

# The Sgroi

## THE ROTH IRA

*As noted in the previous issue of The Sgroi Financial, The Tax Payer Relief Act of 1997 created a new type of Individual Retirement Account, the Roth IRA.*

Individual Retirement Accounts, IRA's, are investment accounts, insurance company annuity plans or bank depository accounts expressly established for one individual's retirement needs. Funds from an IRA may also be used for certain specific, legally approved purposes, which are more fully explained later in this article. There are no joint or group owned IRA's, only individual accounts. Even with a group sponsored IRA, once the funds are deposited into the individual employees plan, they belong wholly to that person. This is called vesting, which means to place something in a person's possession.

Traditional IRA's allowed a person to contribute \$2,000 annually to their IRA so long as they were earning at least that much in *Earned Income*. Earned income being money received for services rendered, such as wages, tips or bonuses. *Unearned Income* includes things such as interest, dividends, rents or pension income. If the person's income was below certain limits or they were not covered by other pension plans, contributions could be deducted for income tax purposes.

Roth IRA's were named after Senator William Roth Jr., Republican from Delaware and Chairman of the Senate Finance Committee. Senator Roth was the prime mover behind these IRA's and is being rewarded with a huge amount of positive name recognition.

Numerous questions have been raised about Roth IRA's and we will attempt here to answer those most frequently asked.

### **Who may contribute to a Roth IRA?**

Any individual, *of any age*, who has an earned income of at least \$2,000. If they file their income taxes as a single individual their adjusted gross income may not exceed \$95,000 to be able to contribute the full \$2,000. The amount of allowed contribution reduces when their income rises above that and is prohibited once their adjusted gross reaches \$110,000. For those who file joint returns, \$2,000 for both partners is permitted and the income limits go from \$150,000 to \$160,000. Persons who are married and file separately may not contribute to a Roth IRA if their adjusted gross income is \$10,000 or more.

### **Are contributions to a Roth IRA deductible?**

No.

### **Are the earnings in the account Taxed?**

No. Just like a traditional IRA, any interest, dividends or growth of capital is not taxed as long as it remains in the account.

### **Are the withdrawals taxed?**

**NO!** There are certain guidelines for withdrawing funds, but this is the terrific advantage of a Roth IRA. Provided you follow the guidelines, whatever your account is worth is yours... **tax free**.

### **What are the withdrawal guidelines?**

Generally, once the account has been in existence for 5 years withdrawals may be made after one reaches the age of 59 1/2. Withdrawals made prior to 59 1/2, with certain exceptions, are subject to a 10% penalty.

The exceptions to the above are noteworthy. \$10,000 may be withdrawn for the down payment on a house for a first time home buyer. The home buyer may be the account owner, their spouse, child, grandchild or other qualifying relative. Funds may also be withdrawn in the case of disability or upon death.

The other major exception, possibly the most important, would be for secondary education expenses at a qualified institution. College or university tuition, books, room and board would all fit in under this heading. The expenses must be for oneself, a spouse, a child or a grandchild.

There are some rules with this type of withdrawal which we'll try to make as simple as possible. If the owner of the account is less than 59 1/2 years of age they may withdraw the amount of their original contribution penalty free and tax free. If they withdraw more than contributed, then any gains, interest, or dividend earnings are taxed as ordinary income. If the owner is over 59 1/2 years old, a grandparent say, then all withdrawals may be taken out tax free.

### **Must withdrawals be made at a certain age?**

No. Unlike traditional IRA's, where withdrawals must start no later than 70 and 1/2, there is no age when minimum distributions begin.

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### **Can a traditional IRA be converted into a Roth IRA?**

Yes. Individual or married couples with adjusted gross incomes less than \$100,000 may convert an existing IRA, in

# A personal letter from Joe

Dear Friend,

Hello. I hope that all is well with you and your loved ones and that 1998 is shaping up to be the type of year you wanted. We will do everything we can to make your financial future as prosperous as possible.

This issue of our newsletter deals with several important topics. Roth IRA's are proving to be extremely popular and for all the right reasons. They offer tax free growth of the contributions made along with less restrictions on deposits and withdrawals. They also offer some unique opportunities for you parents and grandparents. For instance, if you were interested in making a financial gift to a child or a working grandchild, you could open a Roth IRA for them. We just need to be sure they meet the income requirements and are not otherwise contributing. If you are still working and want to set aside funds for the college education of a grandchild, a Roth IRA would probably be a great investment. Your contribution will grow tax free and may be withdrawn for tuition, books, room and board. Furthermore, if you own traditional IRA's and anticipate helping with college expenses in the future, converting your existing IRA's to Roth IRA's may also be an option. There would be tax due on the amount you converted, but if the conversion is done in 1998 the taxes may be stretched over four years and the subsequent growth will be tax free. You will also be able to convert funds to a Roth IRA in future years, but the tax will be due for the year the conversion is made. The arithmetic on all this can get complex but we will help you with it to be sure it's the right financial planning decision for you. Of course we will discuss all this, in detail, at your next appointment.

