

RETIREMENT ACCOUNTS

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The various retirement investment accounts discussed in this document all offer the potential for healthy long-term returns with substantial tax advantages that will typically have the effect of substantially reducing your taxes over the lifetime of your investments.

Which type of account is suitable for you or will be offered to you really depends upon which type of account for which you are eligible.

Review the chart below. This chart identifies how these retirement investment accounts differ from each other.

Alternative Retirement Financial Plans and Their Features						
	Traditional IRA	Spousal IRA	Roth IRA	401-K or 403-b	SIMPLE IRA*	Solo 401-K
Contributions are deductible from taxable income in the year of the contribution.	Yes	Yes	No	Yes	Yes	Yes!!
Income earned by the investment is tax-free or tax-deferred before withdrawals.	Yes	Yes	Yes	Yes	Yes	Yes
Upon retirement, withdrawals are taxed as ordinary income.	Yes	Yes	No	Yes	Yes	Yes!!
Employer normally makes a partial or entire contribution.	No	No	No	Yes	Yes	N/A
Contributions can be made even if employee or spouse has a retirement program at work.	No	Yes‡	Yes	N/A	N/A	N/A
Mandatory withdrawals (taxed) must be made after age 70 1/2. !*	Yes if no longer employed.	Yes if no longer employed.	No	Yes if no longer employed.	Yes if no longer employed.	Yes
Can loans be taken against the account balance (with limitations and restrictions - see text)?	No	No	No	Yes	No	Yes
Can accept rollover accounts with no tax penalty from legacy 401-K accounts.	Yes	No	No	N/A	No	Yes
Maximum annual contribution under age 50 in 2018.	\$6,000	\$6,000	\$6000†	\$19,000	\$13,000	\$56,000
Maximum annual contribution age 50 and above in 2018.	\$7,000	\$7,000	\$7,000	\$25,000	\$16,000	\$62,000
*A Simple IRA is designed for small businesses with 401-K plans to contribute to their employees' own IRA account. These accounts are administered by the employee and not the employer. They are designed primarily for businesses with less than 100 employees (but are not absolutely restricted to that). The SIMPLE vehicle can also be a SIMPLE 401-K, with the same contribution limits.						
‡The spouse of an employee with a retirement plan can make the maximum contribution if he or she is not employed. There are some limits if the spouse has a very high income.						
†Above a certain taxable income there is a phase-out limit where this maximum annual contribution is reduced, ultimately to zero. See the text for discussion.						
!! No instead of Yes if the Individual 401-K is set up like a Roth IRA, which is allowable. See text for discussion.						
!*! No mandatory withdrawal from a fund to which you are still contributing after 70 1/2.						

Most of you who will work for corporations and many non-profits will be offered a **401-K** retirement plan and that will constitute the bulk if not the entirety of your retirement funding outside of whatever equity you have in your home. The **Traditional IRA (Individual Retirement Account)** is available to you as a retirement investment account if you do not contribute to a 401-K because you are self-employed or because your employer offers no retirement plan. The **Individual (Solo) 401-K** is another option for the self-employed. The **SIMPLE IRA** is a retirement investment account that is sometimes offered to the employees of small businesses (less than 100 employees) instead of a 401-K plan. The **Spousal IRA** is a traditional IRA that is available to an unemployed spouse even if the primary breadwinner in the household has an adequate retirement account. Finally, the popular **Roth IRA** is a supplemental retirement investment account available to anyone who does not exceed upper income limits, including someone who already is contributing to a 401-K.

Here is more information about these retirement investment accounts:

Employer (traditional) 401-K retirement investment plans

Most larger employers who offer a retirement plan offer it in the form of a 401-K plan. Usually the plan is designed as a dedicated mutual fund family offering the investor some limited choices in portfolio options. For example, the employee might be allowed to choose between a mix of yield-bearing funds, index funds, money market funds and perhaps a selection of growth and income funds. Normally the choices offered are much narrower than those available through a direct investment in a large mutual fund family and are extremely restricted when compared to other retirement products discussed below, such as most IRAs.

In the past, 401-Ks were not allowed to invest in Exchange Traded Funds, but now many do. Many of the ETFs offered to the market track index funds and behave just like index mutual funds. For example the most popular ETF traded in 2019, the SPDR S&P500 ETF (**SPY**) tracks the S&P 500 index just as well as any mutual fund. Many 401-K portfolio offer either **SPY** or it's dividends-only SPDR S&P500 Dividend ETF (**SDY**).

