5

IRA Decisions: How to Start, Where to Go

I would imagine that just about any American with a TV set has heard the term "IRA" because brokerage firms and mutual fund companies tout the savings devices in their ads. That's not surprising. Besides the fact that IRAs (individual retirement accounts) are invaluable for individuals saving for retirement, they are a $3 trillion business for financial service companies.

One out of every four retirement dollars is in an IRA, according to the Investment Company Industry, the mutual fund industry's trade group. About 40 percent of U.S. households have an IRA. We're talking about 45 million households.

Despite a familiarity with the term "IRA," most Americans aren't sure what to do with them, which may be why the majority of households still aren't taking part.

Over the years, I've received numerous calls from people like Jessica, who called me one day because her grandmother had sent her one of my columns urging people to open IRAs. Life was a struggle for Jessica's grandmother. Her husband had died years earlier, and she was living only on Social Security. There was no pension and no savings.

Obviously, Jessica's grandmother hoped for a better life for her granddaughter, so Jessica listened when her grandmother suggested she start an IRA. Immediately, Jessica appreciated the logic.

Jessica was 23—years away from retiring—but she told me she didn't want to end up like her 76-year-old grandmother, "sitting in a La-Z-Boy in front of a TV without the money to do anything else." Jessica knew she would need savings for a better life. Yet she couldn't imagine finding enough cash to open an IRA. My column said people could put $4,000 into an IRA. On an income of $25,000, Jessica said coming up with $4,000 was about as plausible as "looking in the mirror and seeing Paris Hilton."

She had made a common mistake. You don't need $4,000 to open an IRA. In fact, you don't even need $2,000—a frequent misconception that dates back to the early days of IRAs. Then, people were allowed to put up to $2,000 in an IRA each year. But $2,000 was the maximum yearly contribution allowed by the government, never a minimum.

Today, the maximum level is $4,000 a year for people under 50 and in 2008 the limit becomes $5,000. But there is no minimum whatsoever, and there never has been.

Tiny amounts of money are perfectly acceptable. The U.S. government—which sets the rules for IRAs—wouldn't object if you opened an IRA with just a few pennies. Financial institutions, however, might not want to bother with such a small amount because it would be a bookkeeping nightmare for them. Some mutual fund companies, such as Vanguard, want you to come through the door with $3,000.

Still, a lot of money is not necessary. Some very fine mutual fund companies let individuals open IRAs with as little as $50 if the person promises to put an additional $50 into the IRA every month. I told Jessica that if she invested $50 every month—or less than $12.00 a week—for the next 43 years in a solid mutual fund that invested in the stock market, she would probably have close to $400,000 at retirement.

That, of course, would have put her in a lot better condition than her grandmother, but not good enough. "Get started with $50 a month," I said, "and then as you get raises, add at least half of that amount to your IRA."

I would have told her to do the same thing with a 401(k), but she didn't have that choice at work. That made opening an IRA vital to her future because it was her only tax-efficient way to save for retirement.

If you are looking for a firm that will let you start an IRA with $50, consider T. Rowe Price. I suggested Jessica open the IRA and invest the money in the T. Rowe Price Total Equity Market Index mutual fund—a simple investment in the full stock market, which I will discuss further in Chapter 13,"Index Funds: Get What You Pay For."

First, I want you to be aware of other common misconceptions about IRAs so that a misunderstanding doesn't keep you from making yourself wealthy the easy way. And I will explain, as I did to Jessica, where to go and how to open an IRA.

Married, with No Job

Too often when people are married, and one spouse stays at home while the other works, they miss out on an IRA. That's not necessary. They assume—incorrectly—that the spouse who isn't working cannot open an IRA.

It's understandable that they would make this mistake, but it's especially unfortunate for women who stay home to raise children. Statistically, such women are likely to end up in poverty or tough times late in life because their sporadic work history leads to low Social Security payments. Also, family savings often get decimated caring for a sick husband while a wife outlives him by 17 or more years.

So whether a spouse is working or not, both married people should open an IRA and fill it to the max each year, if possible. As a rule, a person can't put more money into an IRA than he or she earns on a job or from a business. But there is an exception for a person who has a spouse who is working. Both spouses can have IRAs, and they can each put $4,000 into the account. So for a couple, that's a total of $8,000 a year as long as one or both spouses have earned at least that amount.

If you are over 50, you can stash away even more—a total of $5,000 a person, or $10,000 per couple. In 2008, it will be $6,000 a person or $12,000 a couple.

The federal government recently raised the limits for 50-plus-year-olds, because Congress is well aware that people are far behind with their retirement savings. Political leaders are hoping that if they give people a chance to catch up after their kids have finished college and moved away from home, parents will go into action when the financial pressures of a family have eased.

If you are among them, don't breathe a sigh of relief the day you see your child in a cap and gown, and figure you can start spending the thousands that were landing in the bursar's office over the past four years. When you return

home after the graduation ceremony, open an IRA or increase what's in your IRA. And while you're at it, increase your 401(k) contributions, too.

If you forget, go into action the day you get the graduation photos back from the film developer. As you gaze proudly at the pictures of your child, think: "I'm now going to be proud of myself for taking control of my future." Then, get thee to your neglected IRA.

Where Do I Go; What Do I Do?

There are many places to go to open an IRA: your bank, a company that creates and sells mutual funds, a financial planner, or a brokerage firm.

