



Personal Finance: Another Perspective

Retirement 4: Individual Retirement and Small Business Plans

Updated 2017/06/23



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



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)

- In addition, there are also many additional types of IRAs:
 - Spousal IRA: An IRA funded by a married taxpayer in the name of their spouse
 - Non-deductible IRA: An IRA with contributions made after-tax, and earnings grow tax-deferred, with taxes paid when withdrawn at retirement
 - Individual Retirement Annuity: An IRA set up with a life insurance company through purchase of annuity contract
 - Employer and Employee Association Trust Account: set up by employers, unions, associations



Individual Retirement Accounts (continued)

- Rollover IRA: A traditional IRA set up to receive a distribution from a qualified retirement plan
- Inherited IRA: An IRA acquired by the non-spousal beneficiary of a deceased IRA owner
- Simplified Employee Pension (SEP-IRA): A traditional IRA set up by a small business employer for the firm's employees
- Savings Incentive Match Plan for Employees IRA (SIMPE-IRA): 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 \$5,500 annually in 2017 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 \$5,500 per year (\$6,500 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 \$5,500 contribution in 2017 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 \$5,500 if joint AGI is \$186,000 or less in 2017



Traditional IRA (continued)

- Traditional and Roth IRA annual contribution limits are:

<u>Year</u>	<u>Contribution Limit</u>	<u>Catch Up Contr.*</u>
2013	5,500	1,000
2014	5,500	1,000
2015	5,500	1,000
2016	5,500	1,000
2017	5,500	1,000

* Catch up contribution is for those over age 50



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*	MAGI Phase Out Range (in 000's)	
Year	Single Range	Married FJ Range
Both spouses covered by a work ES retirement plan		
2014	\$60-\$70	\$96-\$116
2015	\$61-\$71	\$98-\$118
2016	\$61-\$71	\$98-\$118
2017	\$62-\$72	\$99-\$119
Neither you nor spouse are covered by an Employer plan (ESP)		
2017	No phase out	
Married with only one spouse covered by a ES retirement plan		
2017	\$186-\$196	

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



Roth IRA Deductibility Limits

Roth IRA Year	MAGI Phase Out Range (in 000's)	
	Single Range	Married FJ Range
2012	\$110-\$125	\$173-\$183
2013	\$112-\$127	\$178-\$188
2014	\$114-\$129	\$181-\$191
2015	\$116-\$131	\$183-\$193
2016	\$117-\$132	\$184-\$194
2017	\$118-\$133	\$186-\$196



Deductibility Limits

Education IRA	MAGI Phase Out Range (in 000's)	
Year	Single Range	Married FJ Range
2013	\$95-\$110	\$190-\$220
2014	\$95-\$110	\$190-\$220
2015	\$95-\$110	\$190-\$220
2016	\$95-\$110	\$190-\$220
2017	\$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.



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 \$5,500 in 2017



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 \$5,500 limit in 2017
 - 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 tax free
 - No required minimum distributions (versus a traditional IRA which requires minimum distributions at age 70½)



Summary of Traditional versus Roth

	Traditional IRA	Roth IRA
Tax-deductible Contribution	Yes	No
Maximum total annual contribution to all IRA programs	\$5,500 or 10% of earned income. Maximum contribution for a married couple is \$11,000 or \$5,500 each in 2017	\$5,500 or 10% of earned income. Maximum contribution for a married couple is \$11,000 or \$5,500 each in 2017
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 \$5,500.	Nondeductible. Subject to AGI limits. Contributions from non-earning spouses are based on earnings of employed spouse, up to \$5,500.
Tax-deferred growth	Yes	Yes
Tax-free Withdrawals	No	Yes
Age to begin required minimum distributions	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 only before age 59 1/2 are subject to a 10% penalty and income tax unless for death or disability.



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 2017 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 \$190,000 for joint filers



The Education IRA (continued)

- **Deductibility**

Active status nor age is relevant to determining Education IRA eligibility. Key is that the modified AGI range is below specific amounts. Amounts between the ranges are reduced.

