The Basics of RetirementVehicles

Before one can begin to understand and appreciate the dynamics of investment strategies and retirement distribution planning, one must gather an understanding of where retirement assets come from in the first place. Typically, when a client is in their early 20’s, he or she will first be exposed to pension plans, profit sharing plans, and individual retirement accounts. Even for the very experienced investor, these choices can be daunting.

This chapter will provide an overview of each of the different tax structures (i.e., retirement vehicles) in which retirement assets may be invested. Additionally, it will include an explanation of each of the vehicle’s federal income tax attributes along with examples demonstrating the power of tax-deferred and tax-free growth.

# Qualified Plans

In general, qualified plans can be divided and classified in numerous ways. For purposes of retirement income planning, the most useful classifications might be to define qualified plans as either defined contribution plans or defined benefit plans (see below).

Distributions from a qualified plan, to the extent attributable to employer or before tax employee contributions, will almost always generate ordinary income in the year received. Therefore, there is a great need for tax-sensitive asset allocation planning when qualified plans make up a part of the investor’s retirement portfolio.

Defined Contribution Plan

In a defined contribution plan, the employer (or sometimes the employee) contributes to the employee’s account in the plan. The employee’s benefit is determined by his account balance at retirement. The employee bears the risk of the account’s performance (and, correspondingly, enjoys any upside potential).

The overall limitation on contributions to a defined contribution plan is $53,000 (in 2015) or 100% of pay. For some plans, such as 401(k) plans, an employee can make a salary deduction (elective deferral) contribution of up to $18,000 (in 2015; $24,000 if age 50 or older). If the employee makes the elective deferral election, the amount contributed is excluded from the employee’s income.

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In general, the amount contributed to the plan is not included in the employer’s income for income tax purposes. Taxation of benefits is generally deferred until distributions are made. If the employer provides a Roth option to a 401(k) or 403(b) plan, the employee can elect to make an after-tax contribution instead of the regular pre-tax salary deduction contribution. If this is elected, qualified distributions from the Roth 401(k) or 403(b) can be received tax-free.

Defined Benefit Plan

In a defined benefit plan, the employer contributes to the plan amounts sufficient to fund future retirement benefits for an employee. The employee is promised benefits at retirement from the plan based on compensation and length of service.

Although not as common as they once were, most government agencies and many private employers still offer defined benefit or pension plans. Perhaps the best feature of the pension plan is that it is largely guaranteed and perhaps less dependent upon investment success than the defined contribution plan. Even though these plans are insured by the Pension Benefit Guaranty Corporation (PBGC), the amount guaranteed by the PBGC may still be reduced if the plan is unable to meet its obligations.

Pension plans are a good retirement vehicle choice for businesses which have the financial ability to accept the mandatory funding requirement and can also tolerate the high level of administration and set up costs. They are also a good retirement vehicle choice for businesses which have owners who wish to set aside the largest amount possible for their own and their employee’s retirement. (i.e., up to $210,000 in 2015). Therefore, these types of plans are ideal for small businesses which have only a few employees. Accordingly, as the size of the business increases, pension plans may become relatively less beneficial to the key employees and owners.

In general, the amount contributed to the plan is not included in the employer’s income for income tax purposes. Taxation of benefits is generally deferred until distributions are made.

Projecting Retirement Income

Projections can be made to determine how much money a taxpayer will have in the future available for retirement income based on various scenarios. For example, comparisons could be made of deductible 401(k) contributions versus nondeductible Roth 401(k) contributions. Results may vary depending on the growth rates, current and future tax rates, the time period involved, and the assumptions as to the growth and taxation of amounts outside of the 401(k).

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*Example:* Bill and Sue, both age 35, are looking at whether they should each be making a $5,000 contribution to a Roth 401(k) or to a traditional 401(k). Assuming the facts below, the following tables show the combined after-tax asset balance Bill and Sue would have at various points in time in if they invested in either a traditional 401(k) plan or a Roth 401(k) plan.

***Assumptions*:** Bill and Sue would both invest any contribution they make to their respective 401(k) plans in an equities-based portfolio generating 2% ordinary income and 5% appreciation each year. In addition, Bill and Sue would be in the 25% ordinary income tax bracket (15% tax bracket for capital gains) at all times and each would continue to make a $5,000 contribution to their respective Roth 401(k)s until they both retire at age 65. They would take required minimum distributions from the 401(k) starting at age 70½. Furthermore, they would both reinvest any tax savings (from a deductible traditional 401(k) contribution) in a taxable outside account. The after-tax distributions from the 401(k) are also placed in the taxable outside account. During the years shown projected, no distributions are made from the taxable outside account and neither Bill nor Sue die.

