These 5 Mistakes Can Trip Up Even Seasoned Investors

By Christine Benz | 07-11-13 |

Setting up an IRA might be as simple as buying a takeout sandwich. Pick your vehicle--Roth or traditional--choose your investments, and plunk down your $5,500 ($6,500 if you're over 50). Done.

However, if you've ever glimpsed at Internal Revenue Service Publication 590 or peeked into one of the dark corners of IRA-land, such as "the five-year rule," you know that the rules governing IRAs can get devilishly complicated. These byzantine rules, in turn, have the potential to trip up even sophisticated investors.

Here are some of the common mistakes involving IRAs.

Mistake 1: Triggering an Unexpected Tax Bill With a Backdoor IRA
The so-called backdoor Roth IRA looks like a layup move for investors who earn too much to make a direct contribution to a Roth. (For 2013, single income tax filers cannot contribute to a Roth if they earn more than $127,000; married couples filing jointly cannot make direct contributions if they earn more than $188,000.) Because conversions from a traditional IRA to Roth are allowable at all income levels, the "backdoor" maneuver simply means that you can contribute to a traditional nondeductible IRA and then convert to a Roth shortly thereafter. Assuming you have no other traditional IRA assets, the only income taxes due would be on any investment appreciation since you opened the IRA. (Because it was a nondeductible IRA, you already paid taxes on your initial contribution.)

The trouble starts, however, if you have other traditional IRA assets besides your new traditional nondeductible IRA--that is, money that has never been taxed yet, such as assets rolled over from a previous employer's 401(k) plan. In that case, the taxes due after converting the new nondeductible traditional IRA to Roth would depend on the ratio of taxable versus nontaxable money in the total IRA kitty. For example, if a 45-year-old earning $150,000 a year plows $5,500 into a traditional deductible IRA but also has an additional $200,000 in a rollover IRA--meaning that money was never taxed by his previous employer--more than 97% of his total IRA assets are taxable.

Mistake 2: Rolling Over a 401(k) Plan Laden With Company Stock
Savvy investors often assume that if they leave a former employer, their best bet is to roll the money over into an IRA as soon as possible. Not only does moving the money into an IRA enable them to circumvent the extra layer of administrative costs that may accompany the 401(k), but an IRA also gives them the ability to invest in a much wider range of investment options than are typically found on a 401(k) menu.

However, a rollover to an IRA isn't always the best option, especially if a 401(k) contains a sizable stake in company stock that was amassed with the employee's

own pretax contributions and employer-matching contributions. In that instance, it may be better to leave the money behind in the 401(k) and take distributions directly from the account. By leaving the money in place, the investor can take advantage of a special provision in the tax code that enables him to pay ordinary income tax on his cost basis in the shares, but long-term capital gains tax on the appreciation in the shares over and above the cost basis. By rolling money into an IRA, the investor would owe income tax on the whole amount of the distribution.

Of course, rolling a company-stock-laden 401(k) into an IRA isn't always a mistake. If leaving the assets in place in the 401(k) means a woefully underdiversified portfolio and the investor won't be tapping the 401(k) for many years, rolling the assets into the IRA and reducing the company-specific risk is probably the right move.

Mistake 3: Paying Too Much Attention to Tax Management

Part of the point of investing in an IRA is that you get tax-deferred compounding--or tax-free compounding, in the case of Roth assets. And savvy investors have been schooled on the notion that in order to take maximum advantage of the free ride on taxes, IRAs should be used to shelter those investments that have high year-to-year tax costs, such as bonds and REITs. That's true, but skirting taxes shouldn't be the main consideration when deciding what types of assets to put inside of an IRA. Instead, your time horizon and your overall asset allocation should be the primary driver of what types of assets you hold. Only after you've determined the optimal mix of investments should you turn your attention to what goes where.

If you're in your 20s and 30s, for example, there's no need to go out of your way to add bonds, REITs, or anything else that kicks off a lot of income to your IRA--unless you wanted those assets in your portfolio anyway.

It's also worth bearing in mind that the ideal holdings for a traditional IRA and a Roth IRA may well be different. Your time horizon for each of these asset pools, as well as the tax treatment of each, can help you decide which security types to place where. Because Roth assets have the biggest tax advantages--they give you both tax-free compounding and tax-free withdrawals--the name of the game is to hang on to them as long as possible. That means a Roth IRA is the ideal receptacle for the longest-term assets in your portfolio, usually stocks, even though stocks can be quite tax-efficient on a year-to-year basis. Stocks are likely to appreciate the most during your holding period, and holding them inside your Roth will allow you to circumvent taxes on all that appreciation.

Mistake 4: Failing to Be Selective About RMDs

Savvy investors well know the importance of not missing their required minimum distributions once they've reached age 70 1/2. What they may not know, however, is that if they have multiple IRAs, they needn't take separate RMDs from each account. Instead, they simply need to calculate their total RMD amount due for all traditional IRAs, then pull the distribution from the account that makes the most sense from an investment standpoint. In this way, RMDs can be used to help

address portfolio imbalances; many investors rebalance around year-end, when RMDs are due.

Say, for example, a 73-year-old investor has $250,000 total in two IRAs--a stock portfolio worth $150,000, held in an IRA at a discount brokerage, and $100,000 in two bond funds held in a separate IRA at another firm. Assuming he wanted to reduce his stock holdings following the equity market's runup, he could take his entire $10,121 RMD from the stock portfolio while leaving the bond portfolio intact. (He would arrive at $10,121 by dividing $250,000 by his life expectancy factor of 24.7.)

Note that being selective about RMDs only applies to like account types. For example, if you have both a traditional IRA and a traditional 401(k), it's not an option to pull the RMDs from the IRA while letting the 401(k) assets stay put.

Mistake 5: Running Afoul of the 5-Year Rule

Withdrawals from Roth accounts during retirement are tax- and penalty-free, right? Yes, most of the time. But that's not the case if you haven't met the so-called five-year rule, which stipulates that in order for a Roth withdrawal to be completely tax- and penalty-free, the assets must have been in the account for at least five years before you begin withdrawing them. (Roth contributions can be withdrawn at any time and for any reason without taxes or a penalty.) The clock for that five-year period begins on the first day of the tax year for which the IRA is opened and funded. So if you made a contribution for the 2012 tax year in April 2013, your five-year clock started Jan. 1, 2012.

That's easy enough to get your head around, but things start to get tricky once you get into conversions from traditional IRAs to Roth. In that case, you need to be either 59 1/2 or five years must have elapsed since your conversion for you to be able to take penalty-free withdrawals on the converted amounts on which you paid taxes at the time of conversion. (You won't owe taxes on withdrawals of those monies because you have already paid taxes.) The five-year headaches multiply if you have converted your traditional IRAs to Roth in installments, as each of these partial conversions has its own five-year holding period.

This article goes into a lot more detail on the five-year rule. You don't need to memorize all of them, but the holding-period rules do underscore the value of having a reasonably long time horizon for any IRA assets that you are considering converting from traditional to Roth. If you need to tap those assets shortly after converting, you risk running afoul of the five-year rule.

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