Year	Modified Adjusted Gross Income (000s)	
	Single Range	Married Range
2013	\$95-110	\$190-220
2014	\$95-110	\$190-220
2015	\$95-110	\$190-220
2016	\$95-110	\$190-220
2017	\$95-110	\$190-220



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 earnings 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 a required minimum distribution 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)
 - 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 \$54,000 in 2017
 - 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 SEP-IRA (continued)

Internal Revenue Code

Section 415 Funding Limits

<u>Year</u>	<u>Amount</u>
• 2013	\$51,000
• 2014	\$52,000
• 2015	\$53,000
• 2016	\$53,000
• 2017	\$54,000



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 \$54,000 per year in 2017

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 \$12,500 per year in 2017 (\$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/401(k)

- SIMPLE IRA/401k Plan

US\$ Contribution Limits:

<u>Year</u>	<u>Contribution Limit</u>	<u>Catch up*</u>
2013	12,000	2,500
2014	12,000	2,500
2015	12,500	3,000
2016	12,500	3,000
2017	12,500	3,000

* Catch-up contribution increases for those over age 50



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 \$12,500 in 2017
 - 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 \$12,500 per year in 2017
 - 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 \$12,500 in 2017
 - 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%



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?



Case Study #1

Data:

- You just got out of school last year and you have already begun your retirement program. You have invested enough in your company 401k plan to get your company match this year, and have an additional \$5,000 to invest for retirement above and beyond your other goals. You are also making less than the earnings limits for the traditional or Roth. You are discussing with a friend the benefits of the Roth versus the Traditional IRA.

Application:

- a. Which IRA vehicle should you select and why?
- b. What are your assumptions that would impact your choice of retirement vehicle?



Case Study #1 Answers

- a. Which plan you choose should be based on your goals, objectives, and assumptions for the future
- b. Your assumptions should relate to five key questions:
 1. What is your projected tax rate in retirement? If you expect your tax rate to be higher (lower) in retirement, the Roth (traditional) is preferred. Make sure you take into account your child tax and other credits when determining your current tax rate.
 2. Do you need the tax break now? If the reduction in AGI is important for you to reduce your current tax bill, then you would likely choose the traditional



Case Study #1 Answers

3. Do you have the ability to pay the taxes now? If you have additional money to invest for retirement, you can invest more in the Roth than the traditional. That is because you pay your taxes on the Roth money outside of your investment account. You can actually put in more money into the Roth IRA due to taxes.
4. Will you possibly have a need for principle before retirement? If you might need some of the money in the account (just in case), with the Roth you can take out principle after 5 years without penalty or taxes, as principle has already been taxed. You cannot, however, take out earnings and interest without penalty.



Case Study #1 Answers

- 5. Do you desire to have more money saved at retirement? If you want to put more money in for retirement, since you pay taxes outside the retirement vehicle with a Roth vehicle, you are actually saving more for retirement. For example, if you put both \$5,000 into both a Roth and traditional IRA, the Roth will be worth more as you must pay taxes on the traditional IRA when you pull out the money. With the Roth, you pay taxes outside of the retirement vehicle



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

- Bill will be required to take a 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 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 #3 Answers

- a. Steve will not be able to contribute to a traditional IRA and get the full tax deduction as his income is beyond the MAGI phase-out limits of \$99-119,000 in 2017
- 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 \$120,000 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 can they save for retirement?



Case Study #4 Answers

- Sam is eligible for not only the 401k limit of \$18,000 in 2017, but also the \$6,000 catch up contribution
- Both he and his wife are both eligible for the \$5,500 Roth IRA contribution, as well as the \$1,000 catch up limit, as they are not beyond the phase-out limits for the Roth IRAs (\$13,000 total). They are, however, beyond the limits for the traditional IRA to get the deduction
- Overall, they could invest \$24,000 in their 401k and \$13,000 in their IRAs for a total of \$37,000 saved in 2017