

## Chapter 13: Uncle Sam Wants to Help – Sorta (Uncut Version)

My original manuscript for this chapter was a lot longer, and contained details on a lot of IRS rules pertaining to 401(k) and other tax-qualified plans. Here's the original, uncut version, which includes details that didn't make it to the book on the following subjects.

- Rules for withdrawing money from 401(k) plans
- Rules on early payment penalties
- Minimum distribution rules
- Rules that apply to owning your company's stock in a 401(k) plan
- Different types of Individual Retirement Accounts (IRAs)
- Roth IRA conversions
- SEP IRAs and SIMPLE IRAs, for the self-employed

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The federal government has the 20<sup>th</sup> century model of retirement squarely in its collective consciousness. It firmly believes that full-time retirement is a good thing, and that all citizens deserve this as the way to finish life. It provides powerful incentives for saving for retirement, by allowing retirement investing programs that significantly reduce our taxes – for those of us who take advantage of these incentives.

However, the government also resembles an overly jealous spouse. It has lots of rules to prevent us from abusing the system for evil purposes, like using the savings for things other than retirement, or for letting rich people hog all the tax benefits. These rules often are very confusing, get in the way, and discourage the very behaviors that the government wants to encourage. Also, the rules often conflict with emerging trends, such as people living longer and possibly working in their later years.

One thing is for sure – the rules will change! Congress and the IRS constantly meddle with the rules, to respond to political and economic pressures and to fix what is perceived to be broken. For the past 30 years, Congress has made changes to the pension rules on average once per year. So we need to continually keep abreast of these changes to see how they might affect us.

This chapter reviews how these retirement investing programs work and discusses the rules that will influence our saving behaviors, and the rules that we need to pay attention to when we withdraw money to pay for *rest-of-life* expenses.

I'll confine this chapter to defined contribution plans, which most of us will use to build a *rest-of-life* portfolio. Chapter 15 of *Live Long & Prosper!* discusses defined benefit plans and their IRS rules. Here I'll cover 401(k) plans, 403(b) plans, 457 plans, and Individual Retirement Accounts (IRAs) – both traditional and Roth. I'll also cover plans for self-employed individuals – SEP IRAs and SIMPLE IRAs. For each type of program, I discuss the rules regarding putting money in and taking it out.

This entire subject can be complicated, confusing, and deadly boring. They're enough to make even an accountant or actuary yawn. Studies have shown that reading about IRS rules and then driving is as dangerous as having four drinks and then driving. (Just kidding). To help with this problem, I highlight conclusions and recommendations, usually at the beginning of each section, and then fill in details for those who are interested.

First, let's start with ...

### **Numbers Game - 401(k), 403(b), and 457**

These plans are for people who are employees, and not self-employed individuals. As mentioned in other chapters, these plans offer substantial advantages, and are the best place for our *rest-of-life* portfolios.

*My advice is simple – contribute as much as possible to these plans.* If we are age 50 or older, the maximums can be up to \$18,000 in 2005 and \$20,000 in 2006 and thereafter. For most of us, this is all we can afford to save, so we don't need to go anywhere else with our *rest-of-life* savings.

*Don't save for rest-of-life anywhere else until we have maxed out on these plans.* There is possible one exception for Roth IRAs which is discussed later in this chapter.

The rules for these plans can be complicated, and if we run afoul of the rules, the penalties are high. For many of us, our 401(k) balances represent the biggest pot of money we'll ever see in our lifetimes. We should take the time to make sure we use the plans appropriately to avoid the penalties. If we don't understand the rules, we should seek the advice of a professional, usually

an accountant who specializes in personal finance. It's well worth the money. Having said this, I still believe that the average Joe or Jane can figure out what to do most of the time. So, let's take a look.

All of these numbers refer to the section of the Internal Revenue Code that describe the rules for each type of plan. This is one testament to the success of 401(k) plans – this is the only section of the Internal Revenue Code that the average American knows. Folks who wouldn't know Section 162 from Section 163 if their life depended on it, know that Section 401(k) allows them to save on a pre-tax basis. (If you're interested, Section 162 covers business expense deductions, and Section 163 covers home interest deductions).

401(k) plans can be offered by most for-profit and nonprofit employers. 403(b) plans can only be offered by nonprofit organizations, and for employees of educational institutions (including employees hired by public school systems). 457 plans can be offered only by government and nonprofit organizations. Federal government employees have their own savings plan, which is virtually the same as a 401(k) plan. This section uses the term '401(k) plan,' as shorthand for all three plans, unless noted otherwise.

In the past, the rules were different for each type of plan, but recent legislation has made them almost the same. I'll describe the rules that apply to all three types of plans, and will identify rules that are particular to each type.

First, let's look at the rules regarding putting money in the plan.

*My simple recommendation – don't put in more than the maximum allowed. Your plan's administrator should automatically prevent you from doing this. However, if you have changed jobs during the year or you contribute to more than one plan, you need to provide your plan administrator with information on your contributions to help them help you.*

Now here are the details.

