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# IRAs





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## What is an individual retirement account (IRA)?

An individual retirement account (IRA) is a personal savings plan that offers specific tax incentives to encourage you to save for retirement. Currently, there are two types of retirement IRAs. Traditional IRAs allow for tax-deductible contributions under certain conditions. Roth IRAs are funded with after-tax dollars, but may allow for tax-free withdrawals under certain conditions.

It is important to realize that an IRA is not itself an investment, but a tax-advantaged vehicle in which you can hold some of your investments. You need to decide how to invest your IRA dollars based on your own tolerance for risk and investment philosophy. How fast your IRA dollars grow is largely a function of the investments that you choose.

**Tip:** The term "IRA" can refer either to an individual retirement account or an individual retirement annuity. An individual retirement annuity is an annuity or endowment contract that you purchase from a life insurance company. The contract must not be transferable, and the premiums must be flexible so that if your compensation changes, your premium payments can also change. In general, the same rules that apply to individual retirement accounts also apply to individual retirement annuities.

**Caution:** Special rules apply if you inherit an IRA.

## Overview of IRA types

### Traditional IRAs

#### In general

Prior to 1997, there was only one type of IRA. Because it was the only type, it didn't have a special name — it was simply called an IRA. However, as a result of the Taxpayer Relief Act of 1997, this "original" IRA came to be called the "traditional" IRA to distinguish it from the newly created Roth IRA.

A traditional IRA is a special type of personal savings plan that provides certain tax advantages to encourage you to save money for retirement. You can contribute up to the lesser of \$6,500 (\$7,500 if age 50 or older) or 100% of your taxable compensation to a traditional IRA in 2023 (up from \$6,000 and \$7,000, respectively, in 2022). You may also be able to contribute up to the same amounts to a traditional IRA for your spouse. Funds in a traditional IRA grow tax deferred until they are paid out to you.

#### Deductible versus nondeductible contributions

There are two types of contributions that you can make to a traditional IRA: deductible contributions and nondeductible contributions. When you make deductible contributions, you reduce your taxable income for the year, so the dollars that you contribute are pre-tax. Those dollars will not be taxed until you withdraw them from the IRA. When you make nondeductible contributions, you contribute after-tax dollars that will not be taxed again later when you withdraw them from the IRA. The portion of any withdrawal that represents investment earnings is always taxed.

Your ability to make a deductible contributions to a traditional IRA depends on your annual income, your income tax filing status, and whether you (or, in some cases, your spouse) are covered by an employer-sponsored retirement plan.

### Roth IRAs

Like traditional IRA funds, funds held in a Roth IRA enjoy tax-deferred growth. But the Roth IRA is often described as an alternative to a traditional IRA because other key features differ. Roth IRA contributions are never tax deductible (you can contribute only after-tax dollars), but withdrawals may be completely tax free if you meet the requirements for qualifying withdrawals. For 2023, you can contribute up to the lesser of \$6,500 (\$7,500 if age 50 or older) or 100% of your taxable compensation to a Roth IRA (up from \$6,000 and \$7,000, respectively, from 2022). You may also be able to contribute up to the same amounts to a Roth IRA for your spouse.

You may or may not qualify to establish a Roth IRA. Even if you do, you may not qualify to contribute up to the annual maximum. Whether or not you can contribute to a Roth IRA depends on your annual income and your income tax filing status. Finally, if you qualify, you can convert funds from a traditional IRA to a Roth IRA (see below).

**Caution:** If eligible, you can contribute to both a Roth and traditional IRA in the same year. However, the total amount contributed may not exceed the annual limit — \$6,500 in 2023 (\$7,500 if age 50 or older).

### Spousal IRAs

If you file your federal income tax return as married filing jointly and meet certain other conditions, you can contribute to an IRA (traditional or Roth) for your spouse even if he or she has little or no taxable compensation of his or her own for the year of the contribution. This is usually described as making a contribution to a spousal IRA. A spousal IRA is not, however, a special type of IRA. It is merely a way of describing the fact that you are making a contribution to your spouse's traditional or Roth IRA.



