductibility Limits

Traditional IRA* Year	MAGI Phase Out Range (in 000's) Single Range	Married FJ Range
Both spouses covered by a work ES retirement plan		
2018	$63-$73	$101-$121
2019	$64-$74	$103-$123
2020	$65-$75	$104-$124
Neither you nor spouse are covered by an Employer plan (ESP)		
2020		No phase out
Married with only one spouse covered by a ES retirement plan		
2020		$196-$206

* Note you can still contribute if you earn beyond these limits to a non-deductible IRA, but your contribution is not tax deductible

Traditional IRA (continued)

- Required minimum distributions must begin by April 1st of the year following age 70½.
  - The distribution is the account balance on Dec. 31 of the previous year divided by the life expectancy. There is a 50% penalty on minimum distributions not taken.

Uniform Table

Age	Life Expectancy (LE)	Age	LE
70	27.4	75	22.9
71	26.5	76	22.0
72	25.6	77	21.2
73	24.7	78	20.3
74	23.8	79	19.5

2. The Roth IRA

- What is a Roth IRA?
  - An individual retirement account which provides no deduction for contributions but provides that all earnings and capital gains are tax free upon withdrawal after retirement
- Who can Contribute to a Roth IRA?
  - Anyone, even if part of another Employee Savings Plan
  - Any age, even if you are over age 70½
  - Any amount, up to $6,000 in 2020

Roth IRA (continued)

- What are the advantages of a Roth IRA?
  - You are actually investing more with a Roth, since your investments are after-tax
  - Contributions can be withdrawn tax/penalty free
  - Earnings grow *tax-free* if the Roth IRA is in place for at least 5 years, and you are 59½ years old
  - No requirement for distributions by age 70½
- Disadvantages
  - You can have both a traditional and a Roth, but you cannot exceed the yearly $6,000 limit in 2020
  - There are income limits for investing in a Roth
  - Earnings must be in place 5 years before they can be withdrawn without penalty

Roth IRA (continued)

- How do I make withdrawals from a Roth IRA?
  - Before age 59½ and Roth is held less than 5 years
    - Earnings are subject to early withdrawal penalty of 10%, plus earnings are considered ordinary income for income tax purposes, unless for death or disability until age 59½
    - Contributions can be withdrawn without penalty or tax
  - After age 59½ and Roth is held for less than 5 years
    - Earnings are subject to ordinary income tax
    - Earnings are not subject to early penalty
    - Contributions can be withdrawn without penalty

Roth IRA (continued)

- Withdrawals from a Roth
  - Before age 59½ and Roth is held longer than 5 years
    - Earnings are subject to ordinary income tax and subject to early withdrawal penalty (10%)
    - Withdrawals are treated first as contributions (without tax) and then as earnings (taxable)
      - Withdrawal of earnings for first time home purchase ($10,000 max), or Death/Disability
  - After age 59½ and Roth is held longer than 5 years
    - All contributions & earnings are withdrawn <u>tax free</u>
    - No required minimum distributions (versus a traditional IRA or Roth 401k which requires minimum distributions at age 70½)

Summary of Traditional versus Roth

Key Areas:	Traditional IRA	Roth IRA
Tax-deductible Contribution :	Yes	No
Maximum total annual contribution to all IRA programs:	$6,000 or 10% of earned income. Maximum contribution for a married couple is $12,000 or $6,000 each in 2019 ($14,000 if over age 50 due to $1,000 catchup each)	$6,000 or 10% of earned income. Maximum contribution for a married couple is $12,000 or $6,000 each in 2019 ($14,000 if over age 50 due to $1,000 catchup each)
Eligibility:	Must be under age 70 1/2 and have earned income	Any age with earned income not exceeding AGI limits
Spousal IRA's:	Deductibility is subject to AGI limits. Contributions from non-earning spouses are based on earnings of employed spouse, up to $6,000.	Nondeductible. Subject to AGI limits. Contributions from non-earning spouses are based on earnings of employed spouse, up to $6,000.
Tax-deferred growth:	Yes	Yes
Tax-free Withdrawals:	No	Yes
Age to begin Required Minimum Distributions (RMDs):	70 1/2	None
Tax penalty for withdrawals :	Withdrawals are subject to 10% penalty tax before age 59 1/2 unless for first-time home purchase, deductible medical expenses, or for death or disability.	If funds are held for a minimum of 5 years, withdrawals of earnings before age 59 1/2 are subject to a 10% penalty and income tax unless for death or disability. Contributions are not taxed.