- Each year, we can contribute up to 100% of our pay, or a dollar limit, whichever is lower. This dollar limit is \$14,000 in 2005, and \$15,000 in 2006. Thereafter, this limit is indexed for inflation. These are the IRS limits - many plans have lower limits, say 25% or 50% of pay, to ease administration of the plan.
- If we are age 50 or older by the end of a calendar year, we can make catch-up contributions. This means I can contribute up to the limits, *plus* the amount of the catch-up contribution. The amount of the catch-up contribution is \$4,000 in 2005, and \$5,000 for 2006 and thereafter. Adding up the regular dollar limit plus the catch-up contribution results in limits of \$18,000 in 2005 and \$20,000 in 2006 and thereafter. I don't need to wait until my 50<sup>th</sup> birthday to make catch-up contributions – as long as my 50<sup>th</sup> birthday falls in the current calendar year, I can make these contributions during the year.
- The dollar limit applies to all of our contributions during the year, for all plans in which we participate. So, if we change jobs during the year or have two jobs, then the contributions for all plans combined count towards this dollar limit. In this case, each plan administrator doesn't know about our participation in other plans, so we have to provide them with this information to make sure we don't exceed the limit for our combined savings.
- If we're lucky, our employer will also contribute to the plan. However, that contribution counts towards the 100% of pay limit, but not the dollar limit. Also, matching contributions might be subject to vesting rules. This means that we must work for a minimum number of years before we own the matching contributions and their investment earnings. If we quit before meeting these vesting requirements, we might forfeit part or all of the matching contributions (but not our own contributions, which we always own). Common vesting requirements are 100% after three years of service, or 20% vested after 2 years, increasing 20% per year until 100% vesting at 6 years of service. Fortunately, many companies don't have any vesting requirements, and we immediately own our matching contributions and their investment earnings.

- Only for 401(k) plans, complicated rules apply that make sure that highly paid employees aren't benefiting disproportionately from the plan. This means that additional limits might apply to the annual contributions, but just for highly paid employees. For the purpose of determining who is highly paid, in 2004 this means anybody who earns \$90,000 or more during the year. Most likely this will increase in 2005, probably to \$95,000.
- The penalties for contributing more than the maximum allowed are substantial. The amount of the contribution that exceeds the maximum allowed is taxed twice – once for the year the excess contribution is made, and again when it is withdrawn. If an excess contribution is made by mistake, it can be withdrawn within a specified time to avoid the double taxation. If this situation happens, we should notify our plan administrator as soon as possible. Most of the time, our plan administrator will make sure we don't exceed the limit, but we must help if we participate in more than one plan each year.
- Our contributions are deducted from our paychecks, and aren't subject to income taxes when they are withheld. This reduces our federal and state income taxes that we pay during the year. For this reason, these contributions are also called pre-tax contributions. The contributions are subject to FICA taxes, which are used to pay for Social Security benefits (there's more on these taxes in Chapter 14 of *Live Long & Prosper!*).
- We cannot write a check to contribute to the plan – contributions must come from payroll deductions.
- A few plans also offer after-tax contributions. These work the same way as for described previously, only the contributions are subject to federal and state income taxes when they are made. In this case, the contributions count towards the 100% of pay limit, but not the dollar limit. When we withdraw from these accounts, only the investment earnings are taxed. While these aren't as good as pre-tax contributions, they are still a good deal. I'll use these contributions if they are available to me, but only after I have maxed out on pre-tax contributions. However, as noted later, it might be better to contribute additional money to a Roth IRA, if I am eligible.

By the way, if you work for a nonprofit organization, you might ask – why don't they sponsor both a 401(k) and a 403(b) plan? Actually, some nonprofit organizations do this, but you can't double up on the limits. The above maximum amounts count toward our combined contributions to both types of plans.

While the money remains invested in the plan, the rules are quite simple. The investment earnings aren't subject to federal and state income taxes. We can allocate the accounts among the investment options in the plan, without paying taxes on investment income or capital gains.

These twin tax advantages – contributions aren't taxed when they go in, and investment income isn't taxed along the way – are substantial. We will have more money when we retire, compared to saving outside a tax-advantaged retirement plan. As an actuary, I'm sorely tempted to provide all types of financial projections that would demonstrate this, but I'll spare you. Just take my word for it.

Some plans offer loans, using our accounts as collateral. The most that can be borrowed is one-half of our vested account, or \$50,000, whichever is less. ***I recommend against loans from my 401(k) plan unless I have absolutely no other source of money, and the need is very important, such as buying a house.*** Loans make me nervous – if we terminate employment before paying back all the loan, usually we must pay the balance immediately. If we don't, the plan will 'forgive' the loan by reducing our account balance, but this 'reduction' will be treated like a distribution, and will be subject to penalties that I discuss below.

Most of the time, there are better places to borrow money than our 401(k) plan. For example, 401(k) loans must be repaid within five years; the only exception is for loans used to purchase a primary residence, in which case the term is specified in the plan's rules. Any other loan with a bank or other financial institution will let us take longer than five years to repay. If we own a home, we can take a home equity loan, and the interest will be deductible. If the bill is for college expenses, there are lots of low-interest student loans available. I would check all my sources for loans, and consider a 401(k) loan as a desperate, last resort.

Now let's look at the rules regarding taking money out.

*Here are simple strategies for taking money out of these plans.*

- *If we change jobs before needing the money from our 401(k) plan, either leave our account in that plan, or transfer it directly to a rollover IRA or our next employer's 401(k) plan.*
- *Don't withdraw the money before age 55.*
- *Start drawing the money out no later than age 70-1/2. Using part of our money to buy an immediate annuity, as suggested in Chapter 10 of *Live Long & Prosper!*, goes a long way to stay out of trouble with the applicable rules.*

Now, let's go into detail. First, let's look at some rules that apply any time we take money out.

- The entire withdrawal is subject to federal and state ordinary income taxes, for the year in which we make the withdrawal. The only exception is for after-tax contributions. These aren't subject to income taxes because they were taxed when the contribution was made, but the investment earnings on them are taxed at withdrawal.
- If we were born in 1935 or earlier, we can use special rules that might result in a lower tax. I won't go into these rules here – if they apply to you, see a professional or consult some of the on-line resources mentioned later.
- We don't need to take out all the money at once – we can withdraw it as we need it, subject to minimum distribution rules (explained later).
- Any lump sum withdrawal will have 20% withheld for federal income taxes, unless we roll the money over directly to an IRA or our next employer's 401(k) plan.

