WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Like Goldilocks – Not Too Much, Not Too Little, But Just Right… Balancing IRA Contributions and Distributions in Lifetime Retirement Planning.

MARKET TREND: With individuals continuing to seek efficient methods for saving money while managing their overall tax exposure, individual retirement accounts ("IRAs") remain a desirable vehicle, with proper planning.

SYNOPSIS: Traditional and Roth individual retirement accounts ("IRAs") can provide an effective means of saving for retirement while managing an individual's related tax exposure. As both programs were designed to promote retirement savings, however, and not wealth accumulation, using IRAs involves a bit of a balancing act. To ensure the integrity of IRAs as retirement savings vehicles, they are subject to penalty taxes if distributions are taken prematurely. Yet, there also are strict limits on the amounts that can be contributed to IRAs, and, for traditional IRAs, penalties can apply if certain "minimum required distributions" are not made after the account holder turns age 70½. These requirements can limit the use of IRAs as vehicles for accumulating savings that may benefit future generations.

TAKE AWAYS: Individuals considering IRAs should assess their beliefs about future tax rates and their expectations concerning the relative amount of earnings that will accrue in their IRA to determine whether a traditional IRA (under which contributions are made on a tax-deductible basis and distributions are taxable) or a Roth IRA (under which contributions are made on an after-tax basis and distributions are not taxed) is preferable.

PRIOR WM REPORTS: 15-11.

Traditional and Roth IRAs can provide an effective means of saving for retirement while managing an individual's related tax exposure. As both programs were designed to promote retirement savings, not wealth accumulation, however, using IRAs involves a bit of a balancing act. Various tax rules govern the amount of contributions to these programs, as well as the timing and amount of distributions from the accounts, so that they are not taken either too early or too late, or in too small an amount. This Washington Report reviews how the different types of IRAs are taxed, the contributions that can be made, and the rules that govern IRA distributions during a holder's lifetime (see the attached comparison chart summarizing some of these rules).[1]

CONTRIBUTIONS - TRADITIONAL AND ROTH IRAs

Traditional IRA

Taxation. A traditional IRA is one that allows contributions to be made, within limits, on a tax-deductible basis. Contributions (and earnings thereon) held in the IRA generally are not taxed until distribution to the IRA holder or his or her beneficiary.

Contributions. Generally, in 2015, an individual can contribute $5,500 for a taxable year, which amount increases to $6,500 if the contributor is age 50 or older. If the IRA holder's total compensation for the year is less than the relevant one of these two amounts, his or her compensation will serve as the annual contribution limit for the year. The annual deductible contribution limit also may be reduced in certain cases, such as when an IRA holder (or his or her spouse) is covered by a retirement plan at work and has modified adjusted gross income ("**AGI**") in excess of the specified amount for his or her tax-filing status. The individual may still make a nondeductible contribution up to the applicable limit, in which case only the earnings on those contributions will be tax-deferred.[2]

Roth IRA

Taxation. A Roth IRA is one to which contributions are made on an after-tax basis but, if amounts are held in the IRA for a long enough period, neither the contributions or the earnings thereon will be subject to income tax upon distribution.

Contributions. Like a traditional IRA, the maximum amount that can be contributed for 2015 is $5,500 ($6,500 if the IRA holder is age 50 or older) and is subject to the same annual contribution limit based on compensation as the traditional IRA. Unlike traditional IRAs, however, the ability to contribute to a Roth IRA is limited by the IRA holder's modified AGI for the taxable year, regardless of whether the IRA holder or his or her spouse is covered by a retirement plan at work.[3]

Rollover Contributions

Another means of adding amounts to traditional and Roth IRAs is through a rollover contribution. Amounts can be rolled over from a tax-qualified retirement plan, a 403(b) annuity plan, a governmental 457(b) plan, or another IRA. The rollover can either be accomplished directly or, if the amount is distributed first to the taxpayer, the rollover must be made within 60 days of the original distribution.

Traditional IRAs. Any type of distribution can be rolled over to a traditional IRA, except for a distribution from a Roth account under a qualified plan or a Roth IRA.

Roth IRAs. Any amount can be rolled over to a Roth IRA, but if the amount is coming from a source other than a designated Roth account under a qualified plan or a Roth IRA, the amount rolled over will be subject to taxation to “convert” the amounts rolled over to Roth amounts.

DISTRIBUTIONS - TRADITIONAL AND ROTH IRAs

Not Too Early

As noted, IRAs are designed to facilitate retirement savings, not to operate as general savings accounts. Accordingly, if amounts are withdrawn from an IRA before a certain time, a penalty tax will apply.

Traditional IRAs. Generally, traditional IRA distributions are subject to income tax when made. Further, distributions made before an IRA holder attains age 59½ will incur an additional 10% penalty tax on the taxable amount of the distribution, unless one of the following exceptions applies:

- You have unreimbursed medical expenses that are more than 10% (7.5% if you or your spouse was born before January 2, 1950) of AGI;
- The distributions are not more than the cost of your medical insurance due to a period of unemployment;
- You are totally and permanently disabled;
- You are the beneficiary of a deceased IRA owner;
- You are receiving distributions in the form of an annuity over your life or life expectancy (or the joint lives or joint life expectancies of you and your beneficiary);
- The distributions are not more than your qualified higher education expenses;
- You use the distributions to buy, build or rebuild a first home;
- The distribution is due to an IRS levy of the IRA; or
- The distribution is a qualified reservist distribution.