Roth IRA Deductibility Limits

Roth IRA	MAGI Phase Out Range (in 000's)	
Year	Single Range	Married FJ Range
2016	$117-$132	$184-$194
2017	$118-$133	$186-$196
2018	$120-$135	$189-$199
2019	$122-$137	$193-$203
2020	$124-$139	$196-$206

3. The Education IRA

- What is a Coverdell ESA or Education IRA?
  - An investment vehicle for planning for the future cost of a child's education.
  - The plan allows total after-tax contributions of $2,000 per year in 2020 for each child until age 18.
  - Contributions and their subsequent earnings are tax-free when withdrawn to pay for qualified secondary and post-secondary education expenses
- What are its characteristics?
  - Money is invested after-tax, and earnings grow tax-free if used for qualified education expenses

The Education IRA (continued)

- Advantages
  - Earnings are tax free if used for qualified educational expenses
  - Leftover amounts may be rolled over into accounts for siblings
- Disadvantages
  - Savings must be withdrawn by the time the child reaches age 30
  - You cannot take a Hope Credit the same year you draw money from your Education IRA
  - Contributions phase out at $190-220,000 for joint filers

Deductibility Limits

Education IRA	MAGI Phase Out Range (in 000's)	
Year	Single Range	Married FJ Range
2016	\$95-\$110	\$190-\$220
2017	\$95-\$110	\$190-\$220
2018	\$95-\$110	\$190-\$220
2019	\$95-\$110	\$190-\$220
2020	\$95-\$110	\$190-\$220

- Your modified Adjusted Gross Income is your adjusted gross income and adding back certain items such as foreign income, foreign-housing deductions, student-loan deductions, IRA-contribution deductions and deductions for higher-education costs.

4. Spousal IRA

- A Spousal IRA is an IRA contribution for a non-earning spouse
  - If one spouse is an active participant, the non-earning spouse can contribute to a Spousal IRA. Limits are the same as the traditional and Roth IRA.

5. Non-deductible IRA

- Individuals may contribute to a non-deductible IRA
  - The benefits are that money is contributed after-tax, and investment earnings grow tax-deferred
    - No taxes are paid on the investment earnings until the earning are withdrawn at retirement
  - Accurate record keeping is required to pro-rate the nondeductible portion of any subsequent distribution
    - There is no ordering of distributions before age 59½
    - All distributions are considered to be both contributions and earnings.

B. When does Converting to a Roth Makes Sense?

- Converting to a Roth IRA may be a smart choice for you if:
  - You think your tax bracket will stay the same or go up after you retire
  - You plan to wait at least five years before withdrawing money
  - You want to save more for retirement and can pay the taxes from other savings
  - It won’t move you into a higher tax bracket in the year you convert
  - You want to avoid required minimum distributions from your retirement savings

Roth Conversion (continued)

- You can convert a Traditional IRA to Roth IRA
  - You pay taxes on traditional IRA (but not the 10% penalty) then move funds to Roth IRA
  - The money accumulates tax free if:
    - 5 year and age 59½ rule applies

Roth Conversion (continued)

- Transfers are allowed in 3 ways
  - 1. Accept payment and redeposit within 60 days (it is risky to take payment directly due to 10% taxes withheld at distribution)
  - 2. Request a trustee-to-trustee direct transfer
  - 3. Change the account designation with the trustee to a Roth
  - The direct transfer is the most simple and safest
    - 60 day roll-over rule requires 10% taxes to be withheld at distribution, and you will have to replace withheld taxes with other funds
    - 10% early withdrawal penalty applies if you use IRA funds to pay income taxes at conversion

Questions

- Any questions on individual retirement plans?

C. Understand Retirement Plans for the Self-Employed and Small Businesses

- Are there retirement plans for self-employed and small businesses?
  - Yes.
- Do they have the similar tax advantages?
  - Yes. And some are even better
- Can you contribute to these even if you have another retirement plan through another employer?
  - Yes. If you are self-employed either full- or part-time, or work for a small business, you can contribute to a simplified employee pension (SEP-IRA), a Keogh, or a new savings incentive match plan for employees (SIMPLE) plan.

Small Business Retirement Plans

- Two Categories:
  - 1. Plans funded by the small business employer:
    - Simplified Employee Plan Individual Retirement Account (SEP-IRA)
    - Keogh Plan
  - 2. Plans funded by both the small business employer and the employee
    - Savings Incentive Match Plan for Employees (SIMPLE-IRA)
    - SIMPLE 401k Plan

1. Plans Funded by the Employer

- What is a SEP-IRA?
  - An Individual Retirement Account which allows a small business employer to contribute to the retirement of the employees
- What are the characteristics of the SEP-IRA?
  - Employer contributes the same percentage to all employees, and no required annual contribution
  - Can contribute 25% of salary or up to $57,000 in 2020
  - Contributions are tax deductible, earnings grow tax-deferred, and employees own the plans
  - Employees may have multiple retirement accounts, i.e. a 401(k), a Roth IRA, and a SEP-IRA

The SEP-IRA (continued)

- Advantages
  - Easiest to setup and maintain
  - No annual filings
  - Annual contributions larger than IRAs
  - Most attractive for businesses with few or no employees
- Disadvantages
  - Cannot borrow against a SEP-IRA
  - Contributions vary depending on the employer
  - Distributions before 59½ incur a 10% penalty for early withdrawal plus taxes at your marginal rate

The Keogh Plan

- What is a Keogh Plan?