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**Figure 12.1**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Age | Age | RMD  Factor | Traditional 401(k) | | | | | Outside Taxable Investment Account | | | | | | | | Built-In  Inc Tax  on 401(k)  25% | After-Tax  Total  Ending  Balance |
| **Starting**  **Balance** | **Growth**  **7%** | **Contribu-tion** | **Distribu-tion** | **Ending**  **Balance** | **Beginning**  **Balance** | **Ineome**  **2%** | **Growth**  **5%** | **Inc Tax**  **25%** | **Gr Tax**  **15%** | **Contribu-tion Tax Savings**  **25%** | **Net 401(k)**  **Distribu-tion**  **25%** | **Ending**  **Balance** |
| 0 | 35 | 35 | - | 0 | 0 | 10,000 | 0 | 10,000 | 0 | 0 | 0 | 0 | 0 | 2,500 | 0 | 2,500 | 2,500 | 10,000 |
| 1 | 36 | 36 | - | 10,000 | 700 | 10,000 | 0 | 20,700 | 2,500 | 50 | 125 | 13 | 19 | 2,500 | 0 | 5,144 | 5,175 | 20,669 |
| 2 | 37 | 37 | - | 20,700 | 1,449 | 10,000 | 0 | 32,149 | 5,144 | 103 | 257 | 26 | 39 | 2,500 | 0 | 7,940 | 8,037 | 32,051 |
| 3 | 38 | 38 | - | 32,149 | 2,250 | 10,000 | 0 | 44,399 | 7,940 | 159 | 397 | 40 | 60 | 2,500 | 0 | 10,896 | 11,100 | 44,196 |
| 4 | 39 | 39 | - | 44,399 | 3,108 | 10,000 | 0 | 57,507 | 10,896 | 218 | 545 | 54 | 82 | 2,500 | 0 | 14,023 | 14,377 | 57,153 |
| 5 | 40 | 40 | - | 57,507 | 4,026 | 10,000 | 0 | 71,533 | 14,023 | 280 | 701 | 70 | 105 | 2,500 | 0 | 17,329 | 17,883 | 70,979 |
| 6 | 41 | 41 | - | 71,533 | 5,007 | 10,000 | 0 | 86,540 | 17,329 | 347 | 866 | 87 | 130 | 2,500 | 0 | 20,825 | 21,635 | 85,730 |
| 7 | 42 | 42 | - | 86,540 | 6,058 | 10,000 | 0 | 102,598 | 20,825 | 417 | 1,041 | 104 | 156 | 2,500 | 0 | 24,523 | 25,650 | 101,471 |
| 8 | 43 | 43 | - | 102,598 | 7,182 | 10,000 | 0 | 119,780 | 24,523 | 490 | 1,226 | 123 | 184 | 2,500 | 0 | 28,433 | 29,945 | 118,268 |
| 9 | 44 | 44 | - | 119,780 | 8,385 | 10,000 | 0 | 138,164 | 28,433 | 569 | 1,422 | 142 | 213 | 2,500 | 0 | 32,568 | 34,541 | 136,191 |
| 10 | 45 | 45 | - | 138,164 | 9,672 | 10,000 | 0 | 157,836 | 32,568 | 651 | 1,628 | 163 | 244 | 2,500 | 0 | 36,940 | 39,459 | 155,317 |
| 20 | 55 | 55 | - | 409,955 | 28,697 | 10,000 | 0 | 448,652 | 89,530 | 1,791 | 4,477 | 448 | 671 | 2,500 | 0 | 97,178 | 112,163 | 433,667 |
| 30 | 65 | 65 | - | 944,608 | 66,123 | 10,000 | 0 | 1,020,730 | 189,161 | 3,783 | 9,458 | 946 | 1,419 | 2,500 | 0 | 202,538 | 255,183 | 968,086 |
| 40 | 75 | 75 | 22.9 | 1,557,398 | 109,018 | 0 | 68,009 | 1,598,408 | 568,833 | 11,377 | 28,442 | 2,844 | 4,266 | 0 | 51,006 | 652,547 | 399,602 | 1,851,353 |
| 50 | 85 | 85 | 14.8 | 1,842,020 | 128,941 | 0 | 124,461 | 1,846,501 | 1,863,899 | 37,278 | 93,195 | 9,319 | 13,979 | 0 | 93,346 | 2,064,419 | 461,625 | 3,449,294 |