Typically the employee will contribute some of the contribution from his or her income and the employer will make a matching contribution or even a larger contribution, such as 75% of the full contribution. The relative contribution made by each is determined by the employment contract.

The contribution made by the employer is not taxed as income in the year of the contribution. Additionally, any amount contributed by the employee *reduces the employee's taxable income in the year of the contribution by the amount of the contribution*. In other words, if the employee contributes \$4,000 to his or her 401-K from paychecks throughout the year, his or her taxable income for that year is reduced by the \$4,000 which will result in a direct tax savings for that year.

On the other hand, withdrawals from the 401-K retirement investment account, which *cannot begin* until the retiree is 59½ years of age and *must begin* once the person, whether retired or not, has reached 70½ years of age, are taxed as earned income in the year of the withdrawal. In other words, if you take out \$6,000 from your 401-K in any given year after you retire, your taxable income for that year will rise by \$6,000 which may (probably will) incur a tax liability. Likewise, after age 70½, the minimum withdrawal that you are required to take is determined by a formula that is based upon the life expectancy of the person's age. To be clear, with *one important exception* one must start taking *required minimum distributions* (RMDs) at 70½ even if still employed. The exception? You are *not* required to take distributions from your retirement plan from your *current* employer if you are *still contributing* to that same retirement plan at that place of employment, no matter what your age.

See the chart above for the maximum annual contribution that can be made to a 401-K account. As is the case for most retirement investment accounts, the maximum contribution that can be made is higher for a contributor above age 50 (this is treated in the tax code as a “catch-up” provision).

Although typically inadvisable, if allowed by the employer as a stated provision, an employee may borrow cash against the balance of the 401-K plan for certain purposes: (1) to pay college tuition, (2) to pay medical expenses, (3) to make a down payment on a home purchase if a first-time home buyer. One cannot borrow against a 401-K to fund a vacation, buy a car, or pay off credit cards. The loans must be paid back with monthly or quarterly payments and the typical loan duration is 5 years, or 15 years if used to help fund a mortgage. An employer has the option of forbidding this class of borrowing by employees.

Before reaching retirement a working person may have been employed by many employers offering 401-K accounts. Tax laws allow a former employee of an employer who offered a 401-K program to transfer the funds of the old 401-K account into a traditional IRA account without any tax liability. This “*rollover*,” as it is called, is advisable for a person who has worked at a number of different companies because it allows the worker to gain complete control of his or her retirement funds in a single, manageable account. It also expands the investment options greatly.

The fees that 401-K administrators charge can be high, even unreasonably so, and can be ended or reduced with a rollover into a Traditional IRA.

Because of the importance of this retirement account to one’s retirement, because the employer typically makes a contribution (free money) and given the tax treatment of contributions, one should strive to maximize earnings contributions from the first day of employment until the last.

403-B plans

Some college professors, other public education employees and some non-profit employees are offered 403-B retirement plans. These plans are essentially identical to 401-K plans in every respect, including contribution limits, tax features, and payout restrictions. 403-B’s can be rolled over into IRAs once the employee has left the place of employment, just like 401-Ks.

Individual (Solo) 401-K Retirement Plans

In 2002, a new class of retirement account was created called an Individual 401-K (also called a Solo 401-K). This type of 401-K is designed to offer all of the attractive features of a traditional 401-K (and more) to self-employed individuals. If a person runs a business, like a consulting business or graphics design business, the individual 401-K plan is an ideal retirement plan. The Solo 401-k allows the self-employed person to deduct the same contribution (called an *elective deferral*) as a standard 401-K, which by itself would cap the contribution at the same level as a 401-K, but is *also* allowed to make an additional contribution called an *employer nonelective contribution* which raises the maximum contribution number to the high value shown in the table (profits must be at a certain high level to allow the maximum contribution).

And unlike the traditional 401-K offered to multiple employees, where the contribution is fixed throughout the year and made on payday, the sole business owner can vary the contribution up to the maximum as earnings allow.

The law allows the Individual 401-K even if you have employees, so long as the employees are under age 21 or have less than one year of service or work less than 1,000 hours per year, or are nonresident aliens. The

business may also employ a spouse and still qualify. In fact, if the spouse qualifies then the effective upper limit for total family contributions for married filing jointly is doubled.