  A small business retirement plan set up by a sole proprietor or partnership (not incorporated) which allows employers to make tax-deductible payments to retirement plans, similar to pension or profit-sharing plans. Plans can be either a defined benefit or defined contribution, but most commonly are DC profit sharing or money purchase plans
- What are the characteristics of a Keogh Plan?

  Can set apart 20%, up to $57,000 per year in 2020

  Employers give the same percent to each employee

  Contributions are tax deductible, earnings grow tax-deferred, and employees may borrow from the Plan

Keogh Plan (continued)

- Advantages:
  - Higher contribution maximums
  - Preferred by high-income individuals who have postponed saving
  - Good if in catch-up mode
  - Plan participants can borrow from the plan
- Disadvantages:
  - More administrative work
  - Can not borrow against Keogh if solo
  - Keogh must be established by Dec. 31st of each year

2. Plans Funded by the Employer and Employee

- What are SIMPLE Plans?
  - They are Savings Incentive Match Plans (SIMPLE) that provides matching funds by the employer. It can be established as an IRA or as part of a 401k plan
- What are the characteristics of SIMPLE Plans?
  - Employees can have no other qualified plan, and can contribute up to 100% of compensation to a max of $13,500 per year in 2020 ($3,000 catch up if over 50)
  - Contributions are tax deferred and grow tax-free
  - There is a penalty for early withdrawal
  - The employer is "required" to either contribute at least 2% or to match employee contributions, usually 1-3%

SIMPLE IRA (continued)

- Advantages:
  - Employees can participate
  - Tax deductible contribution
  - Easy to set up and administer (compared with a traditional 401(k))
- Disadvantages:
  - Limited employee contribution of $13,500 in 2020
  - Money withdrawn within two years incurs a 25% penalty
  - There is a 10% penalty if money is withdrawn before 59½, plus regular income taxes as well

SIMPLE IRA Plans

- What is a SIMPLE IRA?
  - A small business qualified retirement plan that provides some matching funds by the employer.
- What are the characteristics of a SIMPLE IRA?
  - Employees can have no other qualified plan, and may contribute up to the lesser of 100% of compensation or $13,500 per year in 2020
  - Contributions are tax deferred and grow tax-free
  - There is a penalty for early withdrawal
  - The employer is “required” to contribute at least 2% each year

SIMPLE 401k Plans

- What is a SIMPLE 401k?
  - A small business qualified retirement plan that provides some matching funds by the employer.
- What are the characteristics of a SIMPLE 401k?
  - Employees can have no other qualified plan, and may contribute up to the lesser of 100% of compensation or $13,500 in 2020
  - Contributions are tax deferred and grow tax-free
  - There is a penalty for early withdrawal
  - The employer is “required” to either contribute at least 2% or to match employee contributions, usually 1-3%

D. Understand some Plans and Strategies for Small Business and Individual Retirement Plans

- As you put your Retirement Plan together, it is important to think through some plans and strategies. Examples include:

Plans and Strategies for SB and IRAs (continued)

- Plans and Strategies

  Accumulation

  - Live on a budget, save 20%, always get the company match
  - Save 20% of every dollar, 15% into your Roth 401k or Roth IRA for both you and your spouse (if you don't have a Roth 401k), 3% for other goals, and 2% for children's mission and education
  - Invest in Roth accounts while young and when rates are low. Use these to target your tax rate in retirement (to a low level)
  - Even though you don't know future tax rates, maximize investments in Roth accounts as you are saving more for retirement

Plans and Strategies for SB and IRAs (continued)

- Plans and Strategies

  Retirement

  - Calculate a *minimum level of retirement income*, and annuitize that amount (if you have sufficient assets). The process is:
    - a. Calc. Social Security and defined benefit plan(s)
    - b. Determine *minimum amount* needed to live on
    - c. Take a percentage of retirement assets (including 401k/403b/Roth/IRAs/SEP Plans) to purchase an ***immediate*** annuity to give you the minimum amount needed for an acceptable level of income
  - Have both Roth and traditional retirement assets so you can target your tax rates in retirement
  - Donate assets from your traditional IRA/SEP/Simple plans to pay tithes and offerings to eliminate your capital gains

Plans and Strategies for SB and IRAs (continued)