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**Figure 12.2**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Age | Age | RMD  Factor | | Roth 401(k) | | | | | Outside Taxable Investment Account | | | | | | | | Built-In  Inc Tax  on 401(k)  0% | After-Tax  Total  Ending  Balance | |
| **Starting**  **Balance** | **Growth**  **7%** | **Contribu-tion** | **Distribu-tion** | **Ending**  **Balance** | **Beginning**  **Balance** | **Income**  **2%** | **Growth**  **5%** | **Inc Tax**  **25%** | **Gr Tax**  **15%** | **Contribu-tion Tax Savings**  **25%** | **Net 401(k)**  **Distribu-tion**  **25%** | **Ending**  **Balance** |
| 0 | 35 | 35 | | - | 0 | 0 | 10,000 | 0 | 10,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 10,000 |
| 1 | 36 | 36 | | - | 10,000 | 700 | 10,000 | 0 | 20,700 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 20,700 |
| 2 | 37 | 37 | | - | 20,700 | 1,449 | 10,000 | 0 | 32,149 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 32,149 |
| 3 | 38 | 38 | | - | 32,149 | 2,250 | 10,000 | 0 | 44,399 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 44,399 |
| 4 | 39 | 39 | | - | 44,399 | 3,108 | 10,000 | 0 | 57,507 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 57,507 |
| 5 | 40 | 40 | | - | 57,507 | 4,026 | 10,000 | 0 | 71,533 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 71,533 |
| 6 | 41 | 41 | | - | 71,533 | 5,007 | 10,000 | 0 | 86,540 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 86,540 |
| 7 | 42 | 42 | | - | 86,540 | 6,058 | 10,000 | 0 | 102,598 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 102,598 |
| 8 | 43 | 43 | | - | 102,598 | 7,182 | 10,000 | 0 | 119,780 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 119,780 |
| 9 | 44 | 44 | | - | 119,780 | 8,385 | 10,000 | 0 | 138,164 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 138,164 |
| 10 | 45 | 45 | | - | 138,164 | 9,672 | 10,000 | 0 | 157,836 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 157,836 |
| 20 | 55 | 55 | | - | 409,955 | 28,697 | 10,000 | 0 | 448,652 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 448,652 |
| 30 | 65 | 65 | | - | 944,608 | 66,123 | 10,000 | 0 | 1,020,730 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1,020,730 |
| 40 | 75 | 75 | | 22.9 | 1,557,398 | 109,018 | 0 | 68,009 | 1,598,408 | 233,844 | 4,677 | 11,692 | 1,169 | 1,754 | 0 | 51,006 | 298,297 | 0 | 1,896,704 |
| 50 | 85 | 85 | | 14.8 | 1,842,020 | 128,941 | 0 | 124,461 | 1,846,501 | 1,277,985 | 25,560 | 63,899 | 6,390 | 9,585 | 0 | 93,346 | 1,444,815 | 0 | 3,291,316 |

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As illustrated in Figure 12.1 and Figure 12.2, in this scenario, using these assumptions, Bill and Sue would amass approximately $52,644 ($1,020,730 - $968,086) more wealth for retirement at age 65, a 5.4% increase, just by choosing to invest in a Roth 401(k) plan instead of a traditional 401(k) plan. Therefore, under the right circumstances, the Roth 401k plan may allow an investor to create additional wealth and constitute a more prudent retirement plan choice.

# Individual Retirement Accounts

A person can make deductible or nondeductible contributions to a traditional IRA and nondeductible contributions to a Roth IRA. The total contribution limit for traditional IRAs and Roth IRAs is $5,500 in 2015 ($6,500 if age 50 or older), but not to exceed compensation. The contribution limit for deductible contributions to a traditional IRA (if the person is an active participant in an employer provided retirement plan) and nondeductible contributions to a Roth IRA is subject to phaseout for certain levels of modified adjusted gross income.

There are also employer provided SEP and SIMPLE IRAs with larger contribution levels. Contributions to SEP and SIMPLE IRAs are made on a pre-tax basis; the amount contributed is excluded from income. Income taxation is deferred until distributions are made and generally the full amount distributed is includable in income.

All traditional IRAs are aggregated together in determining the taxation of distributions from traditional IRAs in any year. Similarly, all Roth IRAs are aggregated together in determining the taxation of distributions from Roth IRAs in any year.

Distributions from traditional IRAs are includable in income except to the extent attributable to nondeductible contributions, on a prorated basis. Thus, if no nondeductible contributions have been made to traditional IRAs, a distribution is fully subject to income tax.

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*Example.* For all of John’s traditional IRAs, there is $100,000 of unrecovered nondeductible contributions as of the beginning of the year, $100,000 is distributed during the year, and the account balance is $200,000 at the end of the year. The amount of the distributions which is excludable is $33,333 [$100,000 x ($100,000 nondeductible contributions / $200,000 account balance + $100,000 distribution)]. The amount includable is $66,667 ($100,000 distribution - $33,333 excludable). For purposes of future distributions, unrecovered nondeductible contributions is reduced by $33,333 to $66,667.

