Understanding the individual retirement account

Traditional and Roth IRA’s

June 9, 2013

Acct. 4611

**Chris Ganzon**

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**Introduction**

In today’s economy, people are changing jobs and careers more frequently than before. Reasons such as better work life balance, relocation, or even increased pay top the list for individuals making career path adjustments. This leads to the important questions for many, “What investment vehicles are out there for me to better my future after retirement?”, or “What do I do with my current company 401k retirement to better my future financial outcome?” As individuals look to live comfortable lives during retirement, it is important to strategically plan as well as understand how to take your current financial standing or previous retirement and have the ability to invest with minimal monetary consequences especially those from taxes. In deciding the various routes to take in optimizing your retirement, having knowledge of the different retirement vehicles and their tax consequences and benefits as well as the negative implications of early withdrawal it is vitally important to understand in making the ultimate decision on your future retirement. Whether you are going to roll over your current 401k into a Traditional IRA, Initially invest in a Traditional or Roth IRA, or withdrawal those acquired funds early, understanding the fees and taxes of each option as well as the benefits or negatives and drawbacks can help you in deciding the best plan to reach your future financial goals. Though there are many investments that individuals can undertake, an individual retirement account either traditional or Roth gives people the ability to contribute with tax benefits that can maximize the investment.

**Traditional IRA**

The original purpose of the IRA was to provide an option for employees without a company pension plan to save tax-deferred money for their retirement (Reichert). The Traditional IRA allows individuals to contribute to the account tax free as well as receive tax free returns from the investment. This method however is taxed when the funds are withdrawn at the taxpayer’s future rate at the time of withdraw. Investors of Traditional IRA’s can begin withdrawing from their funds at the age of 59 ½. One caveat however is that using retirement plan funds from either the Traditional or Roth account before the age of 59 ½, the stated age, is complicated by Internal Revenue Code section 72 (t). If, for instance, an individual borrows money from a retirement account, it will cease to be an individual retirement account as of the first day of the tax year when the loan was made. This will trigger a constructive distribution to the individual of the value of all the assets of the account as of the first day of the tax year. This amount is taxed as ordinary income and may be subject to the 10-percent penalty tax explained in the internal revenue code[[1]](#footnote-1). There are some exceptions allowed by the IRC is to withdraw from the account which allows the investor to pull funds from the retirement without penalty if the use of the funds is for higher education expenses, health insurance premiums, or down payments on homes for first time buyers (Tannahill). In terms of contributions to an IRA, there is a limit of $5,500 per year to the amount that investors can contribute to the account. Individuals at or over the age of 50 can contribute an additional $1,000 which allows the ability to catch-up on contributions (Jones). This contribution limit is also dependent on the status of the contributor either being single or contributing jointly. The total amount of contribution depends on the combined compensation income. Section 219 of the IRC states, married individuals filing separate returns are subject to special restrictions regarding IRA contributions. However, such individuals who live apart at all times during a taxable year are considered single taxpayers for IRA purposes[[2]](#footnote-2). As an alternative option, if you are in a higher tax rate at the time you begin contribution to a Traditional IRA, it may be more profitable and advantageous to consider a Roth IRA (Where to put Retirement Savings).

**Roth IRA**

The key difference between the Traditional IRA and the Roth IRA is the impact of income taxes (Reichert). As mentioned, Traditional IRA’s are taxed when withdrawn, conversely, Roth IRA’s are taxed during contribution though are tax free when taken out. This is beneficial to investors who are taxed at a lower rate and expect to be placed in a higher tax bracket when the funds are removed in the future. Contributions to Roth IRAs are subject to one simple rule: Such contributions are not deductible and therefore consist of only after tax dollars (Jones)[[3]](#footnote-3). Unless there is a dramatic decrease in the tax bracket one expects to be in during their retirement years, the investor would have more money available for their retirement from investing in a Roth IRA. The Roth IRA has similar stipulations to the age maturity at the age of 59 ½. Though with the Traditional IRA the individual is required to start taking distributions, whether monthly or lump sums at the age of 70 ½. As with the Roth IRA this age limit does not apply[[4]](#footnote-4). Another difference that the Roth IRA has is the ability for owners to pass on the accounts to heirs tax-free while continuing to make contributions (Where to put Retirement Savings). These differences between the two IRA options have many beneficial features. It is for this reason that many individuals take advantage of the available option to rollover funds from a previous retirement investment account to an IRA.

**Rollover to a Traditional IRA**

In terms of individuals who previously had an employer sponsored 401(k) retirement plan, they have the option to rollover the funds to a Traditional IRA with no tax effects. An individual does not have the ability to rollover directly to a Roth IRA but does have the ability in the future to do so after rolling over into a Traditional IRA first. When a rollover is performed the funds go directly from one bank or brokerage firm to another without the owner touching the money en route (Slotte). In carrying out a rollover of accounts it allows the individual to continue building and increasing the funds for retirement. Rolling over to an IRA can also be beneficial due to the fact that many company sponsored retirement accounts are handled by human resources as opposed to a retirement plan professional who earns commission. Additionally once an employee is no longer with the previous employer that persons account is most likely receiving very little attention (Drucker). Although there are many benefits to rolling over to an IRA, it may not be feasible if there could be certain requirements that must be met in order to rollover from one account to another (Reichert). Only eligible rollover distributions may be rolled over in a tax-free transfer. An eligible rollover distribution is a distribution of all or any portion of the balance to the credit of an employee's account in a qualified plan (Kluwer). Certain distributions cannot be rolled over, including: corrective distributions; a distribution that is one of a series of substantially equal payments made at least once a year based on life expectancy or paid over a period of ten years or more; a required minimum distribution; a hardship distribution; a loan treated as a distribution; dividends on employer securities; permissible withdrawals from an eligible automatic contribution arrangement; and the cost of life insurance coverage treated as a deemed distribution[[5]](#footnote-5). Under all of these procedures, the untaxed portion of the account is recognized in income by the participant in the year of the rollover (Kluwer). For many investors, the option to withdraw funds from an IRA at maturity tax free may in many instances be more productive and provide for higher value upon retirement. Rolling over funds from a Traditional to a Roth IRA is a possibility that many investors can pursue.

