FINANCIAL ROAD WORK

BY KEN BELLAVANCE

WHAT YOU NEED TO KNOW ABOUT TYPES OF INVESTMENT ACCOUNTS

When you think about saving for retirement or college education, what questions do you have before getting started? Most people understand that they need to set aside their hard-earned cash to be invested; however, what is often overlooked is what type of investment account the money should be held in.

The financial world is full of acronyms, abbreviations, and jargon that create a learning curve for investors who are new to managing money. You have probably heard of an IRA. An IRA is a plan that has certain tax advantages for retirement savings if certain restrictions are met. That broad and unhelpful definition of an IRA is what you have most likely heard before and what I am attempting to avoid. The abbreviation I-R-A stands for Individual Retirement Account. That sounds simple enough right? Well, there are actually 11 different kinds of IRAs (sigh…), but I am going to focus on the six most common types as well as other accounts you may find useful. For those of you who have placed your full faith in Social Insecurity Security as your primary retirement source, feel free to stop reading.

An Individual Retirement Account (IRA) is just that, an account used for retirement with a natural person as the account holder. Mostly, IRAs are used as plans outside of your company-sponsored plan (401k, 403b, 457b) to help you save for retirement. Each kind of IRA has a specific purpose and set of rules.

INDIVIDUAL RETIREMENT PLANS

Traditional IRA – The purpose of this account is to have the ability to put aside pre-tax dollars and have those funds be tax-deferred. *Tax-deferred* is a way of saying that the dollar value in the account can change, and there are not any tax consequences until the money is withdrawn.

So you may be thinking, how do I contribute the money I make before taxes when all I receive is a paycheck after taxes are taken out? What you contribute to the account is classified as pre-tax on your yearly tax return. The contribution you make lowers your *Adjusted Gross Income* (commonly known as a deduction); meaning, your taxable income is now lower for the year. Let's look at the rules and restrictions:

<u>Contribution Limit</u> - You can only contribute $5,500 a year to this account if you are under the age of 50. If you are between the ages of 50 and 70.5 (Yes, 70.5…) then you may contribute up to $6,500 per year. The increased amount is called a catch-up contribution.

<u>Required Minimum Distributions (RMDs)</u> – An RMD is when the IRS requires that you withdraw some of the funds from your Traditional IRA at a certain age. Think about it from the Federal Government's perspective: what you contributed to this account has not been taxed (given you played by the rules), and they want back some of the money they printed. You must begin withdrawing from the account and pay ordinary income taxes on the income at the age of 70.5. The process of withdrawing from the account is called a distribution. What is the penalty for not following the RMD rule? You must pay 50% of the skipped RMD to the IRS.

Deduction Phase-Out – If you make too much money, the IRS will not let you deduct what you contribute. IRA deductions may also be limited if a person has an employer sponsored retirement account. Check out the IRS website for the exact rules on *Deduction Limits*.

Regular Distributions – The purpose for this account is retirement; therefore, you cannot withdraw funds from the account without a 10% penalty until you reach the age of 59.5 (Yes…59.5). After the age of 59.5, the distributions are taxed at your ordinary income tax level. There are some exceptions to the early withdrawal penalty such as using the funds to purchase your first home. For visual learners, here is a chart on the IRS website for *Early Distribution Exceptions*.

Roth IRA – So what if you don't want to pay taxes on distributions from an IRA when you retire? A Roth IRA is funded with after-tax dollars, is tax-deferred, and qualified distributions are not subject to federal income taxes. Qualified means you play by the rules set by the IRS. What you contribute towards a Roth IRA has already been taxed and will not be deductible on your yearly tax return. The distributions taken from the Roth account over the age of 59.5 are not taxed. Let's take a look at the rules and restrictions:

Contribution Limit – The $5,500 per year limit applies to both traditional and Roth contributions. Meaning, you can only contribute a total of $5,500 even if you have a separate Roth and traditional IRA. For example, if you contribute $3,000 to a traditional IRA, you can only contribute $2,500 more to either the traditional or a Roth IRA per year. Catch-up contribution rules also apply to Roth IRAs.

Required Minimum Distributions (RMDs) – NONE. Think about it: the IRS has already collected tax on the money invested in a Roth. There are not any age limits on when you have to withdraw the funds.

Eligibility Phase-Out – If you make too much money, you cannot open a Roth IRA. Check out the IRS website for the exact rules on *Roth Eligibility* .

Regular Distributions – After the age of 59.5, distributions from a Roth IRA are not taxable for federal income tax purposes. In addition to the age requirement, an account holder must hold a Roth for at least 5 years before being eligible to withdraw funds free of tax. The early distribution exceptions listed above also apply to a Roth IRA.