Qualified distributions from Roth IRAs are excluded from income. A qualified distribution is a distribution made after the five-year period after the year in which the person first contributed to any Roth IRA, if the distribution is made after age 59½ or death, attributable to disability, or for certain first-time home purchases. If the distribution is not qualified, the distribution is excluded from income to the extent of unrecovered contributions; any excess is includable in income.

*Example.* For all of Mary’s Roth IRAs, $100,000 of contributions have been made over the years, the account balance is $130,000, no prior distributions have been made, $100,000 is distributed, and the distribution is not qualified. The amount of the distribution which is includable is $0 and the amount excludable is $100,000 (distribution of $100,000 does not exceed contributions of $100,000).

The next year, no additional contributions are made, the account balance is $31,500, and $31,500 is distributed in a qualified distribution. The $31,500 is excluded from income.

For purposes of the discussion that follows, deductible contributions to traditional IRAs, nondeductible contributions to traditional IRAs, and contributions to Roth IRAs are treated separately. However, as noted above, all traditional IRAs are aggregated together in determining the taxation of distributions from traditional IRAs in any year. And all Roth IRAs are aggregated together in determining the taxation of distributions from Roth IRAs in any year.

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Deductible Contributions to Traditional IRAs

Deductible contributions to a traditional IRA, a tax-favored account, creates the opportunity for retirement funds to accumulate faster than they would in a taxable account because of the deferral of income tax. Although the future distributions from a traditional IRA (other than those attributable to nondeductible contributions) will be subject to income tax at the ordinary income tax rates, all earning and asset growth accumulate on a tax-deferred basis during the build-up period, which typically lasts many years. This long-term tax deferral is a very powerful force that should not be underestimated.

Contributions to a traditional IRA may or may not be tax deductible depending on the IRA owner’s coverage by an employer-sponsored retirement plan, such as a 401(k) plan, and the IRA owner’s modified adjusted gross income (MAGI). Additionally, tax deductible contributions to a traditional IRA cannot exceed the lesser of the deductible amount ($5,500 for 2015, or $6,650 for an individual who has attained the age of 50 by the end of the tax year) or the taxpayer’s compensation included in gross income.

The fundamental advantage of a traditional IRA is its tax-deferred nature with the secondary advantage being the deductibility of contributions. The overall effect of placing assets in a traditional IRA, as opposed to a taxable account, may be that the assets may grow at a higher rate of return. This can be seen in Figure 12.3 and Figure 12.4.

