The New Three-Legged Stool ....Update

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Are Roth IRAs Protected from Creditors?

Protection of retirement account assets from creditors during a bankruptcy was a matter of state law until the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was signed into law. Until then, only ERISA plan assets (mainly company sponsored plans) were protected by federal law. Protection for IRAs depended on your state of residency.

BAPCPA excludes from bankruptcy up to $1 million per individual in assets that are held in Traditional IRAs and Roth IRAs. This amount is reviewed every three years and adjusted for inflation. It increased to $1,095,000 in 2007 and $1,171,650 beginning April 1, 2010. This limit does not include amounts rolled over from employer sponsored retirement plans as those assets are excluded for unlimited amounts.

A recent court case determined that this exemption does not apply to inherited IRAs or Roth IRAs. A daughter inherited her mother's IRA and then filed for bankruptcy. A district court found that only the daughter's own retirement funds qualify for the exemption. An inherited IRA remains titled in the name of the decedent for the benefit of the heir. Since the IRA is not titled in the daughter's name, the assets are available to the creditors.

BAPCPA does not protect assets from an IRS tax levy. Neither can any state or local law exempt property from an IRS levy to collect federal tax. Because retirement accounts provide for the taxpayer's future welfare, the IRS will levy these assets only in flagrant cases. One small positive note, Congress established an IRS tax levy as one of the eight exemptions to the 10% premature withdrawal penalty for those under age 59 ½. However, the IRS must go into your retirement account and take the funds in order to qualify for the penalty exemption. A recent court decision found that those assets are still subject to the penalty if you withdraw them to pay an overdue tax bill. In both instances, the funds withdrawn are subject to income tax.

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Convert Your IRA to a Roth Without Feeling the Tax Bite?

There is a ploy going around asserting that high tax bracket households can convert their IRAs to a Roth without feeling the tax hit now. The strategy is to take out a line of credit for 140% of the amount of the conversion. Some of the credit line will be needed to pay the tax on the conversion. The rest is used to buy interests in life settlements. A life settlement is an established life insurance policy on an individual who is either elderly or otherwise has a shorter life expectancy. These policies are bundled and resold to investors. The investors are then responsible for paying the premiums until the policy holder dies.

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Convert Your IRA to a Roth Without Feeling the Tax Bite ?

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The argument for life settlements is that everyone is eventually going to die and therefore your investment return is guaranteed. It's just the timing that is uncertain. The amount of your return is also uncertain since you don't know how long you will be required to pay premiums to keep the policy in force. You also have the cost of the debt service if you follow this strategy by using borrowed money to buy the life settlements.

The strategy appears to be a gimmick to attract investors into life settlements which have hefty commissions. I don't see the connection to Roth conversions other than the illusion that you aren't really paying tax on the conversion since you are getting your money back when the policyholder dies. I don't see any advantage to implementing this strategy over simply borrowing the money to pay just the tax bill. Moreover I haven't found a reputable expert that is recommending this strategy.

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NEED A SECOND OPINION?

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Is your retirement plan tax efficient?

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The New Three-Legged Stool

A Tax Efficient Approach to Retirement Planning
By Rick Rodgers

Imagine you're playing a game called Retirement Distribution. Your opponent, the IRS, wrote the rules of the game. The secret to winning this game is to keep the IRS out of your financial affairs before they have the right to interfere. To win, you will need a guide to the fine print in the rule book, and a sound strategy.

www.thenewthreeleggedstool.com

Roth IRA or 401(k) - Which is Best?

The financial press often touts your company's 401(k) as the "no brainer" savings choice. Congress apparently agreed with this assessment and enacted legislation a few years ago that allows employers to automatically enroll their employees in the company 401(k) plan. Many employees now have to opt out of the company's plan rather than elect to participate. 3% to 6% of the employee's wages are then invested in the 401(k) where the default investment is typically an age based life cycle fund. The plan has been successful. Of companies with 1,500 employees or more, half now are participating in the 401(k).

A 401(k) plan is an easy way to save for retirement. The contribution is taken out of your paycheck before you can spend it. The savings is done pre-tax which is like having the government make part of the contribution. On top of these benefits, many employers will match a portion of the amount saved creating an immediate return on the dollars invested. It would seem the "no brainer" tag line is well deserved.

I will concede that if a person would not save anything unless it was taken out of their paycheck and placed in the 401(k) that this is the best option. However, for those that are disciplined to save in whatever type of account is best, there may be better alternatives. What if you are in a low tax bracket? What if the employer doesn't make contributions? Where is the best place to save?