SEP IRA – Simplified Employee Pension Plan. This type of IRA is used by small business owners and self-employed persons to prepare for retirement. The acronym is often mistaken as representing the words 'self-employed persons' IRA. The purpose of a SEP IRA is to give small business owners and self-employed persons an alternative to establishing plans like a 401k. A SEP IRA is easier to set-up and maintain compared to a 401k. A SEP IRA is only slightly different than a traditional IRA. It is funded with pre-tax dollars and grows tax-deferred. Here are the rules and restrictions:

Contribution Limit – The incentive to open up a SEP IRA is the higher contribution limit compared to a traditional IRA. You can contribute 25% of compensation up to a maximum of $53,000 per year.

No Phase-Out – Make as much as you want, you can still open and fund a SEP IRA.

Required Minimum Distributions – Same as a traditional IRA

Inherited IRA – When an investor opens an IRA, there is an option to list a primary and contingent beneficiary. If the owner of the IRA passes away, the primary beneficiary will be transferred ownership of the account. If the account owner and primary beneficiary die, the account will go to the contingent beneficiary. The title of the account would look something like this: "James Jones, deceased, for the benefit of Carl Jones."

The rules for inheriting an IRA are different for spouses and non-spouses. If a spouse inherits an IRA, he/she will have more flexibility to determine when distributions are taken. If you inherit an IRA, consult with an experienced accountant to help you determine the best way to structure the plan.

Additionally, it is important to note that IRA inheritance bypasses the deceased's estate and transfers directly to the beneficiary listed.

Brokerage Account – Finally, moving past IRAs, a brokerage account is the prototypical investment account that does not have special tax treatment. A brokerage account enables an investor to purchase, trade, and hold different types of investments such as bonds, stocks, and mutual funds. The primary difference of a brokerage account compared to an IRA is that there is *no tax-deferral*. Brokerage accounts can be used in qualified (retirement) accounts as well as non-qualified accounts (retail). In this section, I am referring to non-qualified brokerage accounts. Let's look at a fictional example with Alex and Daniel:

- Alex purchases 10 shares of Coca-Cola Company stock on 01/01/2013 for $10 per share in a Roth IRA. Alex then sells the stock for $12 per share on 02/01/2014 and keeps the cash in the account. Alex had a $2 gain per share. Does Alex have to pay tax on the gain? No, because the gain took place inside a Roth IRA.

- Daniel purchases 10 shares of Coca-Cola Company stock on 01/01/2013 for $10 per share in an individual brokerage account. Daniel sells the stock for $12 per share on 02/01/2014. Daniel has the same $2 gain as his friend Alex. Does Daniel pay tax on the gain? Yes, because a brokerage account does not get the benefit of tax-deferral.

Now, as for what gets taxed, when it gets taxed, how much it gets taxed, and why it gets taxed, that is a lesson reserved for a different article. For a basic understanding of the account type, just know that a brokerage account does not have a special purpose such as retirement or education savings; therefore, the tax treatment of the account is not advantageous.

COMPANY-SPONSORED RETIREMENT PLANS

A lot of people get their first real taste of retirement saving when their employer hands them a form to select funds for a 401(k). While I hear that the Eeny, meeny, miny, moe method is popular, it may not be the most effective.

There are a handful of common company-sponsored plans out there. It is important to know what the capability of your company-sponsored plan is so you better understand how that account fits within your overall investment strategy.

401(k) – This type of account is set-up to contribute a specified amount out of the employee's salary to be invested pre-tax. A 401(k) has the benefits of tax-deferral and distributions are taxed as ordinary income (similar to a traditional IRA). Each pay period, the employer will do the administrative work to contribute the percentage you have selected to the 401(k) account. You will see the contribution on your paystub itemized before taxes are taken out.

The employer has the option of matching some, all, or none of the contribution you make. *Matching* refers to the employer contributing money to your 401(k) that is in addition to the employee contribution. Employers also have rules for vesting. *Vesting* is the process of slowly earning the rights to the funds the employer has contributed. In other words, the employer does not want you to take the money and hit the road; the employer wants you to hang around a while before you have access to the matching amounts. Let's look at some of the details you need to know about a 401(k)

<u>Contribution Limit</u> – For 2015, an employee can contribute a maximum of $18,000 to a 401(k). The employee and employer combined cannot contribute more than $53,000 annually. These limits are higher than a traditional or Roth IRA.

<u>Required Minimum Distributions</u> – After the age of 70.5, you must start taking distributions. This age is the same as a traditional IRA.

<u>No Phase-Out</u>

There is also a Roth 401(k). This account uses after-tax dollars to contribute to the account and distributions are not taxed as income. The plan is still administered by your employer and has the same contribution limits. The relationship between a 401(k) and Roth 401(k) is similar to that of a traditional IRA and Roth IRA.