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**Figure 12.3**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Age | RMD  Factor | | Traditional IRA (Deductible Contribution | | | | | Outside Taxable Investment Account | | | | | | | |  | |  |
| **Starting**  **Balance** | **Growth**  **7%** | **Contribu-tion** | **Distribu-tion** | **Ending**  **Balance** | **Beginning**  **Balance** | **Income**  **2%** | **Growth**  **5%** | **Inc Tax**  **25%** | **Gr Tax**  **15%** | **Contribu-tion Tax Savings**  **25%** | **Net 401(k)**  **Distribu-tion**  **25%** | **Ending**  **Balance** | **Built-In**  **Inc Tax**  **on IRA**  **25%** | **After-Tax**  **Total**  **Ending**  **Balance** | |
| 0 | 35 | - | 0 | | 0 | 4,000 | 0 | 4,000 | 0 | 0 | 0 | 0 | 0 | 1,000 | 0 | 1,000 | 1,000 | 4,000 | |
| 1 | 36 | - | 4,000 | | 280 | 4,000 | 0 | 8,280 | 1,000 | 20 | 50 | 5 | 8 | 1,000 | 0 | 2,058 | 2,070 | 8,268 | |
| 2 | 37 | - | 8,280 | | 580 | 4,000 | 0 | 12,860 | 2,058 | 41 | 103 | 10 | 15 | 1,000 | 0 | 3,176 | 3,215 | 12,821 | |
| 3 | 38 | - | 12,860 | | 900 | 4,000 | 0 | 17,760 | 3,176 | 64 | 159 | 16 | 24 | 1,000 | 0 | 4,358 | 4,440 | 17,678 | |
| 4 | 39 | - | 17,760 | | 1,243 | 4,000 | 0 | 23,003 | 4,358 | 87 | 218 | 22 | 33 | 1,000 | 0 | 5,609 | 5,751 | 22,861 | |
| 5 | 40 | - | 23,003 | | 1,610 | 4,000 | 0 | 28,613 | 5,609 | 112 | 280 | 28 | 42 | 1,000 | 0 | 6,932 | 7,153 | 28,391 | |
| 6 | 41 | - | 28,613 | | 2,003 | 4,000 | 0 | 34,616 | 6,932 | 139 | 347 | 35 | 52 | 1,000 | 0 | 8,330 | 8,654 | 34,292 | |
| 7 | 42 | - | 34,616 | | 2,423 | 4,000 | 0 | 41,039 | 8,330 | 167 | 417 | 42 | 62 | 1,000 | 0 | 9,809 | 10,260 | 40,588 | |
| 8 | 43 | - | 41,039 | | 2,873 | 4,000 | 0 | 47,912 | 9,809 | 196 | 490 | 49 | 74 | 1,000 | 0 | 11,373 | 11,978 | 47,307 | |
| 9 | 44 | - | 47,912 | | 3,354 | 4,000 | 0 | 55,266 | 11,373 | 227 | 569 | 57 | 85 | 1,000 | 0 | 13,027 | 13,816 | 54,476 | |
| 10 | 45 | - | 55,266 | | 3,869 | 4,000 | 0 | 63,134 | 13,027 | 261 | 651 | 65 | 98 | 1,000 | 0 | 14,776 | 15,784 | 62,127 | |
| 20 | 55 | - | 163,982 | | 11,479 | 4,000 | 0 | 179,461 | 35,812 | 716 | 1,791 | 179 | 269 | 1,000 | 0 | 38,871 | 44,865 | 173,467 | |
| 30 | 65 | - | 377,843 | | 26,449 | 4,000 | 0 | 408,292 | 75,664 | 1,513 | 3,783 | 378 | 567 | 1,000 | 0 | 81,015 | 102,073 | 387,234 | |
| 40 | 75 | 22.9 | 622,959 | | 43,607 | 0 | 27,203 | 639,363 | 227,533 | 4,551 | 11,377 | 1,138 | 1,706 | 0 | 20,403 | 261,019 | 159,841 | 740,541 | |
| 50 | 85 | 14.8 | 736,808 | | 51,577 | 0 | 49,784 | 738,600 | 745,560 | 14,911 | 37,278 | 3,728 | 5,592 | 0 | 37,338 | 825,767 | 184,650 | 1,379,718 | |

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**Figure 12.4**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Age | Outside Taxable Investment Account Only | | | | | | |
| **Beginning**  **Balance** | **Income**  **2%** | **Growth**  **5%** | **Inc Tax**  **25%** | **Gr Tax**  **15%** | **Contribution** | **Ending**  **Balance** |
| 0 | 35 | 0 | 0 | 0 | 0 | 0 | 4,000 | 4,000 |
| 1 | 36 | 4,000 | 80 | 200 | 20 | 30 | 4,000 | 8,230 |
| 2 | 37 | 8,230 | 165 | 412 | 41 | 62 | 4,000 | 12,703 |
| 3 | 38 | 12,703 | 254 | 635 | 64 | 95 | 4,000 | 17,434 |
| 4 | 39 | 17,434 | 349 | 872 | 87 | 131 | 4,000 | 22,436 |
| 5 | 40 | 22,436 | 449 | 1,122 | 112 | 168 | 4,000 | 27,726 |
| 6 | 41 | 27,726 | 555 | 1,386 | 139 | 208 | 4,000 | 33,320 |
| 7 | 42 | 33,320 | 666 | 1,666 | 167 | 250 | 4,000 | 39,236 |
| 8 | 43 | 39,236 | 785 | 1,962 | 196 | 294 | 4,000 | 45,492 |
| 9 | 44 | 45,492 | 910 | 2,275 | 227 | 341 | 4,000 | 52,108 |
| 10 | 45 | 52,108 | 1,042 | 2,605 | 261 | 391 | 4,000 | 59,104 |
| 20 | 55 | 143,249 | 2,865 | 7,162 | 716 | 1,074 | 4,000 | 155,485 |
| 30 | 65 | 302,658 | 6,053 | 15,133 | 1,513 | 2,270 | 4,000 | 324,061 |
| 40 | 75 | 581,474 | 11,629 | 29,074 | 2,907 | 4,361 | 4,000 | 618,909 |
| 50 | 85 | 1,069,139 | 21,383 | 53,457 | 5,346 | 8,019 | 4,000 | 1,134,615 |

Along with the benefit of tax-deferred growth, the tax savings which result from the income tax deduction on the contribution can be invested in a taxable account, thereby increasing the overall benefit of the contribution to a traditional IRA.

Furthermore, even when required minimum distributions (RMDs) have begun and the traditional IRA account is being liquidated, the traditional IRA with deductible contributions may still outperform an equivalent investment in an outside taxable investment account. This occurs as a result of the withdrawn RMDs being reinvested into a separate outside taxable account.