The Individual 401-K can be set up with the same features as a traditional 401-K (contributions deductible from taxable income but payouts taxed as income) or a Roth IRA (contribution not deductible from taxable income but earnings and payouts are not taxed - the Roth IRA is described below). Unless set up as a Roth IRA, if the business is a corporation (like a Chapter-S corporation) then the contribution is simply a business expense. If a sole proprietorship, then the contribution is deductible directly from taxable personal income of the contributor.

The contribution procedures are complicated for a Solo 401-K and should probably be guided by a tax accountant, or at a minimum consult ***IRS Publication 560 "Retirement Plans for Small Business."***

The Individual 401-K account can be set up with any institution that generally handles IRAs, like mutual fund families, brokers, and banks, and financial management firms.

Unlike the traditional 401-K offered by large employers, which is typically restricted to a handful of mutual funds, the Individual 401-K is self-directed, which means the business person funding the account can invest it in mutual funds, stocks including ETPs, bonds and other yield-bearing assets, precious metals, startups, private companies, and even foreign bank accounts (if one thinks the dollar is going to fall in value).

The business owner may borrow up to 50% of the balance in the account up to a maximum of \$50,000 (maybe not such a good feature). Unlike a loan from a traditional 401-K, the borrowed amount can be used for any purpose. The loan is typically made by the institution holding the investments, loan payments must be made monthly or quarterly, and the typical duration is 5 years. There are no tax penalties for borrowing 401-K money, but there are tax penalties if the loan becomes delinquent. Like a traditional 401-K, the borrowed amount can be used as a down payment on a home purchase, and the typical duration for that kind of loan is 15 years.

Although complex in its structure, which may require help from a tax account to set up, the Solo 401-K is by far the most generous and suitable retirement vehicle for the self-employed entrepreneur, especially if the business is prosperous. Given that a Solo 401-K may be set up with the tax features of a Traditional IRA (contributions are deductible but payouts upon retirement are taxed) or a Roth Ira (described next, contributions are not deductible but neither payouts nor earnings are taxed) perhaps the hardest decision for the entrepreneur will be which of these two formats to choose (a hybrid selection using proportions of both is also allowed).

The Roth IRA

The Roth IRA is a generous (in terms of tax treatment) supplemental retirement investment account that is available even to those who are fully vesting in another retirement plan such as a 401-K. In other words, you can be enrolled and contributing to a 401-K retirement account at your place of employment and still supplement your retirement savings by making additional contributions to a Roth IRA account. Contributions to the Roth IRA are not deductible from the contributor's taxable earnings as is the case with a Traditional IRA (see below) *but* investment earnings are *never taxed* (except in the case of early withdrawals, described below). They are not taxed in the year that they are earned and withdrawals are not taxed upon retirement. Over a long investment horizon this feature can generate a substantial tax savings.

The maximum annual contribution to a Roth IRA in 2019 is \$6,000, or \$7,000 if above age 50. If contributing to both a Traditional IRA and a Roth IRA, the two contributions combined cannot exceed the limits for a Traditional IRA.

Unlike Traditional IRAs (described below) one can withdraw the *principal value* of the Roth IRA account at any time. However, one cannot withdraw any *income earned* on the principal value prior to age 59½ without paying an early withdrawal penalty equal to 10% of the amount withdrawn. For example, if the saver contributes \$10,000 to the Roth IRA over the years and the Roth IRA has earned \$2,000 in income, the saver may withdraw up to \$10,000 from the account without a tax penalty. If the entire account is liquidated the saver must pay a tax penalty of \$200 on the \$2,000 of earned income and that \$2,000 must *also* be counted as taxable income in the year of the withdrawal. This partial withdrawal option makes the Roth Ira a very attractive option for young savers who want to accumulate tax-free gains on investment accounts while building the principal value to fund the down-payment on a house or some similar investment.

Roth IRAs also have a “phase-out” feature that begins to restrict that maximum allowable contribution above a certain income and phases it out altogether for incomes above a certain level. In 2019 the maximum contribution available to single taxpayers is reduced if adjusted gross income is greater than \$122,000 and is eliminated altogether if adjusted gross income is greater than \$137,000. For married filing jointly the equivalent numbers are \$193,000 and \$203,000.