**Rollover of Traditional to Roth IRA**

Individuals who rollover funds from a traditional IRA into a Roth IRA are converting a tax deferred investment to a tax exempt investment (Jones). In doing so the participant to the conversion must treat this conversion as a tax-deferred investment to a tax exempt investment. This will in turn result in the treatment of this taxable conversion to include the taxable amount of the rollover in gross income[[6]](#footnote-6). When a Traditional IRA is converted to a Roth IRA, the amount treated as distributed is the FMV of the annuity contract on the date the annuity contract is converted[[7]](#footnote-7). One of the reasons for converting from a Traditional to a Roth IRA is if an individual expects to be in the same or higher tax bracket in the future. Converting to a Roth IRA makes sense because the distributions are tax free (Drucker).

**Court Case -** Linda L. Domanico and Anthony M. Domanico v. Commissioner. (April 19, 2006)

“Tax Court: Summary opinion: Retirement plans: 401(k): Early distributions: Ten percent penalty: Exceptions. – Married taxpayers who received an early distribution from the wife's 401(k) plan were subject to the additional 10-percent tax imposed by Code Sec. 72(t). The taxpayers used the funds from the distribution to pay several years worth of the wife's higher education expenses. Although Code Sec. 72(t) (2) (E) provides an exception from the 10-percent addition to tax on early distributions from an individual retirement account (IRA) used for higher-education expenses, the taxpayer's 401(k) plan was not an IRA. The definition of an IRA is limited under the Code to retirement plans described in Code Sec. 408 (a) and retirement annuities described in Code Sec. 408(b). Although this distinction may appear to exalt form over substance, it is a distinction that is legislatively mandated. Further, that the taxpayers used the distribution for a laudable purpose did not override the fact that the court lacks general equitable powers and is constrained to apply the law as written.—CCH.”

Although the IRC allows for the 10% penalty to be waived for early withdrawal for higher education expenses from an IRA. In this case the funds that the defendant withdrew were not from an IRA but from an employer sponsored 401(K) qualified retirement plan. As such qualified retirement plans have varying stipulations on the penalties and exception from premature withdrawals. The 10 percent penalty applies only to the portion of a withdrawal included in the participant’s income. Individuals who withdraw funds from a qualified plan can avoid both the income tax and any premature withdrawal penalty by rolling the funds to an IRA within 60 days of the withdrawal (Jones). In this case Mrs. Domanico was a flight attendant for Trans World Airlines (TWA) and was injured on the job which lead her to leave the company and pursue an education in teaching. Upon leaving TWA the firm allowed her the ability to withdrawal the funds directly from her qualified 401(K) plan or rollover the balance to an individual IRA. In doing personal research on the various rules and regulations of such actions, Mrs. Domonico directly withdrew the entire amount of $40,457, in which she used $10,357 for her higher education expenses. At the time of the distribution she had not reached the eligible age for withdrawal of the funds. Consequently, on the Domonico’s 1040 individual income tax form they reported the $40,457 as income but did not report the additional 10% penalty tax for early distribution due to the idea that they were not subject to taxes on the withdrawal for higher education expenses. In support of their actions of using the early withdrawal for higher education purposes the petitioners relied on the Master Tax Guide paragraph 2179 explaining early distributions. However, the common retirement-oriented purpose of a 401(k) plan and an individual retirement plan may have led petitioners to a “finite misinterpretation” based on their reading of the Master Tax Guide, a 401(k) plan and an individual retirement plan are separate and distinct in that only withdrawals from an IRA may qualify for this exception[[8]](#footnote-8). The distinction between the two for purposes of section 72(t)(2)(E) may appear to exalt form over substance, but it is a distinction that is legislatively mandated (Kluwer). In conclusion, the court’s decision for Mrs. Domonico to apply the 10% tax penalty was a result of the fact that Federal tax law are the statutes, regulations, and judicial decisions and not guides such as the Master Tax Guide that are published by private commercial publishers.

**Conclusion**

In comparison of the Traditional and Roth IRA options, the investment in either can pose very beneficial returns dependent on the investor’s current and future financial standing and goals. The importance of taxpayers to fully understand the tax laws and regulations in regard to their retirement accounts is vitally important in order to maximize the benefits of the retirement accounts. Due to several penalties and potential taxing obligations from various actions in relation to investments in IRA’s, being fully compliant and knowledgeable is key in decision making. Even though Investment Retirement Accounts are in nature for the benefit of the investor, there are many finite details that are necessary to understand.

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1. (§18,922.0325) [↑](#footnote-ref-1)
2. (§219(g) (4) [↑](#footnote-ref-2)
3. (§219(g) (7) [↑](#footnote-ref-3)
4. (§219 (d) (1)) [↑](#footnote-ref-4)
5. (Code Sec. 402(c) (4); Reg. §1.402 (c)-2) [↑](#footnote-ref-5)
6. (§408A (d)(3)(A)(i)) [↑](#footnote-ref-6)
7. (§1.408 (A4)) [↑](#footnote-ref-7)
8. §. 72(t)(2)(E), 401(k), 408(a), and (b) [↑](#footnote-ref-8)