Roth IRAs. Contributions made to a Roth IRA can be withdrawn anytime, without imposition of income tax or penalty tax. However, both income tax and an additional 10% penalty tax may apply to certain premature Roth IRA distributions.

For income tax purposes, the earnings portion of a Roth distribution is subject to income tax if the distribution is not a “qualified distribution” – i.e., any ***distribution made after a five-year holding period***, beginning with the year the IRA was created and funded with the first contribution, and which is made under one of the following conditions:

- On or after the date on which the owner attains age 59½,
- To the owner’s beneficiary or estate after the death of the owner,
- Due to the owner’s being totally and permanently disabled, or
- To buy, build or rebuild a first home.

Regardless of income taxation, both qualified and non-qualified distributions may incur a 10% penalty tax if the distribution is made before age 59½ and none of the exceptions discussed above apply.

Not Too Little or Too Late…

For IRAs, rules exist that prevent IRA assets from remaining in the IRA indefinitely. These so-called "minimum required distribution" ("**MRD**") rules require that distributions from IRAs begin by a certain time and be made in certain specified amounts. While MRD rules apply to beneficiaries of both traditional and Roth IRAs after the account holder's death,[4] only traditional IRAs have MRD rules that apply during the account holder's life. ***No MRDs are required from a Roth IRA during the lifetime of the IRA holder.*** The following summarizes the lifetime MRD rules applicable to traditional IRAs.

For traditional IRAs, the MRD rules require that the IRA holder begin taking distributions as of April 1^{st} following the year in which he or she attains age 70½. This date is referred to as the IRA holder's "required beginning date" ("**RBD**"), and a distribution must be made by the RBD and again by each subsequent December 31^{st}.

As the MRD rules are designed to support retirement, they cause the IRA assets to be distributed over the joint life expectancy of the account holder and his or her beneficiary, <u>if</u> that beneficiary is the holder's spouse. Otherwise, to avoid an excessive delay in the distribution of the IRA account balance, if the account holder's designated beneficiary is not his or her spouse, distributions are made over the joint life expectancy of the IRA holder and a hypothetical beneficiary who is ten years younger than the IRA owner. The appropriate life expectancies are set forth in tables contained in the applicable IRS regulations.

It is extremely important to observe these MRD rules. An account holder's failure to take the full MRD for any year will result in application of an ***additional 50% penalty tax*** on the shortfall between the MRD and the amount actually distributed.

TAKE AWAYS

- Based on the above, individuals considering IRAs should assess their beliefs about future tax rates and their expectations concerning the relative amount of earnings that will accrue in their IRA to determine whether a traditional IRA (under which contributions are made on a tax-deductible basis and distributions are taxable) or a Roth IRA (under which contributions are made on an after-tax basis and distributions are not taxed) is preferable.

Comparison: Traditional & Roth IRAs: Lifetime Contributions and Distributions

	Traditional IRA	Roth IRA
Taxation	• Tax-deductible contributions • Taxable distributions	• After-tax contributions • Withdrawal of contributions without imposition of tax • Qualified distributions without imposition of tax (made after 5-year holding period and to the account holder or under other specified conditions)
Contributions (2015)	• Limited to $5,500 ($6,500 if age 50+) • Deductible contribution limit reduced if IRA holder (or spouse) is covered by a work retirement plan and has modified AGI in excess of specified thresholds • Nondeductible contributions up to applicable limit allowed	• Limited to $5,500 ($6,500 if age 50+) • Ability to contribute is limited if holder's modified AGI is in excess of specified thresholds. regardless of whether IRA holder (or spouse) is covered by work retirement plan
Rollovers from Specified Plans/Other IRAs	• Can rollover any distribution amount to IRA, except from a qualified plan Roth account or a Roth IRA	• Can rollover any amount to Roth IRA, but if not from a designated qualified plan Roth account or Roth IRA, rollover amount subject to tax
Lifetime Distributions	• MRDs after account holder attains 70½	• No MRDs during account holder's life
Additional Penalties	• 10% penalty for distributions before age 59½, unless exception applies • 50% penalty on shortfall between MRDs and actual distribution taken during account holder's life	• 10% penalty for distributions (qualified or non-qualified) before age 59½, unless exception applies

NOTES

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[1] *See WRMarketplace No. 15-11* for a discussion of the transfer and distribution rules that apply following the death of a traditional IRA holder.
[2] The contribution for any year must be made by the individual's deadline for filing the tax return for the year, without extensions, for which the contribution is made (generally, April 15th of the following year).
[3] Like traditional IRAs, the contribution for any year must be made by the individual's deadline for filing the tax return for the year, without extensions, for which the contribution is made (generally, April 15th of the following year).
[4] *See WRMarketplace No. 15-11* for a discussion of the MRD rules that apply following the death of a traditional IRA holder.

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