- Plans and Strategies

  Distribution

  - Have taxable (tax now), Roth (tax never) and traditional (tax later) to target your tax rate in retirement
  - Set a target rate, then pull traditional assets up to that amount, then Roth assets afterwards to reduce taxes
  - During your later years, i.e., during missions, transfer money from your tax-deferred to tax-eliminated accounts. Use this time to move assets into Roth accounts with as little tax consequences as possible
  - After age 69.5, donate assets from your traditional IRA/SEP/Simple/401k/403b plans to pay tithes and offerings, to eliminate your capital gains, and to fulfill your required Minimum Distribution amounts

Review of Objectives

A. Do you understand Individual Retirement Accounts?

B. Do you understand when converting to a Roth IRA makes sense?

C. Do you understand retirement plans for the self-employed and small businesses?

D. Do you understand plans and strategies for small business and individual retirement accounts?

Case Study #1

Data:

- Steve is considering a traditional IRA. He is married and he and his wife both have an Employer Sponsored 401k retirement plan at work. His modified adjusted gross income is $115,000 this year.

Application:

- a. Can Steve fully contribute to a traditional IRA and get the tax deduction? Why or why not?
- b. Can he contribute to any other IRAs?
- c. If neither Steve nor his wife have an employer sponsored retirement plan at work, could he still contribute to a traditional IRA and get the tax deduction?

Case Study #1 Answers

- a. Can Steve contribute to a traditional IRA?
  - Steve cannot contribute to a traditional IRA and get the full tax deduction as his income is beyond the MAGI phase-out limits of $104-124,000 in 2020
- b. Can he contribute to other IRAs?
  - He could contribute to a Roth or a non-contributory IRA which is a traditional IRA with no initial tax benefits
- c. Neither have an employer plan, so what can they do?
  - If neither Steve nor his wife are covered by an employer sponsored retirement plan at work, they can both contribute to a traditional IRA regardless of MAGI limits. If only one spouse is covered by a retirement plan at work, the traditional IRA limits are expanded to the limits of the Roth IRA

BYU
MARRIOTT SCHOOL
OF MANAGEMENT

Case Study #2

Data:

- Bill has money in a traditional and a rollover IRA. He retired on his 60th birthday and did not use any of his traditional IRA balances. On December 31st of his 69th year, he had $150,000 in his traditional IRA.

Calculations:

- How much is he required to take out of his account the next year (use the unified table below)?

Age	Life Expectancy (LE)	Age	Life Expect. (LE)
70	27.4	75	22.9
71	26.5	76	22.0
72	25.6	77	21.2
73	24.7	78	20.3
74	23.8	79	19.5

Case Study #2 Answers

- How much is Bill required to take out for required minimum distributions?
  - Bill will be required to take a RM distribution of
  - $150,000 / 27.4 (from the life expectancy table) or

    $5,474.45 the next year.

Case Study #3

Data

- Steve is considering a traditional IRA. He is married, and his modified adjusted gross income is $123,000 per year.

Application

- Can Steve contribute to a traditional IRA? Why or why not?
- Can he contribute to any other IRAs?
- If neither Steve nor his wife have an employer sponsored retirement plan at work, could he still contribute to a traditional IRA and get the tax deduction?

Case Study #3

- a. Steve will not be able to contribute to a traditional IRA because his income is beyond the MAGI phase-out limits of $104-124,000 in 2020
- b. He could, however, contribute to a Roth IRA as he is below the phase out limits, or a non-contributory IRA which is a traditional IRA with no initial tax benefits.
- c. If neither Steve nor his wife are covered by an employer sponsored retirement plan at work, they can both contribute to a traditional IRA regardless of MAGI limits. If only one spouse is covered by a retirement plan at work, the traditional IRA limits are expanded to the limits of the Roth IRA.

Case Study #4

Data:

- Sam and his wife just turned 60, and they are very concerned about retirement. All their kids are grown, and they have additional money they want to contribute toward retirement. Their modified adjusted gross income is $123,000 this year, and they feel they can save 30% for retirement this year. Their company has a 401k plan without a match

Application:

- Which vehicles can they use and how much total can they save for retirement?

Case Study #4 Answers

- Which vehicles can they use?
  - They can use both the 401k and an IRA
- How much are they eligible for?
  - Sam is eligible for the 401k limit of $19,500 in 2020, and also the $6,500 catch up contribution
  - He and his wife are each eligible for the $6,000 Roth IRA, as well as the $1,000 catch up limit, as they are not beyond the phase-out limits for the Roth IRAs ($14,000 total). They are beyond the limits for the traditional IRA to get the deduction
- How much total can they save in 2020?
  - Overall, they can invest $26,000 in their 401k and $14,000 in their IRAs for a total of $40,000 in 2020