Contributions to a Roth IRA can be made at any age, including past the age of 70½ . Withdrawals are not mandatory (because they are not taxed) so Roth IRAs are very suitable investments if the intent is to leave the account to heirs upon the death of the contributor (see below for rules about inheritance of retirement accounts).

The Traditional IRA

The Traditional IRA is designed for the self-employed and others who are not funding a retirement account by other means, such as through a 401-K plan.

Income contributed to a Traditional IRA can be deducted from taxable income earned in the same year as the contribution and up until April 15th of the following year. In other words, if the IRA contributor contributes \$1,000 in December 2019 and another \$1,000 in March 2020, \$2,000 can be deducted from the contributor’s taxable income for 2019. Obviously this can result in a sizeable tax savings in the year of the contribution.

Income earned by the investments made in the Traditional IRA, whether from capital gains or interest earned, are tax deferred until withdrawals are made from the IRA.

After age 59 ½, withdrawals can be made from the Traditional IRA. The amount of the withdrawal is taxed as earned income in the year of the withdrawal. In other words, if a retiree takes \$10,000 out of his retirement account, \$10,000 is added to his taxable income in the year of his withdrawal.

Early withdrawals (prior to age 59 ½) are also taxed as earned income in the year of the withdrawal. In addition to that an early-withdrawal penalty of 10% of the amount withdrawn is added to the tax. In other words, if a retiree withdraws \$10,000 from his IRA account when he is 55, the \$10,000 is added to his taxable income in that year which will generate a higher tax liability for that year, and an additional \$1,000 will be added to his tax bill on top of that.

Minimum withdrawals from a Traditional IRA must begin once a retiree reaches the age of 70½. The amount of the withdrawal is determined by the remaining life expectancy of the retiree (more or less), which is provided by the IRS under the title Uniform Lifetime Table (see ***IRS Publication 590 Individual Retirement Arrangements (IRAs)*** or any of many sources on the internet to view a complete, current table). The number of remaining years is called the Distribution Period. The Distribution Period is the same for both genders (even though women generally outlive men). The minimum required withdrawal is equal to the account balance of the

Traditional IRA divided by the number of years on the Distribution Period for the retiree's age. For example, in 2019 a 80-year-old retiree consulting the Uniform Lifetime Table will find a Distribution Period of 18.7 years for that age. If the retiree has \$200,000 in her IRA account, she must make a withdrawal of at least \$11,695 ($200,000/18.7$). That amount will be counted as taxable income in that year.

Unlike a Roth IRA, contributions cannot be made to a Traditional IRA after age 70½.

If the retiree dies before the IRA account is exhausted (the typical case) the remaining balance can be inherited by heirs *as an IRA account* with no tax penalty so long as the IRA is rolled into a special IRA account called an **Inherited IRA Beneficiary Distribution Account**. If this is done properly no tax is paid at the time of the rollover (although the estate might be subject to an estate tax, a subject not discussed here). Normally taxable withdrawals must begin in the tax year following the retiree's death. Setting up an Inherited IRA Beneficiary Distribution Account can be complicated, especially if there are multiple heirs, and minimum withdrawal requirements are variable and complicated, so *a tax accountant should be consulted before rolling over an inherited IRA account*, and should be consulted *soon after the death of the retiree*.

The annual contribution limits to Traditional IRAs is shown in the table at the beginning of this document.

The SIMPLE IRA

The **SIMPLE** (the acronym stands for Savings Incentive Match Plan for Employees) **IRA** can be established by employers who have no more than 100 employees. It is meant to be a substitute for a 401-K plan and is usually much easier to administer.

Generally, all employees who work for a small business who offers a SIMPLE IRA plan and who make more than \$5,000 per year are eligible for the SIMPLE IRA. The employer *must* contribute to the SIMPLE IRA plan for all eligible employees if the plan is offered.

Typically the employer contributes to the plan and the employee is allowed to invest an amount that matches the employer's contribution (hence the acronym). The employee, however, has the option of investing less than this amount or contributing nothing at all. The employer is allowed to set up a plan that does not match employee contributions, but only if the employer makes a minimum contribution equaling 2% of the employee's salary for the calendar year. The maximum contribution allowed (the sum of the employer's and employee's contribution) is shown in the table at the beginning of this document.