- We avoid income taxes if we roll the money into an IRA or transfer the money to our next employer's 401(k) plan. However, special rules apply (discussed later in this chapter).
- We'll also avoid the 20% withholding if we make direct transfers from our 401(k) plan to an IRA or our next employer's 401(k) plan.
- **Special note for 457 plans:** you might have heard that these can't be rolled over to IRAs or to our next employer's plan, like with 401(k) and 403(b) plans. In 2001, Congress changed the rules yet again to allow rollovers from 457 plans to IRAs and other employer-sponsored plans.

Next, a bunch of rules apply if we take out money too soon. In this case, the government assumes we are slothfully squandering our retirement resources for other purposes, so it discourages this behavior by applying penalties.

*Early payment penalties.* If we withdraw money before age 55, we are subject to an early payment penalty of 10%. There are several important exceptions which I'll discuss next. This penalty is in addition to the federal and state income taxes. ***My advice is simple – avoid the early payment penalty!*** Many people terminate employment well before this age and take the money and run. Unfortunately, they don't get far, since Uncle Sam takes such a big chunk. ***Special note for 457 plans only*** – there is no early payment penalty, like there is for 401(k) and 403(b) plans.

*Early payment penalties – the 'leave it in the plan' exception.* We can avoid the 10% penalty by simply leaving our money in the plan until we eventually withdraw it for *rest-of-life* purposes. In most cases, this is what I recommend, for reasons explained in Chapters 10 and 12 of *Live Long & Prosper!* Our employer must allow us to do this if we have at least \$5,000 in the plan. In this case, we can leave it indefinitely, subject to the minimum distribution rules which I'll discuss soon. Note that some employers may charge former employees for the right to leave money in their plan – in this case, we should compare the charges to similar costs if we roll the money into an IRA, which I'll discuss next.

*Early payment penalties – the IRA rollover exception.* We can also avoid the 10% penalty by rolling the money into an IRA. If we do this, we must transfer the money within 60 days of receiving the money from our 401(k) plan. Otherwise, it is subject to income taxes and the 10% penalty.

For the 60-day rule, we start counting days on the day after we receive the check. We get to include the day we deposit the money into our IRA. For example, if we get the check on June 1, we must deposit the money into our IRA on or before July 31 (count 29 days in June, 31 days in July).

It's best if we set up a special 'rollover IRA' for this purpose. This way, we can eventually transfer our rollover IRA to the 401(k) plan of a new employer, if we want to do this. If we commingle our 401(k) distribution with a regular IRA account, we lose this right.

The best way to do an IRA rollover is to have our 401(k) plan transfer the money directly to the IRA. If we do this, we avoid the 20% withholding mentioned earlier. If we don't and we simply get a check from our 401(k) plan, then we might fall into a trap for the unwary. In this case, our employer will apply the 20% withholding and we will receive only 80% of our account. However, this withholding amount is subject to the 10% early payment penalty if it isn't rolled over as well. If we want to avoid this penalty, we'll need to come up with the 20% withholding amount from other resources, and send a check to our IRA rollover.

This is complicated, so let's look at an example.

Suppose I terminate from *My Old Employer, Inc.* and I have \$10,000 in the *My Old Employer 401(k) Plan*. The best strategies are to leave the money in that plan, transfer it to my new employer's 401(k) plan, or direct the plan to transfer this account directly to a rollover IRA. I avoid the 10% penalty, federal and state income taxes, and the 20% withholding.

Now, let's suppose that I didn't read this chapter, and I ask the *My Old Employer 401(k) Plan* to mail me a check. They send me a check for \$8,000, and send \$2,000 to Uncle Sam for withholding. If I just cash this check, then it will be subject to the 10% early payment penalty. However, I don't want this to happen, so I cleverly send the \$8,000 check to a rollover IRA at the *Friendly Mutual Fund Company*, within 60 days of receiving it. I congratulate myself for avoiding the early payment penalty, and break out one glass of red wine to celebrate. (Note that I have dutifully followed the advice from Chapter 7 of *Live Long & Prosper!* on taking care of ourselves. I select a French wine, which has no additives).

*Not so fast!* The \$2,000 amount will be considered an early distribution for the purposes of the 10% penalty. So, after the end of the year when I turn in my income taxes, I'll pay a penalty of 10% of \$2,000, or \$200. Much more than the cost of my celebratory glass of wine! I can avoid this penalty if I send a check for \$2,000 to the *Friendly Mutual Fund Company* before 60 days have elapsed. However, I'll need to raid my piggy bank for the \$2,000, since Uncle Sam has my \$2,000 that came from the 401(k) plan. Note that I will get credit for the \$2,000 withholding when I file my income taxes for the year.

*Early payment penalties – the 401(k) rollover exception.* I can also avoid the early payment penalty if I roll over the account to my new employer's 401(k) plan. All of the rules that apply to an IRA rollover apply here as well. Usually I prefer this to an IRA rollover, because my new employer won't charge me for maintaining this account, and usually they do the shopping for me on fund investments.

*Early payment penalties – the early retirement exception.* The IRS will let us use this money for very early retirement, before age 55. So another way to avoid the 10% penalty is if we buy a lifetime annuity. We can also take something called ‘substantially equal periodic payments’ (SEPPs). In this case, we spread our withdrawals in roughly equal amounts over our expected lifetime. Complicated IRS rules determine how much each year’s withdrawal must be to avoid the 10% penalty. Since I’m not planning to retire before age 55, and most of you won’t either, I won’t describe these rules here. If I wanted to take advantage of these rules, I’d see an accountant.