### SEP IRAs and SIMPLE IRAs

A Simplified Employee Pension Plan (SEP) is a retirement plan an employer can establish for employees (self-employed individuals can also adopt a SEP plan). Employer SEP contributions, which can be as high as \$66,000 a year for each employee (in 2023), are made to employee traditional IRAs (usually called SEP IRAs). All of the rules applicable to traditional IRAs apply to SEP IRAs. In addition, employees can make their own traditional (but not Roth) IRA contributions to their SEP IRAs, subject to regular traditional IRA rules and contribution limits.

A Savings Incentive Match Plan for Employees of Small Employers (SIMPLE IRA plan) is also an employer-sponsored retirement plan. With a SIMPLE IRA, both the employer and the employees make contributions to SIMPLE IRAs established for the employees (employees can defer up to \$15,500 in 2023, \$19,000 if age 50 or older). SIMPLE IRAs are different from traditional IRAs — employees can't make regular IRA contributions to SIMPLE IRAs. After an employee participates in the SIMPLE plan for two years, however, the employee can roll the SIMPLE IRA assets into a traditional IRA.

### Deemed IRAs

Employers who maintain certain retirement plans [like 401(k), 403(b), or 457(b) plans] can allow employees to make regular IRA contributions — traditional or Roth — to special accounts set up under their retirement plan. These accounts, called "deemed IRAs," function just like regular IRAs. Advantages include the fact that your retirement assets can be consolidated in one place, contributions can be made automatically through payroll deduction, the employee can take advantage of any special investment opportunities offered in the employer's plan, and protection from creditors may be greater than that available in a standalone IRA. The downside is that investment choices in an employer's plan may be very limited in comparison to the universe of investment options available through a separate IRA. Also, the distribution options available to employees and their beneficiaries in a deemed IRA may be more limited than in a standalone IRA. Because of the administrative complexity involved, most employers have so far been reluctant to offer these arrangements under their retirement plans.

### Rollovers and transfers

You can transfer funds from one traditional IRA to another traditional IRA or from one Roth IRA to another Roth IRA. One way to accomplish this is by having the trustee or custodian of one IRA transfer the funds directly to the trustee or custodian of a second IRA without ever distributing the funds to you (a "trustee-to-trustee transfer"). You can instead arrange for the trustee or custodian of your IRA to first distribute your funds to you (an "indirect" or "60-day" rollover). To avoid taxes and penalty, you must then roll the funds over into another IRA by contributing the funds to that IRA within 60 days after receiving the distribution from the first IRA (the IRS can waive this 60-day rule under limited circumstances, such as proven hardship). Transferring funds from a traditional IRA to a Roth IRA is considerably more complicated (see below).

**Tip:** You can also roll over funds from an employer's qualified retirement plan [for example, a 401(k) plan] to a traditional IRA or Roth IRA. [Roth 401(k) and Roth 403(b) funds can be rolled over only to a Roth IRA, not to a traditional IRA].

**Caution:** When considering a rollover, to either an IRA or to another employer's retirement plan, you should consider carefully the investment options, fees and expenses, services, ability to make penalty-free withdrawals, degree of creditor protection, and distribution requirements associated with each option.

**Caution:** You can make only one tax-free, 60-day, rollover from one IRA to another IRA in any one-year period no matter how many IRAs (traditional, Roth, SEP, and SIMPLE) you own. This does not apply to direct (trustee-to-trustee) transfers, or Roth IRA conversions.

### Converting or rolling over funds from traditional IRAs and employer plans to Roth IRAs

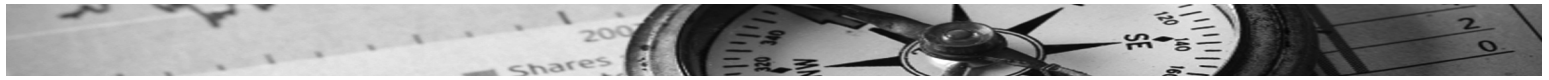
You can convert or roll over all or a portion of the funds in your traditional IRA to a Roth IRA. Similarly, you can generally roll over (convert) eligible distributions of non-Roth funds from an employer-sponsored retirement plan [such as a 401(k)] to a Roth IRA. In either case, those funds will be included in your taxable income for the year to the extent that the funds consist of pre-tax or deductible contributions and investment earnings. The decision whether to convert funds is complicated and should not be made without consulting a professional advisor.