403(b) – The main difference between a 403(b) and 401(k) is the type of employer who can administer the plan. These types of employers can use a 403(b):

- Non-profit organizations
- Public education organizations
- Cooperative hospital organizations
- Ministers who are self-employed or employed by a non-profit organization.
- ~~Circus clowns east of the Mississippi~~

In 2015, the rules and structure of a 403(b) and 401(k) are extremely similar. For the basic understanding, the main difference is listed above (and I hope you appreciate my humor).

Rollover IRA – So what happens when you retire or leave your current employer? A rollover IRA is the solution to getting the funds disconnected from your old employer. For example, a *direct rollover* will transfer the funds from a 401(k) to a rollover IRA. You do not have to 'cash-out' the account. Also, the rollover is not subject to any contribution limit.

A rollover IRA can be a Roth or a traditional. If you are rolling over a Roth 401(k), open up a Roth IRA rollover account and vice versa for a regular 401(k). Once the rollover is complete, the account will be treated like the respective account type. If you roll the funds into a Roth IRA, then Roth IRA rules apply.

The rollover concept is simple; however, many people are unaware that they have options. You may take advantage of the rollover option or simply leave the plan with your former employer. As this article is for educational purposes, this is a conversation to have with your financial advisor.

SIMPLE IRA – Savings Incentive Match Plan for Employees – This plan is designed to be utilized by employers with 100 or fewer employees. The title for this account is slightly misleading. The employer that initiates a SIMPLE IRA plan for eligible employees has a variety of options for funding the IRA. The two most common ways for the employer to fund the SIMPLE IRA are as follows:

1. The employer can match the contributions of the employees dollar for dollar up to 3% of employee compensation. If the employee does not contribute, the employer does not contribute.
2. The employer contributes a flat 2% of compensation regardless of whether the employee contributes to the account.

For the employee, they do not have to contribute anything, but the maximum amount they may contribute for 2015 is $12,500. The SIMPLE IRA rules for distributions are the same as a traditional IRA.

There is a significant amount of flexibility with a SIMPLE IRA. I have highlighted the main points, but if you are interested in more detail, see the IRS website for SIMPLE IRAs.

EDUCATION SAVINGS PLAN

So you just had a child, you have a child, or best of all, you now have a grandchild. How do you save for college education? In Georgia, you can try to rely on the HOPE scholarship to pick up some of the bill, but, it is increasingly becoming the norm to change your major a few times and become a super-senior on the five year plan. Take a look at a couple of account options below that may help you and your directionless student prepare for the future expenses.

Coverdell Education Savings Account – Are you looking for an account to help with primary, secondary, or post-secondary education? A Coverdell ESA has the flexibility for distributions to go toward qualified education expenses for more than just college. For example, distributions from a Coverdell ESA can go towards school uniforms, academic tutoring, books, and even some transportation.

Similar to a 529, the funding of a Coverdell is provided with after-tax dollars, investments grow tax-deferred, and qualified distributions are not subject to income taxation. There are key differences between Coverdell ESAs and 529s that need to be highlighted.

- The maximum contribution per year per child is $2,000
- The value within a Coverdell ESA must be distributed by age 30 or given to another family member below the age of 30.
- For single persons, you may not contribute to a Coverdell ESA if your income is greater than $110,000.
- For married persons filing jointly, you may not contribute to a Coverdell ESA if your income is greater than $220,000.

529 Plan – This account type can be used to save for education. The details for these plans will vary by state.

Any questions, whether they be situationally specific, hypothetical, or completely off the wall, can be directed to my email at ken@investplanadvise.com or call me 770-205-4394. When emailing, please include appropriate contact information.

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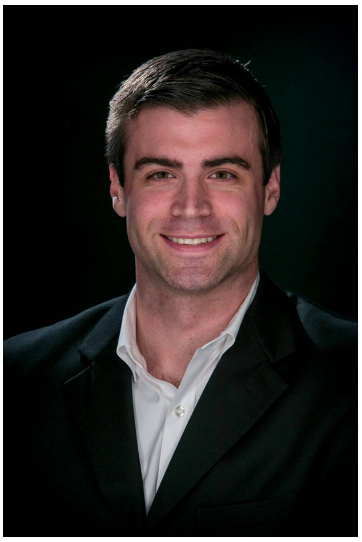

Ken Bellavance studied Finance at the University of North Georgia as a student/athlete. Ken graduated at the top of his class from the Mike Cottrell School of Business and received the Excellence in Finance award for his academic efforts within his field. After four years of college baseball, Ken ended his playing days as an Academic All-American.

As a professional, Ken worked at Provident Funding Associates as a Credit Analyst in the wholesale mortgage industry. He was able to develop a unique skill-set by participating in the mortgage lending process.

Ken and his wife Danielle live in Cumming, GA. They take full advantage of the beautiful North Georgia mountains by kayaking, hiking, and fishing. Being from Stone Mountain, GA, Ken is a Georgia Bulldawg, Atlanta Braves, and Atlanta Falcons fan. He also enjoys losing less than 10 golf balls when he plays a round of golf.