October 2006 – IRAs

Since Individual Retirement Accounts (IRAs) are frequently the subject of your questions, we felt that an overview of the two most important varieties, the Traditional and the Roth, would be a timely topic for our letter. As the following will be a simplified discussion of a very complicated area, governed by IRS regulations, we urge you to consult with your tax professional prior to taking any action.

An IRA is a personal retirement account available to anyone or the spouse of anyone who earns taxable income in a given year. A Traditional IRA allows contributions (which may or may not be tax deductible as discussed below) to an investment account in which taxes are deferred on the earnings and appreciation until distributions are eventually made. At that time all withdrawals are treated as ordinary income and taxed accordingly. As mandated by statute, IRAs may be established at a variety of types of financial institutions and invested in a number of allowable securities. Contributions are limited in 2006 to the lesser of taxable earned income and $4000 ($5000 if you are over 50); however, the limits escalate in future years. Contributions are deductible if they qualify under either of two tests. First, you may deduct the contribution if you are not covered by a retirement plan at work and if your taxable income falls below certain limits dependent on your filing status. Second, you may deduct them if your taxable income falls below certain lower limits even if you are covered by a retirement plan. After reaching age 70½ you can no longer make contributions regardless of employment status.

Distributions prior to age 59½ are subject to an additional 10% tax penalty unless utilized for certain acceptable purposes such as medical expenses, educational expenses and first-time home purchases. Minimum distributions based on life expectancy tables are required at 70½. Failure to meet the mandatory distribution requirements results in a penalty equal to 50% of the shortfall.

The question is often asked whether nondeductible contributions make sense for persons who do not qualify for deductible contributions. The answer unfortunately depends on a number of factors. With the current maximum tax rates on dividends and capital gains at 15%, the benefit of the deferral of taxes on a stock portfolio could be offset by the cost of paying ordinary tax rates on the eventual distributions. If you plan on investing in interest- generating securities not subject to the reduced 15% rate or if you believe that the 15% rate is only temporary, you might well choose to make nondeductible contributions. Further, if you anticipate converting to a Roth, as described below, you would probably consider the nondeductible option.

Roth IRAs are a wonderful choice for many who qualify because although contributions are not deductible, distributions are tax-free no matter how large and are not required during your life time. The contribution limits and the earned income requirements are identical to those for Traditional IRAs; however, if your taxable income exceeds certain levels based on filing status, you are barred from making a Roth contribution for the current year. Unlike Traditional IRAs, if otherwise eligible, you can make contributions after reaching 70½. As with Traditional IRAs, distributions prior to 59½ are subject to penalties with similar exceptions. Unlike Traditional IRAs, however, the lack of required distributions allows you to preserve the entire IRA for the benefit of your heirs on a tax-free basis. For example, you could leave your Roth to your grandchild who upon your death would withdraw it free of taxes over his or her life expectancy.

If your adjusted taxable income does not exceed still another limit, which in this case is not based on your filing status, you can convert your Traditional IRA to a Roth by paying the taxes currently as if the account were being distributed. As the result, however, of a change in the law this year, beginning in 2010 the income limit for conversion disappears, and the conversion tax liability can be spread over the two years following conversion. Factors that determine whether a conversion is justified are tax rates now versus tax rates later, the anticipated holding period for funds in the Roth, whether the tax liability would be paid with funds external or internal to the IRA and estate planning goals. In light of the potential financial benefits of conversion to a Roth, we strongly recommend that every owner of a Traditional IRA give such conversion serious consideration. Again, we urge you to consult with tax professionals prior to making a final decision.