*Early payment penalties – the death and disability exception.* If I die and my heirs withdraw the 401(k) money, the penalty doesn’t apply. Most of us would consider this a high price to pay for avoiding the penalty. I can also become disabled and avoid the penalty – again, a high price to pay.

*Early payment penalties – even more exceptions.* The 10% penalty doesn’t apply for withdrawals to pay for our first home, but there is a \$10,000 lifetime maximum. It won’t apply to withdrawals to cover medical expenses in excess of 7.5% of our adjusted gross income (AGI), to pay health insurance premiums if we have received unemployment compensation for at least 12 consecutive weeks, or to pay for the costs of qualified postsecondary education (a fancy phrase for college education).

### **Minimum Distribution Rules**

Now let’s look at the rules for taking money out too late. In this case, the IRS also assumes we are using these plans for purposes other than retirement, like leaving an estate to our children, so it wants to discourage this behavior.

- We must begin withdrawing money no later than April 1 of the year following the year in which we turn age 70-1/2. In each year thereafter, we need to withdraw the minimum amount during the year. One important exception to this rule – if we are still working for the employer who sponsors the plan, we don’t need to start withdrawing money until we actually retire.

- The withdrawal amounts are taxed as ordinary income. Note that if we take advantage of the April 1 deferral for our first year, we will be taxed on two withdrawals in the second year – the minimum withdrawal for the previous year plus the minimum withdrawal for the second year. This could put us in a higher tax bracket. So, it may pay to make our first withdrawal during the year we reach age 70-1/2, so that we don't double up in the next year.
- We don't need to take out all the money – just a minimum amount - hence the name 'minimum distribution rules.' We can also withdraw more than the minimum amount.
- Each year, the minimum amount we must withdraw equals our account balance at the end of the previous year, divided by the combined life expectancy for ourselves and a spouse 10 years younger. This is done even if we don't have a spouse! This usually gives us a break, and results in a smaller minimum withdrawal amount. In an effort to confuse us totally, the IRS allows three different methods for calculating this minimum distribution amount, and describes them in 42 pages of fine print. I'm not going to detail these rules here, but I'll provide an example to give us the feel for these rules. If and when these rules apply to me, I'll check with my accountant or another professional to verify that I'm withdrawing enough. I'll also use helpful websites which have minimum distribution calculators, and lots more information on these rules. I found two good examples at [www.newrmd.com](http://www.newrmd.com) and [www.smartmoney.com](http://www.smartmoney.com).
- One note – if my spouse is more than 10 years younger than me, I'm allowed to use a higher joint life expectancy than the standard tables. In this case, it may pay to check out the special rules.
- If we withdraw an amount that is less than this minimum amount, the IRS takes 50% of the difference between the minimum amount and the amount we actually withdraw.
- These rules apply to our remaining account balance each year. So, in one year if we take out more than the minimum distribution amount, we don't get credit for this in future years. The minimum distribution amount is always based on the account at the end of the previous year.

- If we buy an immediate annuity with our account, we automatically comply with the minimum distribution rules for the money we spend on the annuity. Any amounts remaining in our 401(k) plan must still comply with the minimum distribution rules. This is another good reason to buy an annuity. When we get much older, we might not pay attention to the minimum distribution rules, so it is helpful to buy a solution that automatically complies with them.

Only a demented actuary would make these rules so complicated! We'll look at an example, but first, let's understand 'half-birthdays.' If our birthday is on or before June 30, we will reach age 70-1/2 in the same year as our 70<sup>th</sup> birthday. Otherwise, we'll turn age 70-1/2 in the following year. Now for the example.

Suppose my birthday is June 30, 1945. I turn age 70 on June 30, 2015, so I turn age 70-1/2 on December 30, 2015. I must withdraw the minimum amount from my 401(k) plan by April 1, 2016.

Further suppose my account balance is \$500,000 at the end of 2015. My joint life expectancy for a 70 year-old with a 60 year-old spouse is 27.4 years, according to the standard IRS tables. Note it doesn't matter what my spouse's age is, or even if I have a spouse. So I divide \$500,000 by 27.4 years, to determine my minimum distribution of \$18,248.18.

Suppose I'm not paying attention, and withdraw \$13,248.18 instead. I should have withdrawn at least \$18,248.18 - \$5,000 more than what I actually withdrew. Now the IRS takes half of this amount, or \$2,500. There go the next few vacations I was planning!

But I'm not done in 2016, since I must also withdraw the minimum amount for 2016 by the end of 2016. Then the minimum distribution amount is based on the joint life expectancy for a 71-year-old with a 61-year-old spouse, or 26.5 years. It is also based on my account at the beginning of the year, minus the minimum distribution I took on April 1. So in this case, it's based on \$500,000 minus \$18,248.18, or \$481,751.82. Dividing this amount by 26.5 yields my minimum distribution amount of \$18,179.31.

If I take advantage of the April 1<sup>st</sup> deferral rule for my first year, then in 2016 I'll have \$36,427.49 of taxable income (\$18,248.18 plus \$18,179.31). If this puts me in a higher tax bracket, I might want to make my first minimum withdrawal in 2015. In this case, it will be based on my account value at the beginning of 2015.

Here is more on the minimum distribution rules.

- If we are still working, the minimum distribution rules do not apply to the 401(k) plan at my current employer. For example, suppose I'm over age 70-1/2 and now work for *My Current Employer, Inc*, I don't need to withdraw from *My Current Employer's 401(k) plan* until I actually terminate employment from *My Current Employer*. However, if I have money invested in *My Old Job's 401(k) plan* where I worked previously, I still need to comply with

the minimum distribution rules for that money. Here's one reason to roll prior 401(k) balances into *My Current Employer's plan*. If I plan to work beyond age 70-1/2, and I don't need the money from my 401(k) plan, I can avoid the minimum distribution rules through successive rollovers into my new employers' plans.