picture of  
Joey

I wanted to take a moment and commend the work done by New York State Assemblywoman Sandra Lee Wirth on the "STAR" tax program. My understanding is that she was one of the major sponsors and driving forces in passing this legislation and I think she performed a fine public service in doing so. We've included some brief information about the program, and provide the required form for you to use. It does note on the form that you have until June 1st if you live in Erie County, but you may want to check with your town's assessor or call Sandy's office at (716) 675-7170.

Finally, I wanted to take this opportunity to thank all of you for referring so many of your family, friends and associates to our offices. With your help and support, my firm has expanded greatly over the years and I am very pleased with the work we do and the care provided. On a personal note, Gregory, Betsy and my youngest, recently graduated from Long Island University not only as a dean's list student, but also as a four year starter (co-captain the last two) on their awesome volleyball team. Way to go big guy!! Now that tuition time is over, mom and dad can start loading more into our great mutual funds.☺

# THE ROTH IRA

*Continued*

whole or in part, into a Roth IRA.

## **Is conversion a taxable event?**

Yes. Funds converted from a traditional, deductible IRA are taxed as income the year they are converted over. If the conversion is done during the 1998 calendar year, then the income may be **averaged** over a four year period. For example, if a person in the 28 percent federal tax bracket converted a \$10,000 IRA into a Roth IRA, the federal income tax liability would be \$2,800. If the conversion were done during calendar year 1998, they could spread those taxes over four years, \$700 per year. If they were to wait until a later year, the tax would be due entirely for that year.

## **Should I convert?**

Possibly. This is a choice that can only be made on an individual basis after a thorough examination of *your* circumstances. One rule of thumb is the further from retirement you are the more likely you'll want to convert.

## **If I do a conversion to a Roth IRA may I convert it back at a later date?**

No.

## **If I am close to retirement should I start a Roth IRA?**

Probably. This, again, will depend on your circumstances, but if you have maximized your pension opportunities a Roth IRA will probably be of great advantage to you.

## **Is a Roth IRA subject to Estate Taxes?**

Yes, but pay close attention here. Essentially any accounts which one owns, including life insurance policies, are considered to be part of one's estate when they pass away. If the estate is sufficiently large, \$625,000 for 1998, the transfer of those assets, above \$625,000, is taxed. (In New York State, the tax is called the Inheritance Tax and the exempt amount is, not surprisingly, much lower, \$115,000.)

In the case when a qualified retirement plan (401k, 403b, traditional IRA) passes to an heir at death, the amount of the plan is included in the estate for estate tax and inheritance tax purposes. *In addition the value of the accounts are considered to be income of the recipient and taxed at their current income tax rate.* Because one's heirs are usually employed, they often have a higher income tax rate which can get pushed higher still by the inheritance of the retirement account.

For funds held in a Roth IRA, only the estate and inheritance taxes would be due, not any income tax!

It may be hard to believe but there have been cases when the various taxes due exceeded the size of the estate and the heirs ended up owing money. All of this points out the need for full and comprehensive financial planning.

## **What is the 5 year period and how is it calculated?**

In order for funds to be withdrawn tax free, they must have been deposited in a Roth IRA account for five calendar years. For example, contributions or conversions made any time during calendar year 1998, up to and including December 31, would be eligible for withdrawal any time after January 1, 2003, provided the owner is 59 1/2 years old at

time of withdrawal.

If a conversion is done during a later year, the assets attributable to that conversion must remain in the account for 5 calendar years. Let's say, for instance, one started a Roth IRA in 1998 with a \$2,000 contribution and converted an additional \$10,000 during the year 2001. The amount attributable to the \$10,000 conversion would not be eligible for withdrawal until January 1, 2006.

## **Can a non-deductible IRA be converted to a Roth IRA?**

**WARNING!** It depends! Strictly speaking the answer is yes, and the earnings portion of the account would be considered taxable income. However, there are very complex (and little understood) regulations regarding the withdrawal and now conversion, of non-deductible IRA's. *If these rules are not properly followed, all of your IRA assets, deductible IRA's included, may be considered to have been cashed in and thus taxable income at the time of withdrawal or conversion.* This is one reason why we never allowed the investment into non-deductible IRA's. If you own one and want to convert you will, most likely, need to convert all your IRA's. Should you find yourself in this situation, please contact and schedule an appointment to fully review your situation.

## **Can a SEP IRA be converted to a Roth IRA?**

Yes. A SEP IRA needs to be first converted into a regular IRA and then converted into a Roth IRA.