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Nondeductible Contributions to Traditional IRAs

When nondeductible contributions are made to a traditional IRA, the earnings and growth accumulate tax-deferred. However, nondeductible contributions means they are not deductible for federal income tax purposes. A nondeductible contribution to a traditional IRA contribution may result if the individual (and/or his spouse) are active participants in an employer-sponsored qualified retirement plan and the individual (and/or jointly with his spouse) have a MAGI which exceeds the threshold amount.

While earnings in the traditional IRA are distributed as taxable ordinary income, the nondeductible contributions are returned free of tax as principal or basis. Therefore, the essential advantage in the case of nondeductible contributions to a traditional IRA is that it enables an investor to accumulate funds on a tax-deferred basis, thereby allowing the funds to grow at a higher effective rate of return than assets in a taxable account yielding the same rate of return.

However, the inherent disadvantage of nondeductible contributions to a traditional IRA is that on an after-tax basis, it may produce returns which are no better, and in some instances worse, than the returns in an outside taxable account. This result is illustrated in Figure 12.5, which shows the total investment assets an investor would amass with nondeductible contributions to a traditional IRA at various points in time compared to an equivalent investment in an outside taxable account (see Figure 12.4).

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**Figure 12.5**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Age | RMD  Factor | Traditional IRA (Nondeductible Contribution | | | | | | | Outside Taxable Investment Account | | | | | | | | |  | |  |
| **Starting**  **Balance** | **Growth**  **7%** | | **Contribu-tion** | | **Unrecov-ered Contribu-tion** | **Distribu-tion** | **Ending**  **Balance** | **Beginning**  **Balance** | **Income**  **2%** | **Growth**  **5%** | **Inc Tax**  **25%** | **Gr Tax**  **15%** | **Contribu-tion Recovered** | **Net IRA**  **Distribu-tion**  **25%** | **Ending**  **Balance** | **Built-In**  **Inc Tax**  **on IRA**  **25%** | **After-Tax**  **Total**  **Ending**  **Balance** | |
| 0 | 35 | - | 0 | | 0 | | 4,000 | 4,000 | 0 | 4,000 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4,000 | |
| 1 | 36 | - | 4,000 | | 280 | | 4,000 | 8,000 | 0 | 8,280 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 70 | 8,210 | |
| 2 | 37 | - | 8,280 | | 580 | | 4,000 | 12,000 | 0 | 12,860 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 215 | 12,645 | |
| 3 | 38 | - | 12,860 | | 900 | | 4,000 | 16,000 | 0 | 17,760 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 440 | 17,320 | |
| 4 | 39 | - | 17,760 | | 1,243 | | 4,000 | 20,000 | 0 | 23,003 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 751 | 22,252 | |
| 5 | 40 | - | 23,003 | | 1,610 | | 4,000 | 24,000 | 0 | 28,613 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1,153 | 27,460 | |
| 6 | 41 | - | 28,613 | | 2,003 | | 4,000 | 28,000 | 0 | 34,616 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1,654 | 32,962 | |
| 7 | 42 | - | 34,616 | | 2,423 | | 4,000 | 32,000 | 0 | 41,039 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2,260 | 38,779 | |
| 8 | 43 | - | 41,039 | | 2,873 | | 4,000 | 36,000 | 0 | 47,912 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2,978 | 44,934 | |
| 9 | 44 | - | 47,912 | | 3,354 | | 4,000 | 40,000 | 0 | 55,266 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 3,816 | 51,449 | |
| 10 | 45 | - | 55,266 | | 3,869 | | 4,000 | 44,000 | 0 | 63,134 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4,784 | 58,351 | |
| 20 | 55 | - | 163,982 | | 11,479 | | 4,000 | 84,000 | 0 | 179,461 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 23,865 | 155,596 | |
| 30 | 65 | - | 377,843 | | 26,449 | | 4,000 | 124,000 | 0 | 408,292 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 71,073 | 337,219 | |
| 40 | 75 | 22.9 | 622,959 | | 43,607 | | 0 | 102,910 | 27,203 | 639,363 | 123,116 | 2,462 | 6,156 | 616 | 923 | 4,200 | 21,453 | 155,848 | 135,163 | 660,048 | |
| 50 | 85 | 14.8 | 736,808 | | 51,577 | | 0 | 61,875 | 49,784 | 738,600 | 629,943 | 12,599 | 31,497 | 3,150 | 4,725 | 3,907 | 38,315 | 708,387 | 170,158 | 1,276,829 | |

