Saving for Retirement Outside of Employer Plans

North Star Resource Group Contributors Column

Preparing for retirement is oftentimes a main concern for physicians as they begin building a financial foundation for their future. A common question when saving for retirement is that if you are taking advantage of your employer-sponsored plans, what other savings vehicles are available? In this article we will touch on using Traditional and Roth IRAs to continue to build your retirement savings.

What are Traditional IRAs and Roth IRAs?

- A Traditional IRA and Roth IRA are individual retirement accounts that allow you to accumulate retirement funds outside of your employer-offered retirement plans. Both of these investment vehicles have very unique benefits and, for certain people, can be a beneficial part of a diversified financial strategy. The current maximum contribution limit for both the Traditional and Roth IRA is $5,500 per year (as of December 2017). For people who are age 50 or older, the government allows you to make “catch-up contributions” increasing the maximum to $6,500 per year.

Am I eligible to fund a Traditional IRA or Roth IRA?

- To be eligible to fund a Traditional IRA you need to have taxable income for that year and fund this account before you reach age 70 ½.
- The Roth IRA has additional eligibility restrictions compared to the Traditional IRA. The factors that go into deciding whether or not you are eligible to fully fund a Roth IRA are your income and tax filing status. For a single individual, you have to make $118,000 or less to be eligible. As a married couple filing jointly, you have to make a combined income of $186,000 or less to be eligible. If you are a married and filing separately, you have to make less than $10,000 a year to be eligible to fund a Roth IRA. If you fall into the married filing separately category, there is a conversion method you can use called the “Backdoor Roth IRA” that we will be discussed later.

What are the tax benefits for a Traditional IRA vs. Roth IRA?

- The first tax benefit for the Traditional IRA is the ability to make pre-tax contributions much like a 401(k) or 403(b). By making these contributions on a pre-tax basis, you will be able to fully or partially deduct your contribution for that year off of your gross income and lower your taxable income. You should consult your tax advisor to determine whether you are able to fully or partially deduct your contribution depending on the rules set by the IRS. After you make your annual contribution into your account the funds that are being invested grow on a tax-deferred basis which allows the funds to grow without being taxed until you withdraw them in retirement. Once you are retired and ready to begin making withdrawals from this account, it will be subject to federal income tax.
- When utilizing a Roth IRA, the contributions made during the year are done with after-tax dollars and grow tax deferred like the Traditional IRA. The main advantage of this account is that
in retirement you are able to withdraw these funds completely tax free, which can offer you tax diversification in retirement when deciding where to withdraw income.

When can I withdraw money from my Traditional IRA and Roth IRA without penalty?

- You are able to begin withdrawing from your Traditional IRA without incurring a 10% penalty once you reach the age of 59 ½; however, you will still be taxed on the withdrawal at your ordinary income rate. For people under the age of 59 ½, there are a few exceptions of where you are able to withdraw funds without incurring a penalty. These exceptions are made for a first-time home purchase, qualified educational expenses, death or disability, unreimbursed medical expenses and health insurance if you are unemployed. If you elect not to withdraw from your Traditional IRA and reach the age 70 ½, the owner will have to begin taking mandatory minimum required distributions from the account or incur penalties.

- If you are contributing to a Roth IRA, you are able to begin withdrawing funds tax and penalty free at age 59 ½. Much like the traditional IRA, you have a few exceptions that allow you to withdraw funds without penalties (e.g. death, disability, or a qualified first time home purchase).

Unlike traditional IRAs, Roth IRAs are not subject to minimum required distributions during the lifetime of the original owner of the account.

Once my income goes above the income restrictions can I still fund my Roth IRA?

- As mentioned briefly in the beginning of this article, if you do not qualify to contribute to a Roth IRA directly (based on income restrictions or filing married but separately), you can still utilize the “Backdoor” method to fund the account. The first step in this strategy is to open up a Non-Deductible Traditional IRA which you will fund with after-tax dollars. Once you make the contribution to the Non-Deductible Traditional IRA you will have to fill out a conversion form which will then convert the money to your Roth IRA.

- This strategy can also be used if you have old retirement accounts from past employers as you are able to roll over an old 401(k) or 403(b) to your Non-Deductible Traditional IRA and then convert these funds into your Roth IRA. One thing to consider before moving forward with this strategy is that, based on the funds in your 401(k) or 403(b) not being taxed yet, you will owe taxes on the amount you decide to convert into your Roth IRA. This can be beneficial if you have old retirement accounts during training as you will be able to convert this money and get a jump start on building tax free savings for retirement and will pay the taxes at your lower income bracket. If you are currently thinking of taking advantage of this strategy you should consult both your financial advisor and tax advisor to make sure this is an efficient strategy for you.

What is the pro rata rule when utilizing the “Backdoor” Roth IRA Method?

- If you have individual retirement accounts such as Traditional IRA’s or a Simplified Employee Pension IRA (SEP IRA), then you must factor in the Pro Rata Rules when converting a Non-Deductible Traditional IRA to a Roth IRA. As we mentioned above, if you convert the entire amount of a Traditional IRA or SEP IRA to the Roth IRA, then you are subject to paying income tax on this conversion. However, if you intend on only converting a portion of your traditional IRA to the Roth IRA, then you will be subject to the Pro Rata Rule. We have listed an example of this below:
Let’s assume that you have $94,500 in a Traditional IRA which is all pre-tax, and you would like to make a “Backdoor” Roth IRA contribution of $5,500 which is non-deductible for the year. In this example, you would not owe taxes simply on the $5,500 non-deductible contribution that is being converted, but instead, you would owe taxes based on the proportion of your IRA money overall that is before tax and after tax. When we breakdown the numbers in this example, the total IRA balance would be $100,000, of which $5,500 would be after-tax. Therefore, only 5.5% this Roth IRA conversion will be tax free ($5,500 / $100,000 = 5.5%). This means that only $302.50 ($5,500 x 5.5% = $302.50), of the non-deductible contribution would be tax free, while the remaining $5,197.50 ($5,500 - $302.50 = $5,197.50) would be taxable. If you are currently thinking of taking advantage of this strategy you should consult both your financial advisor and tax advisor to make sure this is an efficient strategy for you.

Developing a strategy and deciding what retirement vehicles are most efficient for you are important steps in creating a bright future and providing you the retirement lifestyle you are working to obtain. There are many resources that you can take advantage of to learn more about these vehicles, and being proactive in developing a strong retirement strategy can provide the retirement you always imagined.

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