### Early withdrawal penalty

You decide when and how much to withdraw from your traditional and Roth IRAs, but taxes and penalties imposed by the federal government will likely influence your decision-making process. A 10% early withdrawal penalty is generally assessed on the taxable portion of any distribution you take from a traditional or Roth IRA prior to age 59½. This tax is over and above regular federal income tax. There are a number of exceptions to the tax, however.

**Caution:** Special rules may apply if you convert or roll over funds from a traditional IRA to a Roth IRA and then withdraw funds from that Roth IRA within five years of the conversion.

### Required minimum distributions



Like many people, you may want to keep your funds in your IRAs for as long as possible to maximize tax-deferred growth and/or preserve the funds for your beneficiaries. Unfortunately, the federal government does not allow you to do this. The required minimum distribution rule states that when you reach age 73, you must begin taking minimum annual withdrawals from your traditional IRAs (this rule does not apply to Roth IRAs). These annual withdrawals are based on a life expectancy calculation and are intended to dispose of your traditional IRA balance over a given period of time. You can always withdraw more than the required minimum in any year, but if you withdraw less, you will be subject to a 50% penalty on the shortfall.

## The importance of beneficiary choice

When you open a traditional or Roth IRA, you have to designate a beneficiary. This is the person or entity that will receive the funds remaining in your IRA after you die. It can be your spouse, a child or grandchild, a friend or other relative, a trust, a charity, your estate, or some combination of these (you can have more than one designated beneficiary). Obviously, your beneficiary should be someone you wish to provide for financially. What you may not realize is that choosing a beneficiary involves other important considerations. Your choice will determine how quickly the IRA funds must be distributed after your death, and could even impact the required minimum distributions that you must take from a traditional IRA during your life (if you choose a spouse who is more than 10 years younger than you).

## Investment choices appropriate for IRAs

Remember that an IRA is not itself an investment, but a tax-advantaged vehicle in which you can hold some of your investments. Choosing specific investments to fund your IRAs is an important decision. Here are some points to keep in mind:

- You need to decide how to invest your IRA dollars based on your own retirement goals, tolerance for risk, investment philosophy, and other personal factors
- How fast your IRA dollars grow is largely a function of the investments that you choose, as well as tax deferral
- There are specific types of investments that you cannot use to fund your IRAs (such as collectibles), and there are some choices that usually make more sense as IRA investments than others (e.g., mutual funds, CDs)
- If you're unhappy with your IRA investment choices, you can typically move your money to other investments offered by the same financial institution, or to a different institution
- You should consider any fees associated with opening and maintaining your IRA

**Caution:** All investing involves risk, including the possible loss of principal. Before investing in a mutual fund, carefully consider its investment objectives, risks, fees and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing. You should talk to a financial professional about choosing appropriate investments for your IRAs.

**Caution:** The IRS has ruled that the wash sales rules apply if you sell stock or other securities outside of your IRA for a loss, and purchase substantially identical stock or securities in your IRA (traditional or Roth) within 30 days before or after the sale. The result is that you cannot take a deduction for your loss on the sale of the stock or securities. In addition, your basis in your IRA is not increased by the amount of the disallowed loss.

## Choosing the right type of IRA

How do you decide which type of IRA is right for you? As a general rule, there is no advantage to making nondeductible contributions to a traditional IRA if you qualify to make either deductible contributions to a traditional IRA or after-tax contributions to a Roth IRA. The question is: Assuming that you qualify for both, do you contribute to a traditional IRA with deductible contributions, or to a Roth IRA? There is no easy answer. You have to analyze your situation and determine which type of IRA offers the best fit for you. You should also consult a financial planner, tax advisor, or other professional.



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