Taxpayers in the 15% tax bracket with no employer match would do better to opt out of the company 401(k) and make Roth IRA contributions. The 15% tax bracket applies to joint filers with taxable income up to $68,000 in 2010 (single filers up to $34,000). Your taxable income is the amount of income subject to tax after all of your itemized deductions and personal exemptions are applied. You will probably never be in a lower tax bracket but you may be in a higher tax bracket in the future. Tax brackets could go up and so could your income. This is especially true for younger workers who have not reached their peak earning years. You will be giving up a small tax advantage today in exchange for a lot of tax-free income in the future.

Some employers offer a Roth 401(k) option. This option would allow you to save more in a Roth 401(k) each year than the current maximum of $5,000 ($6,000 if you are 50 years of age or older). If you have a Roth 401(k) option at work but will not be saving more than $5,000, you should invest your savings in an individual Roth IRA to avoid the investment option limitations that apply to most company 401(k) plans.

I recommend that taxpayers in the 25% bracket look at how much they would need to put into a 401(k) plan to reduce their tax bracket to 15%. Only put in enough to reach that level and then put the rest of your savings in a Roth IRA. For example, John and Mary Smith have joint taxable income of $75,000. They plan to save $10,000 this year for retirement. The Smith's should have $7,000 deferred into their company 401(k) plan to reduce their taxable income to $68,000. The remaining $3,000 should be saved in a Roth IRA.

You can make a Roth IRA contribution this year as long as you have earned income and your Adjusted Gross Income (AGI) doesn't exceed $167,000 for joint filers ($105,000 for single filers). Once your AGI exceeds these levels, you can make a partial contribution until your income reaches $177,000 ($120,000 for singles) and then you are not eligible to make any Roth contributions. Anyone that is not eligible to make a Roth contribution could make a non-deductible IRA contribution and then convert it to a Roth. However there are complications to this strategy if you have other IRA accounts. (See the February 2010 newsletter for an article on the Pro Rata Rule at www.rodgers-associates.com)

This would be another level to try to reach if you can reduce your income with 401(k) deferrals so that you become eligible to make Roth contributions. Jim and Sally Jones are expecting their AGI to be $200,000 this year which would make them ineligible to fund Roth IRAs. They can each put $16,500 into their employer's 401(k) plan (total of $33,000). Making the maximum contribution to their 401(k) plans would reduce their AGI to $167,000 so they can each fund a Roth IRA for 2010.

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Rick's Tip - The Biggest Financial Planning Mistake? Not having a Written Plan.

It is easy for life to get in the way of creating a financial plan. Demands from work and family can easily crowd out time to work on a plan for your future. This can be a costly mistake because time is your greatest ally. The sooner you have a plan in place the greater the probability of reaching your goals.

There are other benefits to having a written plan. A recent survey by the Certified Financial Planner Board of Standards found those with a written financial plan are more satisfied with how their finances are managed, more confident about their financial decisions, and less worried about being financially secure at retirement. We can all use a little boost in confidence.

Financial planning begins with visualizing how you want to live the rest of your life. Where do you want to live? What do you want to do? Once you have a firm idea of what your future should look like, you can spend some time quantifying how much it will cost. Only then can you put together a savings and investment strategy to help you get there.

A solid financial plan will also include asset protection. This would include life insurance, property and casualty (as in homeowners coverage and automobile), and disability. Don't forget an umbrella liability policy. Umbrella coverage is fairly inexpensive and most financial planners are recommending $2 million of coverage these days. You should check to see if you already have some of these coverages like life and disability insurance through your employer.

The goal should be to create a comprehensive plan that will help you understand how each financial decision affects other areas of your finances. Look for ways to create efficiencies in all aspects of your plan. For example, suppose you receive an inheritance and use it to pay off your mortgage. That frees up more of your earnings to put into your retirement plan. But your taxes rise because you've lost your mortgage interest deduction, and your expanding net worth means estate taxes could become a problem. Like a compass, your financial plan keeps you pointed in the right direction even as your life inevitably changes. What's more, the comprehensive nature of financial planning should help you avoid major mistakes.

Developing a plan takes time, but often, simply articulating your values, hopes, and dreams can increase your motivation to save. Your plan also enables you to chart your progress. Review and regularly revise it as needed, and it will be a road map that can last a lifetime.

The sooner you get on the planning road, the better. As Yogi Berra once said, "If you don't know where you are going, chances are you will end up somewhere else."

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Visit http://www.rodgers-associates.com/retirement-newsletter/ to see how to write a plan.

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