- If we have accounts with more than one 401(k) plan, we must comply with the minimum distribution rules with respect to each plan.

Obviously, I recommend complying with the minimum distribution rules, because the penalty is so high. By the way, the minimum distribution rules are an example of the government having the old model of retirement in its collective consciousness. It doesn't consider that people might live and work well beyond age 70-1/2.

That's about all that most of us need to know about 401(k), 403(b), and 457 plans. There are plenty of additional details and exceptions to the rules that might apply in special cases. I plan to check with my accountant as I'm approaching the age when I will use these accounts, just to make sure I'm doing the right thing. I'll also consult online resources by going to my favorite Internet search engine and typing the words '401(k) distributions.' I found a good source at [www.smartmoney.com](http://www.smartmoney.com).

If this weren't enough, there's more on the horizon. Starting in 2006, employers will be able to change their 401(k) plans to provide contributions that are like Roth IRAs. I will prefer these accounts over regular 401(k) accounts, so if my employer offers them, I'll use them. I discuss Roth IRAs in the pages that follow, including the reasons why I prefer them.

Next, let's look at a special, common wrinkle with employer-sponsored plans – investments in company stock.

### **We're owners!**

Many 401(k) plans of large companies provide part or all of their matching contributions in company stock. Another variation, less common, is an Employee Stock Ownership Plan (ESOP). With an ESOP, our employer contributes company stock to our account, regardless of whether we contribute to our 401(k) plan.

The government provides incentives to our employers for these plans and their special features, because the government thinks it's a good thing that employees own company stock. Generally I agree with the government, but with prudent limits with respect to diversification. I want no more than 10% of my *rest-of-life* portfolio in company stock. Otherwise, I have too many eggs in one basket. If the company doesn't do well, not only does my 401(k) balance decline, but I stand a chance of getting laid off or receiving lower pay through reduced hours or smaller bonuses.

In a few paragraphs, I'll discuss a potential tax advantage that might influence me to leave more of my holdings in company stock. If I work for a very stable company, I might be willing to increase my holdings from 10% to 20%, but if I do I'll be nervous and watch the stock very carefully. We do have one advantage over other investors - most of us are very familiar with our company and its prospects for the future. However, when balancing my priorities, I'll favor protection through diversification over tax advantages. I won't let tax goodies influence me to make a mistake.

Some plans let us diversify the company stock. They may make the match in stock, but I'm immediately eligible to move it to other investments. In this case, I'll take advantage of this flexibility, and stay under the 10% rule-of-thumb mentioned above.

Other plans force us to leave the matching contribution in company stock. This won't make me cranky and stop me from saving in my 401(k) plan. After all, the company match is still free money, and I will be contributing to my 401(k) plan anyway. In this case, there's nothing much I can do, except wait until federal law requires my company to let me begin diversifying my account. This starts at age 55 with 10 years of service. Some companies allow diversification earlier – it pays to check our plans' rules.

Now let's look at the rules that apply when I terminate employment, and am eligible to take a payment. If the company stock has appreciated significantly since it was contributed, I may be able to take advantage of a special tax break. It goes like this.

- The amount of the original contribution is subject to ordinary income tax rates.
- The appreciation on the stock from the time of contribution to the time of payment is subject to capital gains rates, provided I've held the stock for at least one year. However, to take advantage of this, I must take the distribution in cash or shares – I can't roll it to an IRA. If I roll over the stock payment to an IRA, I lose the tax advantage and, when I eventually make a withdrawal, I will pay ordinary income taxes on the entire payment.
- Additional appreciation after the time of payment is also taxed at capital gains rates, provided I hold it for at least 12 months following the date of payment.
- Ordinary income tax rates can be as high as 35%, while capital gains taxes can be as high as 15% - hence the advantage of this special tax break. Add state income taxes to these rates.
- A distribution in company stock is subject to the 20% withholding rules, so if we don't roll it to an IRA, we must come up with this 20% from any other distributions received from the plan.

So, it might pay to take the stock distribution directly, rather than roll it over into an IRA. However, this strategy works best if I am age 55 or older – otherwise, I'll be dinged by the early payment penalty. Another strategy is to simply leave the stock in the plan after I terminate employment, if my plan will let me do this.

This can be complicated, so let's look at an example.

Joe receives a lump-sum distribution of \$300,000 from his 401(k) plan, including \$200,000 in cash and employer stock worth \$100,000. This amounts to 5,000 shares at \$20 per share. The original cost of these shares was \$5 per share. He directly transfers this entire distribution to an IRA. At least 12 months later, Joe sells the shares for \$150,000 (the price has now risen to \$30 per share) and takes a distribution in cash for to buy a Winnebago. He leaves the other part of his original distribution in the IRA. Joe deferred all gain at the time of distribution and rollover. However, when Joe sells the stock and withdraws the cash from the IRA, Joe pays taxes at ordinary income rates, which may be as high as 35%. At this highest rate, Joe pays \$52,500 in taxes. He might need to downsize his expectations to a used Winnebago.

Jane receives the same lump-sum distribution of \$300,000, including \$200,000 in cash and employer stock worth \$100,000 (5,000 shares with a cost basis of \$5 per share, and current fair market value \$20 per share). Jane holds this stock in a regular account at her favorite no-load mutual fund company that allows individual investments. Such an account has no special tax advantages. Of the remaining \$200,000, she keeps \$25,000 to pay the mandatory 20% withholding on the company stock, and she rolls \$175,000 into an IRA. You might think that 20% of \$100,000 is \$20,000, so why is she keeping \$25,000? She will need to pay withholding on the amount she withdraws for the withholding. So she will need to withhold 20% of \$100,000 plus 20% of \$25,000, for a total withholding of \$25,000.