The employer determines what financial institution (usually a mutual fund) will receive the deposits and manage the fund, much like a 401-K.

Rules for withdrawal and tax deferments are the same as they are for the Traditional IRA. The rules for the *inheritance* of a SIMPLE IRA are slightly different than they are for a Traditional IRA. As is the case with any IRA that is to be inherited, a tax accountant should be consulted soon after the death of the deceased.

The Spousal IRA

The Spousal IRA is simply a Traditional IRA that is available to a married person who is not employed. This IRA is available to the unemployed spouse regardless of whether the employed spouse contributes to a retirement plan. (In most cases the funding for the contribution to the Spousal IRA will come from the income of the employed spouse). The Spousal IRA can greatly enhance the retirement savings and tax breaks for a married couple when one works and the other doesn't.

The maximum annual contribution limits are different the traditional IRA and are shown in the table at the beginning of this document.

The rules for withdrawal, tax deferments, and inheritance are the same for the Spousal IRA as they are for the Traditional IRA.

Rollover IRAs

Young men and women entering the work force should realize that they are likely to have many employers over their working lifetimes. This might imply that by age 55 or so, the typical retirement-bound employee might have four, five, or more old 401-K (or similar) accounts floating around out there, possibly neglected, sustaining high fees, and doing little to contribute to a secure financial retirement.

This sad fate can be avoided if the (former) employee is aware that she or he has the right, upon leaving a place of employment, to *roll over* (transfer) the funds in the old 401-K account to a traditional IRA. This transfer may be undertaken any time after leaving a place of employment (the former employer is required to comply with the transfer request) with no fees or tax penalties of any kind. All brokerages and mutual funds offer and welcome rollovers and make them easy to facilitate.

The funds are transferred to a normal, traditional IRA under your control with all of the rights, privileges, and rules of any other traditional IRA. (There actually is no such thing as a "rollover IRA." The term refers to the privilege of rolling over old retirement accounts into a new traditional IRA. Once the money is transferred, the resulting IRA is no different than any other traditional IRA).

For a person changing jobs, the rollover is highly advised. You gain complete control of your own retirement funds and your investment options expand vastly from the limited choices of the IRA to any kind of investment that is allowed under an IRA (discussed next). There is a very good chance that you will reduce fees considerably if you shop wisely for the fund in which you invest your transferred money. Instead of having four or five retirement accounts to monitor and understand, you can consolidate all of your investments over time into two, the retirement plan offered by your current employer and an IRA account managed by you funded by your previous employment.

IRA Investment Options

Traditional, Roth, Spousal IRAs and Individual 401-Ks are called self-directed investment accounts, which means they are managed by the investor. The investor therefore gets to choose where the investment is to be made. Once the investment is made, the investor must choose between managing the account herself, hiring someone like a financial advisor to do it, or accept the general investment advice of the fund in which she is invested. Generally fees will be much higher if the investor does not manage the funds herself and over the years these fees can substantially reduce the size of the retirement nest egg.

There are few limitations on the types of investments available to IRA and Individual 401-K accounts. Contributions to these self-directed accounts can be invested in mutual funds, directly in stocks, ETPs and options in a stock brokerage account, futures in a futures trading account, bank deposits like CDs (including bank deposits in foreign currencies), life insurance products like variable annuities, even real estate (with *many* restrictions), so long as the account created for the investment is specifically identified as an IRA account. IRAs

can also be mixed among many different types of accounts. An active investor might place 80% of her Roth IRA in a safe and diversified family of mutual funds and 20% in an online stock trading account.

Of course any investor should keep in mind that these are *retirement* accounts and selected investments should reflect the relatively conservative profile of a typical retirement account. The rollover IRA probably shouldn't be invested in gold, silver, or cryptocurency ETFs.

Disclaimer

You should not rely upon this document to make any important decisions about retirement accounts. This information was current only by the date in the copyright statement and might also include errors. For current law consult ***IRS Publication 590, Individual Retirement Arrangements*** and related documents, available at the IRS website <http://www.irs.gov>, or your employer in the case of an employer-directed account. Personal tax calculation software like ***TurboTax***TM seems to do a reasonably good job of helping with self-directed investment plan decisions. If in doubt however, given the financial stakes involved, it is probably best to pay to consult a qualified tax accountant.