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### ARE YOU CONFUSED ABOUT IRA CHOICES?

By Victor Sy, CPA, MBA

Once upon a time, there was one IRA deduction - a simple choice. Then came 401(k)s. Then deductibility limits. Then SIMPLE IRAs (it was anything but simple). Non-deductible IRAs followed. Then came more phase-outs, ROTH IRA, and education IRAs. With each new choice came additional complexities. Today, we are bombarded by so many choices that this has increasingly become confusing to go through what was once a simple choice. Hopefully, this short article will help you go through the IRA maze.

The ability to set up and make current contributions to each type of IRA depends on the level of your adjusted gross income (AGI). The higher your AGI is, the fewer choices you have. In addition to the AGI limitation under old law, the most that you can contribute for a particular year to all your IRAs combined is the lesser of **\$5,000** or your earned income for the year.

#### Let's visit each type of IRA:

- 1. Traditional IRA:** Nearly everyone under 70 ½ years of age who receives compensation can contribute **\$5,000 for 2011 and after** to a traditional IRA. Compensation includes wages, fees, commissions, tips, bonuses, and even alimony. If you are 50 years or older, you may add **\$1,000 for 2011 and after**. Active participants who used to be excluded can now contribute to their own IRAs. There are phase out rules that limit your deduction when your adjusted gross income reaches certain levels.
- 2. Non-deductible IRA:** Taxpayers who are covered by a retirement plan and whose income exceeds the AGI limitations do not qualify for a ROTH IRA. Thus, the only choice is a non-deductible IRA contribution.
- 3. ROTH IRA:** Contributions to ROTH IRA are not deductible for tax purposes. Although there is no deduction, the ROTH IRA offers significant advantages over regular IRAs. Once funds have been in a ROTH IRA for at least five years, the contributions plus any earnings can be withdrawn without any tax or penalty if the money up to \$10,000 is used to help purchase a home for yourself or a family member or is withdrawn after you reach age 59 1/2 or become disabled. Qualified distributions are free of income tax and the 10 % penalty. These distributions can only be made either after five years, after age 59 1/2, after the death of the IRA owner, after the disability of the IRA owner or for first-time homebuyers. Remember that the five-year period begins in the year of ROTH IRA contribution and should not be restarted for subsequent contributions or conversions. There is no requirement for minimum distributions at age 70 1/2. If you do not need the money, you can leave it inside the ROTH IRA and have it continue compounding tax-free for years to come. ROTH IRAs also allow you to withdraw your original contributions without any tax or penalty. For example, if you contribute \$20,000 to a ROTH IRA for 10 years and the account grows to \$30,000, you can withdraw the \$20,000 principal anytime for any purpose without any tax or penalty.

New law allows employers to create Designated Roth Accounts - qualified Roth 401(k) programs - that allow participants to designate a portion of their contributions as Roth contributions. Employee's contributions are after-tax (not deductible but grows tax free) while employer's matching contributions

are pre-tax (deductible as traditional). These accounts do not have the problematic phase-outs of traditional and Roth IRAs. We'll discuss this subject more in future issues.

4. **Coverdell Education IRAs:** You may contribute \$2,000 for any beneficiary who is younger than 18 years old. There is no requirement for you to have any earned income. You can make contributions to an education IRA and still make a full \$2,000 contribution to a traditional or ROTH IRA. Withdrawals from education IRAs are tax-free for qualified higher educational expenses. This is ideal for taxpayers with children or grandchildren who will likely not qualify for financial aid, the new HOPE or lifetime learning credits. On the other hand, students who expect to qualify for financial aid or the new education credits should not set up education IRAs because of their effect on the financial aid formula and on eligibility for education credits.

Let me help you make a choice:

1. My first choice is to fully fund your **401k** and get your full employer match, if any.
2. If you are relatively young and have not reached your earning potential, it is hard to beat the **Roth IRA** for the second spot as a wealth accumulation vehicle because of tax-free distributions, lack of mandatory distributions at age 70 1/2, and the option of withdrawing your principal contributions tax-free and penalty-free at anytime.
3. If you are approaching middle age or beyond, the next choice is a **deductible IRA** to maximize the funds available for retirement. If your current tax bracket is substantially higher than what you expect it to be when you retire, a deductible IRA is better choice because of the up-front deductibility that you now need since you are in a higher tax bracket. Another situation when you may want to make a deductible IRA contribution over a ROTH IRA is when there is a reasonable chance that you might need the contributed funds plus earnings within the next five years. (If you withdraw funds from a ROTH IRA in the first five years, the tax-free benefit of the ROTH is defeated).
4. If you are covered by a retirement plan and your income exceeds AGI limitations and, therefore, do not qualify for either deductible or the ROTH IRA, then your next bet is a **non-deductible IRA**.
5. The education IRA is not really an IRA at all but has the same benefits and is subject to the same rules as traditional IRAs. This is more of a college-savings vehicle that you can fund in addition to an IRA. It is now called **Coverdell Educational Savings Account (ESA)** that allows you to contribute up to \$2,000 per beneficiary.

Assess your tax deduction needs and make a choice. I hope that this article can lead you to the right IRA. Good day.