Jane pays ordinary income taxes on \$5 per share (the original contribution amount) when the stock is distributed from the 401(k) plan. Assuming her tax rate is 35%, this amounts to \$8,750.

At least 12 months later, Jane sells the shares (fair market value of \$30 per share) in order to get cash to pay off her mortgage on her house. When Jane sells the stock, she owes taxes on the gain from \$5 to \$30 per share (\$25 per share). The gain from \$5 to \$20 is taxed as a long-term capital gain, and the gain from \$20 to \$30 also is taxed as a long-term capital gain (because Jane also held the stock at least 12 months after the qualified plan distribution). The maximum rate for long-term capital gains is 15%. So, Jane pays capital gains taxes of \$18,750. So, her total taxes, including the \$8,750 amount she paid when she received the distribution, amount to \$27,500. She just proved she is \$25,000 smarter than Joe!

In this example, both Joe and Jane were age 55 or older, so they avoided the 10% early payment penalty. If Jane were under 55 and did not roll over the \$100,000 payment from the 401(k) plan, she would have owed \$10,000 in early payment penalties. This complicates the situation, although in this example she is still better off by paying the penalty to get the lower capital gains tax rates. She could avoid this problem if she simply leaves her shares in the plan until she attains age 55.

Note also that state income taxes on the capital gains would be added to the amounts shown here.

In spite of this example, we still might be confused. *My simple recommendation – if we have a lot of company stock in our 401(k) plan and we are terminating employment, we should check with an accountant to determine the best strategy. It will be money well-spent.*

Now let's turn to...

### **Traditional and Roth IRAs**

These are retirement investing accounts for anybody who works. They are particularly suited for people who work for an employer that does not sponsor a retirement investing program. However, all of us might be eligible, provided we meet the eligibility requirements. There are better programs for self-employed individuals, which I'll cover soon.

There are three types of IRAs:

- Traditional deductible IRAs.
- Traditional nondeductible IRAs.
- Roth IRAs.

Each works differently, with different rules regarding eligibility and withdrawals. We need to do a little work to decide which one best suits our circumstances.

Here's what they all have in common.

- For 2005 through 2007, each of us can contribute up to \$4,000 from our pay; a married couple can contribute \$8,000. Beginning in 2008, the limits increase to \$5,000 for individuals, and \$10,000 for married couples. Thereafter, the limits will be adjusted for inflation.
- We can add \$500 to these limits if we have attained age 50 by the end of the year (add \$1,000 for a married couple where each has attained age 50). For 2006 and thereafter, the additional contribution increases to \$1,000 for singles, and \$2,000 for married couples. The contribution must come from wages – we can't contribute more than we earn each year.
- These limits are the most we can contribute to all types of IRAs combined. So we can't contribute \$4,000 to each of the three types of IRAs. We can split this amount – say \$2,000 to a traditional deductible IRA and \$2,000 to a Roth IRA, if we meet the eligibility criteria for each.

As I promised at the beginning of this chapter, I highlight recommendations and conclusions. This promise was hardest to keep with IRAs. Here's the simple recommendation. When it comes to IRAs, there are no simple recommendations! However, I am able to provide some guidelines. Even these have exceptions, so if you're really interested and want to know the reasons, read the rest of the details on IRAs.

## IRA Strategy Guidelines

- *I'll contribute the maximum to a Roth IRA if I am eligible. But first, I'll max out on 401(k) contributions that are matched by my employer, if available. Beyond this amount, if I have to choose between a Roth IRA and nonmatching contributions to a 401(k) plan, I won't go wrong with either choice, although I prefer a Roth IRA. Of course, if I can afford to contribute to both, I will. This is the only exception to my rule to max out on 401(k) contributions. Note that my choice can affect the amount of income taxes that I pay – I'll discuss this in the next few pages.*
- *The only circumstance that makes sense for contributing to a traditional nondeductible IRA is if I'm not eligible for a traditional deductible IRA or Roth IRA, and I'm maxed out on any contributions to a 401(k) plan and still want to contribute more. Even in this case, it might make sense to invest outside a retirement investing program, due to the withdrawal restrictions on these accounts. If I am eligible for either a traditional deductible IRA or a Roth IRA, it makes no sense to use a nondeductible IRA.*
- *I might contribute to a traditional deductible IRA instead of a Roth IRA, if I believe that my income tax rate will be much lower when I withdraw the money, compared to when I contribute the money. This will happen only if I am not participating in a retirement plan at work. If I am participating in such a plan, I am only eligible for a traditional deductible IRA if I am currently in a low tax bracket, due to the income limits.*

Now let's go into details about each type of IRA.

*Here's how a traditional deductible IRA works.*

- Contributions are deductible from our wages for the purpose of calculating federal and state income taxes.