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The first reason for this disparity between the after-tax performance of the deductible contributions (see above) and nondeductible contributions to a traditional IRA is the nondeductible nature of the contributions. Because the contributions are not tax deductible, there is no tax savings to invest in a taxable account, which decreases the overall performance of the IRA. The second reason is that the portion of the earning in the IRA that constitute qualified dividends and capital gain are losing their favorable tax treatment (5% - 15% tax rates) and are being taxed as ordinary income (10% - 35% tax rates). Therefore, due to these two factors, the after-tax performance of the nondeductible contributions to a traditional IRA may be no better, and in some cases, may be worse, than the after-tax performance if contributions were made only to the outside taxable account. Consequently, generally only a person who has a modified adjusted gross income in excess of the Roth IRA contribution limitations, or a person who is anticipating a Roth IRA conversion, should consider making nondeductible contributions to a traditional IRA. If possible, nondeductible contributions should generally be made to a Roth IRA (see below) rather than to a traditional Roth IRA.

Contributions to Roth IRAs

When contributing to a Roth IRA, a person is not allowed a deduction for federal income tax purposes. However, qualified distributions received by a person from a Roth IRA will not by subject to federal income taxation. For the 2015 tax year, the maximum allowable Roth IRA contribution a person can make is generally $5,500 (increased to $6,500 for a person who has attained the age of 50). Furthermore, this contribution amount is phased out between certain levels of modified adjusted gross income (MAGI).

Due to the tax-free character of distributions, funds in a Roth IRA may experience growth at a higher after-tax rate of return than funds in a traditional IRA (even if contributions to the traditional IRA were deductible) under some circumstances. Furthermore, because the distributions are received tax-free, they will have no effect on a person’s marginal income tax bracket during retirement.

In addition to the benefit of tax-free withdrawals, a Roth IRA may also be beneficial because a person can make contributions to the Roth IRA after the person has attained the age of 70½ (assuming the person has compensation). Deductible contributions to a traditional IRA cannot be made after the person has attained the age of 70½. Furthermore, unlike a traditional IRA, which mandates the withdrawal of required minimum distributions (RMD) upon the attainment of age 70½, a Roth IRA does not require RMDs to be withdrawn when the IRA owner reaches age 70½. [However, the RMD rules generally apply to a Roth IRA after the death of the IRA owner.] This allows

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the funds in the Roth IRA to remain in the retirement vehicle accumulating additional compounded growth and increasing the balance of the investor’s retirement assets.

Contribution Limits for Traditional and Roth IRAs

The summary below indicates the 2015 contribution limitations and income level limitations at which an individual is allowed to contribute to the traditional and Roth IRA.

Traditional IRAs

Individuals who receive compensation which is includable in gross income and who are under the age of 70½ during the tax year are entitled to make contributions to a traditional IRA based on the following parameters:

* IRA Contributions Cannot Exceed the Lesser of:
* The deductible amount, or
* The taxpayer’s compensation included in gross income
* The deductible amount is
* $5,500 in 2015
* $1,000 catch-up provision available for taxpayers over age 50
* Reduced if an investor is an active participant in an employer-maintained retirement plan, depending upon the investor’s modified adjusted gross income (MAGI) and filing status
* Individuals who are married and filing a joint tax return and who are both active participants - their allowable IRA deduction is phased out in 2015 when their modified AGI is between $98,000 and $118,000
* Individuals who are married and filing a joint tax return and one spouse is an active participant - the allowable IRA deduction for the spouse who is not an active participant is phased out in 2015 when their modified AGI is between $183,000 and $193,000
* Compensation includes:
* W-2 (Box 1) income
* Self-employed income

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* Alimony
* Other earned income
* Compensation does not include:
* Interest, dividends, and royalties
* Pensions and annuities
* Deferred compensation
* Other unearned income

Roth IRAs

Individuals who receive compensation which is includable in gross income are entitled to make contributions to a Roth IRA based on the following parameters:

* The maximum annual contribution per individual is the amount that may be made to both traditional and Roth IRAs combined.
* Rollover contributions to a Roth IRA are not counted against the annual maximum contribution
* The 70½ age limitation does not apply to Roth IRAs – investors may make contributions to a Roth IRA after reaching age 70½
* Contributions to a Roth IRA are never deductible
* Maximum annual contribution to Roth and traditional IRAs cannot exceed:
* $5,500 in 2015
* $1,000 catch-up provision available for investors over age 50
* Maximum yearly contributions are phased-out based on investor’s MAGI For 2015:
* Single individuals: $116,000 - $131,000
* Married individuals filing a joint return: $183,000 - $193,000

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* Compensation includes:
* W-2 (Box 1) income
* Self-employed income
* Alimony
* Other earned income
* Compensation does not include:
* Interest, dividends, and royalties
* Pensions and annuities
* Deferred compensation
* Other unearned income

# Outside Taxable Accounts

Just as the name implies, an outside taxable investment account is a portfolio of mutual funds and securities which are not contained within a qualified plan and which receive no preferred income tax treatment based on being retirement plans (but there might be other, non-retirement based, tax benefits available, see below). Therefore, the earning on the outside taxable investment account (i.e., interest, dividends, capital gains, and other income) are generally taxed in the year received. Furthermore, because there is no tax deferral on the earning, taxable investment accounts are subject to “tax drag.”

