IRA UPDATE: APRIL 2013

Generally speaking you can contribute the maximum to an IRA (references to IRAs will include Roth IRAs as well) of $5,500 (for 2013) plus $1,000 catch-up contribution if you reach age 50 during the year as long as you have at least that amount of income to make the contribution. Most people generally focus on their ability to make IRA contributions for themselves. But what about making IRA contributions for other people?

Spousal contributions

If you have a non-working spouse (or the spouse does not have income high enough to make the contribution), you can make a contribution for your spouse as long as the total income for the couple is at least the amount of the contribution. The spouse must meet all contribution requirements except for the fact that they do not have compensation. For example, the spouse must be under age 70 ½. In order to make a spousal IRA contribution, you must file joint tax return.

Participation in an employer provided retirement plan does not impact eligibility to make an IRA contribution however it is the deductibility of the IRA contribution that would be in question. When only one spouse is active participant in an employer plan, the deductibility is figured on different threshold amounts which you can find by going to http://tinyurl.com/2013RetirementChart.

There is no order requirement for spousal IRA contributions. For example, the taxpayer can make a spousal contribution without one for themselves, a partial for themselves and full for the spouse, or partial for both. There is also no requirement that both spouses contribute to the same kind of IRA. One can contribute to a Roth (if eligible) while the other to a traditional IRA.

Same-sex married couples will face a different set of rules however. Same-sex spouses who are legally married in their state are currently not considered married at the Federal level under DOMA (Defense of Marriage Act) and therefore cannot make spousal IRA contributions until this law is changed (as of 6/26/2013, the Supreme Court has struck down DOMA allowing legally married same-sex couples to receive federal benefits. It may be some time until we know how this affects other tax issues such as spousal IRA contributions).

Contributions for children

Suppose your 15 year old gets a summer job and makes $2,000. Are they likely to save any of that money; probably not because young people typically are not good savers. Teaching children to same money however is certainly an excellent idea but aside from the point today.

The main requirement to contribute to an IRA is having enough earned income. In my example, the child has made $2,000 and while the maximum IRA contribution is $5,500, the child would only be able to contribute $2,000. The tax

code does not specify where the money must come from thus you as a parent (or grandparent) could make the contribution for the child (or grandchild). For those who want to help out their children or grandchildren, this is an excellent way to give a monetary gift. If the child is a minor, then a custodial IRA must be set up and the child would have full access once they reach that age of majority however this gives the child a huge boost in retirement savings.

Most young people will not even start to think about saving money well into their late 20's and early 30's and that assumes they find savings to be important. Many people do not take savings seriously until they reach their 40's. So let's assume the age of 30 for when an individual would start saving on their own and assume that they will make a maximum Roth IRA contribution of $5,500. Assuming an 8% average rate of return (over a 35 year period is reasonable), their Roth IRA would grow to $1,023,562 ($198,000 of contributions). If you contributed $2,000 per year for 15 years starting at age 15 for the child, assuming the same 8% return, the child would have $58,649 at age 30 when they start saving on their own which would grow to $867,146 by the time they reach age 65. That's a huge bonus especially considering that the original contributions only added up to $30,000 in total! This shows the importance of the time value of money. Together this child would have $1,890,707 at age 65.

For a child that is probably in a low tax bracket, a Roth IRA probably makes the most sense. It would allow them to grow a tax free account for decades, the contributions of which would be accessible at anytime for any reasons free of tax or penalty. This makes an IRA contribution for a child a great idea! One way to encourage the child to save on their own would be to match any savings they do (could be any amount such as $5 for every $1 they save) into the IRA, subject to the maximum limits of course.