- We are eligible for a traditional deductible IRA if we are single and not covered by any type of retirement plan at work, including 401(k) plans, or if we are married and both individuals aren't covered by a retirement plan at work. Even if we are covered by a retirement plan at work, we still may be eligible for this IRA, depending on our modified adjusted gross income (MAGI, which I'll define soon). If our MAGI is under \$40,000 for singles and under \$65,000 for married couples, we can deduct all of our IRA contribution. The deduction phases out, and is completely gone if our MAGI exceeds \$50,000 for singles and \$75,000 for married couples. If only one spouse participates in an employer-sponsored plan, then the eligibility phases out between MAGI of \$150,000 and \$160,000 for the spouse not covered by the plan, and between \$65,000 and \$75,000 for the spouse covered by the plan. When I say phased out, I mean that we can make a partial contribution, which generally is a pro-rata portion of the IRA limit. Have you cried uncle yet?
- The investment earnings aren't subject to income taxes while the money remains invested in the IRA.
- When we withdraw the money for spending, all of the withdrawal – our principal plus investment earnings - is subject to federal and state income taxes.
- If we withdraw money before age 59-1/2, we are subject to the same 10% early payment penalty that applies to 401(k) plans, as described previously. Note, however, that the penalty applies at age 59-1/2 for IRAs, but age 55 for 401(k) plans. Go figure! I guess the government thinks that retirement at age 55 is o.k. from a 401(k) plan, but not o.k. from an IRA.
- There are also exceptions for the early payment penalty for first time home purchases up to \$10,000, death and disability, as described previously for 401(k) plans.
- An IRA is subject to the minimum distribution rules once we reach age 70-1/2. They are the same as described previously for 401(k) plans. If we have multiple IRA accounts, we can aggregate them for the purpose of satisfying these rules. For example, suppose we have IRA accounts with two separate mutual fund companies. We can take all of the minimum

distribution from one IRA account plan, but to calculate the minimum distribution amount, we combine the balances from both accounts.

*Here's how a nondeductible IRA works.*

- Anybody who has earned income is eligible.
- Contributions are not deductible from our wages for the purpose of calculating federal and state income taxes. That is, we are making contributions with income that will be taxed now.
- The original amount of our contribution isn't taxed when we withdraw it, since it was taxed when we contributed it.
- All the other rules for deductible IRAs apply.

*Here's how a Roth IRA works.*

- Contributions are not deductible from our wages for the purpose of calculating federal and state income taxes at the time they are made. They will not be taxed when withdrawn.
- Investment earnings are not taxed – ever, if we follow the rules.
- Eligibility is not tied to participation in a retirement plan at work, and only depends on our modified adjusted gross income (MAGI, which I'll define soon). If our MAGI is under \$95,000 for singles and \$160,000 for married couples, we are fully eligible, meaning we can make a full contribution. Singles with MAGI over \$110,000 and married couples with MAGI of over \$160,000 are not eligible. For amounts between these limits, we are entitled to a pro-rata contribution.
- Withdrawals are tax-free and penalty-free at the later of five years of participation, or reaching age 59-1/2. There is a 10% penalty for withdrawals before this date, but only on investment earnings. The penalty does not apply to the original contribution amount.

There are exceptions to the penalty on investment earnings for withdrawals on account of death, disability, and first time home purchase up to \$10,000.

- There are no minimum distribution rules that apply at age 70-1/2.

To figure your modified adjusted gross income (MAGI), start your adjusted gross income (AGI), which is found on the bottom of the first page of your federal tax return. Generally this is gross income, reduced by ‘above the line deductions.’ These are deductible IRA contributions, alimony payments, and a variety of other special contributions and deductions (but not the standard deduction or itemized deductions). For most people, the MAGI is simply the AGI, with deductible IRA contributions added back in. There are other adjustments for people with student loans, deductions for higher education, and a few other special situations – I won’t go into these complications here. If I am close to the limits, I’ll ask my accountant or read the IRS forms carefully.

If our income for the year is close to the MAGI limits, we’ll need to pay close attention. This is one reason to wait until year-end to make our contributions – when we know for sure whether we are eligible. A lot of investment institutions will urge us to make our contributions much earlier – as soon as possible. While normally this is wise advice, we should wait if our income will be close to these limits.

There are a few good reasons why I like Roth IRAs better than traditional IRAs.

- With a Roth IRA, there is no minimum distribution rule at age 70-1/2, like there is for a traditional IRA. Since I plan to live well beyond this age, I want the flexibility to leave this money invested for when I eventually need it.
- With a traditional IRA, we only get income tax *deferral*. The Roth IRA gets us tax *avoidance* (on the investment earnings). Let me explain. When it comes to our contributions, we can deduct now our contribution to a deductible IRA, but we get taxed on it when we withdraw it. With the Roth IRA, it’s the other way around. We get taxed on the contribution when we make it now, but not when we withdraw it later. Either way we still pay taxes on the contribution – either now or later. However, the goodies with Roth IRAs come with the

investment earnings. With a Roth IRA, the investment earnings are *never* taxed, compared to an IRA, which only *defers* taxes until we withdraw them. This is tax avoidance.

Normally, this advantage gives us more money when we need it, compared to a traditional IRA.

- I have more flexibility with a Roth IRA for early distributions, before age 59-1/2. I can withdraw the original contribution amount without a 10% penalty, while this penalty applies for traditional IRAs.

The only exception to my preference for Roth IRAs might be if I expect to be in a much lower tax bracket when I withdraw the money, compared to when I contribute the money. Then a traditional deductible IRA might be better than a Roth IRA.

Let's revisit the first point in my IRA strategy guide from a few pages ago, where I stated that my preference would be for a Roth IRA over nonmatching 401(k) contributions. If I can afford to do both, that's great. However, if I'm limited in my funds and can do only one or the other, my choice will influence the income taxes I pay this year. Suppose I have \$5,000 I can afford to save. If I put this in a 401(k) plan, then I pay no taxes on this contribution. If I put this in a Roth IRA, I will pay income taxes on the \$5,000 amount; if my tax rate is 35%, this amounts to \$1,750. If I don't have this amount lying around in other sources, I'll need to contribute \$3,250 to the Roth IRA and keep \$1,750 to pay the income taxes. However, when I later make a withdrawal, the original contribution to the Roth IRA is not subject to income taxes. On the other hand, if I used nonmatching 401(k) contributions, it is subject to income taxes at the time of withdrawal.