## **May a person with a SEP IRA also contribute to both the SEP IRA and a Roth IRA?**

No. For all intents and purposes they may do one or another.

## **May an employee participate in their company's SIMPLE IRA and a Roth IRA?**

Yes. Just as they are not restricted from participating in a 401k, 403b, or other like plan, they would not be restricted if they participate in a SIMPLE IRA.

## **Can a Roth be set up for a child or grandchild?**

Only if that person is otherwise eligible. If the recipient does not have an *earned income*, they would not be eligible. However, if eligible, then the account could be contributed to as a gift. This may, in fact, be an appropriate estate planning action for many of you.

## **Are there more questions on Roth IRA's?**

There are a few and there will be more in the future. But we have tried very hard to cover the most important points for you in this issue. Even today there is legislation in Congress pending to enact corrections and clarifications. Roth IRA's can be a wonderful investment for many. We will help you to take advantage of them as part of *your* comprehensive financial plan. ☺

# MONEY MARKET ACCOUNTS

Many of you own “Money Market Accounts”, invested in through our firm or sometimes as an option in your pension plan or elsewhere. We feel that in their proper place these are superior financial planning tools and we have searched the marketplace to find the finest for you. However, the question sometime arises as to what is the “Money Market” and what is a “Money Market Fund”?

The overall financial “marketplace” is actually not a place as much as it is a worldwide activity. All of us are participants in that marketplace in one form or another. Even if one owns just a checking account, they are, in fact, loaning money to the bank which then, in turn, loans it further or otherwise invests it.

Two of the major components of the financial marketplace are the *capital market* and the *money market*. The capital market is where corporations and governments look to *secure* intermediate to long-term funding. Corporations may do this by selling stock, *equity securities*, which represents ownership in the company or by borrowing the money. When a corporation borrows it issues bonds which are *debt securities*.

Governments, whether federal, state or local, are prohibited from selling stock in themselves. They may only borrow. When a government is spending more than it is taking in through taxes and fees it has a *deficit*. When revenues exceed expenditures, it has a *surplus*.

When a corporation or government needs funding for only

a very short term, less than a year, it turns to the *money market*.

Institutions that are able to issue these securities normally have a very high credit rating. In the case of the United States Government, you have essentially the highest credit rating possible. Because this type of debt is so short term it provides a high degree of liquidity. Combined, these two factors provide a very high level of safety.

A “Money Market Account” is a mutual fund that places the money of the investor in these types of investments. A “Government Money Fund” would invest only in short term debt securities of the U. S. Government.

Currently, the money market funds we recommend are paying interest of about 5.25%. They offer check writing privileges and the electronic transfer of funds between accounts. They are liquid, convenient and safe. If you don’t have one or don’t use it, you probably should.

Some common usages of these accounts include: a savings fund for property taxes where a monthly amount is automatically deposited, a savings fund for expenses, such as tuition bills, vacations or wedding, and low risk short term investing, as an alternative to a CD.

The possibilities are endless!



## SCHOOL TAX RELIEF



### *The “STAR” Program*

School taxes in our state have risen dramatically over the years, for a number of reasons. In order to lessen the burden, especially for our senior citizens, the Governor and our legislators developed The New York State School Tax Relief Program, the “STAR” program.

The fundamental concept of the program is that the state will grant individual citizens an exemption on a part of their school tax and then reimburse the school districts. Here are the basic guidelines: For the school year 1998-99, those senior citizens who have combined incomes of less than \$60,000 will be granted a \$12,500 reduction in the full-value assessment of their home. By school year 2001-02 that exemption will rise to \$50,000. For example, if the full-value assessment on your primary residence is \$95,000 (and you meet the age and income qualifications) then you would be taxed as if your home were worth \$82,500 for school year 1998-99. By school year 2001-02 the taxable value would be down to \$45,000 ( $\$95,000 - \$50,000 = \$45,000$ ). This is called the “enhanced” STAR Program.

The “basic” STAR Program will apply to those who are not senior citizens or those seniors who do not meet the income requirements. This part of the program begins in school year 1999-2000. For that school year all property owners will be eligible for a \$10,000 reduction in their full-value assessment for school tax purposes. By school year 2001-02 that figure will increase to \$30,000.

Those seniors who live in Erie County, outside of Buffalo or Lackawana, have until June 1st to apply. The application is filed with your local property assessor and we have included a copy of the form for your use.

At the present time, a copy of your tax return is required with the application. Also, please remember, only your primary residence is eligible, not vacation or income properties, and the STAR Program applies only to your school taxes, not county and town property taxes.

We applaud the governor and legislature for this program and hope you take advantage of it. If you have any questions please feel free to call your town’s assessor. 😊😊😊😊😊