IRA contributions for parents

There are a couple of potentially good reasons to make an IRA contribution for a parent. Suppose you are not eligible to make a Roth IRA contribution, you could gift money to a parent to put into a Roth IRA in their name. Or if they are in a lower tax bracket than you, provide money to contribution to a regular IRA which they could convert at a lower tax bracket. Or you could simply provide a gift of cash to help pay tax on a conversion of their own IRA to Roth. Either way, you help your parent build tax free income which could lower their tax liability and also possibly increase the value of the inheritance you may one day receive. While there are no Required Minimum Distributions for Roth IRA owners, there are RMDs for Roth IRA beneficiaries, so when you inherit the Roth IRA you helped build, you will be forced to take distributions starting the year after death however those distributions would be tax free and could then be used for any number of potential needs.

Keep in mind that making an IRA contribution for a parent or child means loss of control of the funds which may impact your decision to engage in such a gift.

Widow's penalty

After one spouse dies, the survivor is likely to be subject to higher marginal and average tax rates. Generally speaking, there will be an expectation of lower income due to loss of the spouse's social security benefit and a pension if there is one (and it is not set as a survivor benefit) and thus income can be expected to go down. However, even with a loss of income, the survivor still may be subject to higher tax.

Once the surviving spouse starts filing as a single taxpayer, he/she will be faced with lower brackets but similar income at least and until (if) the spouse remarries. For example, a married couple with $60,000 of income will be subject to the 15% tax bracket however if one spouse dies, even with a loss of say $10,000 from Social Security, the survivor will now be in the 25% tax bracket. In such a case, there is lower income and higher taxes! Not only does the marginal tax rate increase, so does the average tax rate (the average % they pay on every dollar of income).

Other potential tax changes include lower thresholds for phase-outs, the new 3.8% surtax on net invest income, Alternative Minimum Tax (AMT), and Medicare Part B stealth tax. For example, the survivor would lose a personal exemption, part of the standard deduction (if they do not itemize) or itemized deductions may be lower. Now with the 10% threshold for deducting medical expenses, the survivor will have a harder time hitting that since there would be medical expense for only one person but possibly similar income.

Income may not be much lower for some survivors. If the survivor inherits retirement accounts for example, the required minimum distribution may push the survivor into brackets higher than they might normally be subject to if it were not for the death of their spouse. While there would be a loss of social security, that loss may not be much if one of the spouses was collecting 50% of their spouses amount via the spousal benefit which means Social Security income would only go down by 1/3 at the death of the first spouse. For those who have pensions, especially if a 100% survivor option is chosen, the pension income will not change. If there is a life insurance policy that pays out, that would then cause an increase in investment income (life insurance is income tax free but the future earnings are not) which could offset any loss in income from Social Security or pension reductions.

This widow's penalty can make Roth conversions very attractive to the surviving spouse. Consider converting and paying tax now to reduce the future potential tax increase. This may not work for everyone however and thus you must determine if your surviving spouse would face this increased tax situation.

If after analyzing your own situation, you come to the conclusion that your surviving spouse may be subject to higher taxes, Roth conversions may make sense for you. If you assume tax rates will be the same, then converting now locks in the current tax rate to hedge against tax rates going up (due to US fiscal problems). Even if tax rates stay the same, by using taxable assets to pay for the conversion for money that would be taxed at the same rate anyways, you reduce the tax drag on those investments and reduce required minimum distributions. Remember that Roth conversions are not an all or nothing proposition; you can convert small amounts each year to keep you in the same tax bracket. For some that have a very low income (or even negative income) due to deductions, you may be able to do tax free Roth conversion which in my opinion there is no reason not to, or conversions at very low tax rates such as 10% and lock in that tax rate now.

For those who do not want to pay the tax on conversions now, life insurance can be a viable strategy. For a relatively small premium, the survivor would have liquid cash that could be used to do conversions after death, or simply extra funds to pay potentially higher taxes. Investments in life insurance can provide a reasonable IRR (internal rate of return) similar to a bond portfolio that would not bear the same risks of rising rates that traditional bond portfolios now face.

As is the case with tax planning concepts, they will not apply to everyone. Be sure to discuss these matters with a properly trained financial planner and tax professional to determine if these strategies are right for you. If you would like to discuss how these strategies may apply to your individual situation, please contact me directly or schedule a meeting at http://booknow.so/PortnoffFinancial.

Sincerely,

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