If all this weren't enough to think about, there's one more thing. We can convert a traditional IRA to a Roth IRA, provided our MAGI is under \$100,000 for the year (this limit applies whether we are single or married). If we do this, we must pay taxes on the conversion amount at the time of conversion. We need to cough up these taxes from other sources, since any distribution from the IRA will be subject to the 10% penalty. From then on, we are subject to the other Roth rules. Conversions to Roth IRAs are generally a good thing, provided we won't need the money for at least 5 years from the conversion date (remember that a 10% penalty applies to withdrawals from Roths before 5 years have elapsed). Why are Roth conversions a

good idea? For the same reasons I prefer Roth IRAs – investment income is never taxed, and we don't have the minimum distribution rules at age 70-1/2.

One final word – we can get any type of IRA at any of the institutions I discussed in Chapter 12 of *Live Long & Prosper!* – including the no-load mutual fund companies. Just give them a call or visit their websites – they are very helpful, and they make it real easy to sign up and give them our money.

### **Retirement Investing Programs for the Self-Employed**

If we're self-employed, SEP IRAs or SIMPLE IRAs are better than traditional IRAs or Roth IRAs, because we can contribute a lot more. SEP stands for Simplified Employee Pension Plan, and SIMPLE stands for Savings Incentive Match Plan for Employees.

First, let's look at SEP IRAs.

- The self-employed, any employed person with freelance income, and business owners are eligible.
- For self-employed individuals, the maximum contribution is 20% of self-employment income, but no more than \$41,000 in 2004.
- For employees of self-employed individuals, the maximum contribution is 15% of salary, but no more than \$41,000 in 2004.
- They operate like 401(k) plans in many respects, as described previously.
  - Contributions aren't included as taxable income for the year they are made.
  - Investment earnings aren't taxed until they are withdrawn.
  - Contributions and interest are subject to income taxes when they are withdrawn.
  - Early payment penalties and minimum distribution rules apply.
- They are different from 401(k) plans in one important respect. Contributions are not deducted from the regular paycheck. Instead, they are considered an 'employer contribution,' and can be deposited in a lump sum any time up to the deadline for filing tax

returns for the year. Note that if we have employees, contributions might need to be made for them as well, in the same manner.

Now let's look at a SIMPLE IRA.

- Employers with 100 employees or less, and who do not sponsor any other type of retirement plan, are eligible to set up a SIMPLE IRA. Also, any self-employed individual who does not set up another retirement plan can set up a SIMPLE IRA.
- Employees can contribute through payroll deduction, up to \$10,000 per year in 2005. Add \$2,000 if the employee reaches age 50 by the end of the year.
- The employer must match employees' contributions dollar for dollar, to a maximum of 3% of pay. Alternatively, the employer can simply contribute 2% of pay, regardless of employees' contributions, subject to a maximum contribution of \$3,200.
- All employer contributions must be vested 100% immediately.
- In many other respects, SIMPLE IRAs operate like 401(k) plans as described previously.
  - Contributions are deductible from income for the purposes of calculating federal and state income taxes.
  - Investment earnings aren't taxed until they are withdrawn.
  - Contributions and interest are subject to income taxes when they are withdrawn.
  - Minimum distribution rules apply.
- However, the early payment penalties are different from 401(k) plans and regular IRAs. Withdrawals are subject to a 25% penalty if made within two years and before age 59-1/2, and a 10% penalty after two years and before age 59-1/2.

Both SEP IRAs and SIMPLE IRAs have a good feature in common – they are simple to administer, without a lot of complicated IRS filings. If we want to stash away more money than the limits for SEP IRAs, we can use a defined benefit Keogh plan. However, these are

complicated and more expensive to administer – we want to use them only if we want to save a lot of money. In this case, we should see an accountant or retirement plan professional.

Here's one more feature to watch for. If we are self-employed but have employees, generally we need to cover them in the plan as well. In this case, we should see an accountant or retirement plan professional, to make sure we are complying with the appropriate rules.

If we're really hungry to save, we can set up a SEP IRA and one of the three types of IRAs mentioned in the previous section – Roth, traditional deductible or traditional nondeductible. However, we need to meet the IRA eligibility requirements described previously.

One final word – we can get a SEP IRA or SIMPLE IRA at any of the institutions I discussed in Chapter 12 of *Live Long & Prosper!* – including the no-load mutual fund companies. Just give them a call or visit their websites – they are very helpful, and they make it easy for us to sign up and give them our money. They also help with the annual reporting requirements for the IRS.

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These types of plans can really help in building a *rest-of-life portfolio*. However, we shouldn't get too wrapped up in the rules, and let them prevent us from saving or otherwise doing what we really want to do with our life. If we don't like the rules, we can always save the old-fashioned way, in a taxable account with a mutual fund company or any other institution. As I mentioned in Chapters 11 and 12 of *Live Long & Prosper!*, we can get investments with advantages that minimize our taxes, such as municipal bonds, tax-managed mutual funds and tax-deferred annuities. So we do have alternatives to the tax-advantaged programs described here.

In addition, if we have maxed out on our retirement program contributions and want to save more, we shouldn't let the limits prevent us from making these additional savings. In my case, I have maxed out on my company's 401(k) plan. I save outside this plan, and I appreciate the flexibility of having some money without any strings attached, like the early payment penalties and minimum distribution rules. With this money, I use investments with tax advantages mentioned in the previous paragraph.

Whew! I hope this wasn't too boring!