“Tax drag” is basically the reduction in the portfolio’s rate of return due to the annual tax liability on the return. For example, assume an investor in the 25% marginal income tax bracket has a stock portfolio generating 4% dividend income each year. In this scenario, the investor would have a 3% (4% - 1%) after-tax rate of return because the investment would be subject to a 1% (4% x 25%) tax drag on dividend income. [Lower tax rates, not illustrated here, may be available for qualified dividends.] Therefore, due to the encumbering effect that “tax-drag” can have on taxable investments; it is generally a more prudent choice to compare retirement options on an after-tax basis.

There may, however, be special tax breaks available for such outside taxable accounts. For example, qualified dividends and capital gains may qualify for special lower tax rates that are generally not available for distributions from so-called tax favored

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accounts as qualified plans and IRAs. Capital gain is generally not recognized until property is sold, providing some tax deferral.

In making projections of a portfolio’s returns and after-tax accumulations, the effect of gains and the taxation of gains must often be added to such projections. Projecting future accumulations of property that will be sold may include assumptions as to growth rates for the property (capital appreciation that is in addition to any dividends, interest, or other such income), how often property will be sold and how much will be sold, whether the gain recognized is capital, and the tax rates applicable.

The following table, showing accumulations of a taxable account versus a traditional IRA account with deductible contributions (derived from Figures 12.3 and 12.4) illustrates the encumbering effect that “tax-drag” can have on taxable investments.

|  |  |  |
| --- | --- | --- |
| Age | Taxable  Account | Traditional  IRA  (Deductible) |
| 45 | 59,104 | 62,127 |
| 55 | 155,485 | 173,467 |
| 65 | 324,061 | 387,234 |

The encumbering effect of “tax-drag” on taxable investments depends on the assumptions made. Under the assumptions made here, simply by choosing to invest her money in a tax-deferred retirement, a taxpayer would amass approximately $63,173 ($387,234 - $324,061) more wealth at age 65, a 12% increase, than by investing in a taxable account.

As in the traditional 401k versus Roth 401k decision, the choice between deductible contributions to a traditional IRA and nondeductible contributions to a Roth IRA, when available, is not always an easy choice. See Figures 12.1 and 12.2 for one example. When indifferent from a tax bracket standpoint, the prudent planner may consider creating a Roth IRA simply to diversify one’s eventual tax retirement portfolio, in other words, to create a third source of retirement income to allow more flexibility in post-retirement income tax planning. By creating three classes of retirement assets, each with different tax characteristics, the investor favorably positions himself to take advantage of the various retirement distribution planning strategies.

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Results can vary widely depending on the assumptions made. It may be advisable to run projections with a variety of assumptions.

# Annuities

An annuity is a popular retirement asset which generally is purchased from an insurance company. An annuity is a contract that provides the investor with the right to receive annual (or more frequent) payments over the investor’s life or for a guaranteed number of years. The annuity is generally purchased years before the investor retires.

The benefit of an annuity is that it allows funds to accumulate tax-deferred because the investor generally does not pay income tax on the annuity payments until they are received during retirement. Furthermore, they are beneficial because of their limited risk and guaranteed payments.

# Deferred Compensation Plans

Deferred compensation plans allow employees to perform services currently, but defer receipt of the compensation for those services – and thereby defer the taxation otherwise payable – until a later date (often retirement, when presumably the employee will be in a significantly lower income tax bracket). Thus, a deferred compensation plan is basically the payment for services which occurred in an earlier tax period in some later tax period.

For income tax purposes, deferred compensation plans are generally treated in the same manner as employer profit sharing plans. Contributions are received on a pre-tax basis and distributions are characterized as taxable ordinary income when received. Furthermore, deferred compensation plans generally take two forms, qualified (see above) and non-qualified. Non-qualified plans are subject to IRC Section 409A requirements and are generally not regulated by ERISA or the DOL. They can be discriminatory and customized and can also be forfeited.

In a nutshell, deferred compensation plans afford employers and employees the opportunity to:

* Defer compensation on a tax favorable basis
* Attract, develop, and retain top talent
* Provide “golden handcuff” protection for employers
* Provide “golden parachute” protection for employees