If you use a local bank or brokerage firm, you'll walk into the office and say you'd like to open an IRA. If you deal with a mutual fund company instead, you will contact them on the telephone through a toll-free number or over the company's Web site. (I supply several names and contact information in later chapters, and you can find any name through a Google search on the Internet or through help in the "business" section at a public library.)

Other than the difference between phone contact and direct human contact, the process of opening an IRA is virtually the same everywhere.

It's an easy, quick task, similar to opening a bank account. You tell the firm's agent you'd like to open an IRA, and they give you a short form to fill out. You provide basic information: name, address, Social Security number, and "beneficiary" (the person who you want to give the money to if you die). Then you have to specify whether you want a traditional IRA or a Roth IRA—a decision I will walk you through later in this chapter.

After completing the form, you write a check that will go into your IRA account—maybe as little as $25 or $50; maybe as much as $4,000.

After you have done that, you will have an IRA. But you aren't done.

Opening your IRA is only the first step. At that point, your money is just sitting there, doing nothing. You were smart to open an IRA for yourself. But the money isn't going to grow until you take the second step—a critical one. You must decide how you want to invest the money you just put into the IRA account. You will fill out a second form stating what investments you choose. Your choices could make the difference between ending up with little more than you originally deposited or having hundreds of thousands of dollars later in life.

If you haven't finished reading this book, making investing choices might make you nervous. Don't worry, though. In the chapters ahead, you

will become as wise as many financial planners, and I will give you specific mutual fund names that will help you choose.

Meanwhile, as you open your first IRA, be assured that you don't have to decide right there on the spot how to invest your money. Request a list of mutual funds to consider, and take it home with you if you need time to think. As a temporary move, you can tell the person who opened your IRA that you'd like to park your money in what's called a "money market fund"—a safe choice that's almost like a savings account but generally pays a little more interest.

Don't leave the money that way for long. You won't make enough interest on it to harness the power of compounding and make your savings blossom. Instead, you are going to need to select mutual funds, including some that invest in stocks. I will tell you exactly how to do that in the chapters ahead.

Now, however, I just want you to be comfortable opening an IRA so that nothing stops you.

You might feel most confident opening an IRA at a bank because you have been there before and can walk in and talk with a human being. If you need that security for your first step into an IRA, go for it. Yet I want you to understand other options that might seem a little less comfortable at first but are actually as simple and ultimately could be much more lucrative.

Too often banks aren't the best place for an IRA, because they charge high fees. They may charge a $25 so-called "maintenance fee" each year, just to keep your money in an account. And then, mutual funds offered to you by the bank might include extra fees called "loads." On the face of it, these fees might look like small numbers, but over time they erode your savings by thousands. I will explain this in detail in Chapter 12, "How to Pick Mutual Funds: Bargain Shop." For now, just understand that fees matter a lot.

Ask about fees, and try to open your IRA at a bank, broker, or mutual fund company that won't charge you a fee to open the account or an annual "maintenance fee." There is no need to pay such fees, because equally good institutions don't charge them.

If you want human contact, you can do it through a brokerage firm or financial planner, as well as a bank. Perhaps you have heard of firms like Merrill Lynch or Charles Schwab. These are brokerage firms. They sell stocks, bonds, and mutual funds. But they differ greatly by the fees they charge.

Merrill Lynch, Citigroup Smith Barney, and other so-called "full-service brokers" charge fairly high fees. In theory, the fees are supposed to be the broker's compensation for giving you advice. But keep in mind their advice

can be good or bad. Brokers are hired to sell, and too often that means they sell what enriches them the most, rather than you—a topic covered in Chapter 15, "Do You Need a Financial Adviser?"

Charles Schwab—and other so-called "discount brokers" like Scottrade or TD Ameritrade—generally charge lower fees, which is why I prefer the discounters. There are many of them—too numerous to list. (Search "discount brokers" on the Internet, comparing the fees they charge and the ease of contacting them.) When you go to a discount broker, you need to know what you want. If you are still at the stage where you feel you need a significant amount of guidance, you won't get it there.

My goal with this book is to give you the tools you need so that you don't need much advice and can consequently save tremendous amounts of money by keeping your fees low at a discount broker or "no-load" mutual fund company. Still, if you feel like you need a helping hand, in person, to get started, do not stew and let valuable time pass by. Go to a broker at a bank or brokerage firm, or find a certified financial planner. In Chapter 15, I tell you how to find qualified advisers who will work for you, not against you.

On the other hand, if you have the comfort level with mutual funds that I hope you get from Chapters 7 through 13, you can go directly to a low-cost mutual fund company like Vanguard, Fidelity, or T. Rowe Price. I provide many other examples in later chapters. You can also use fund "screeners" that will help find funds. Try www.morningstar.com, or at www.moneycentral.msn.com, click on "Investing" and "Funds." Morningstar's website offers Picks and Pans to find long-standing quality mutual funds. If you search most screeners by "low minimum," you find funds which will let you start investing with $250 or $500.

Can't I Wait Until I File My Taxes?

When I first told Jessica to open an IRA and deposit $50 into it every month, she was perplexed. She, like many people, assumed you are allowed to open IRAs only once a year at tax time—part of the process of filling out a tax return.

Again, it's understandable why people would make this mistake. Often people open IRAs when they complete their tax return so that they can use a tax-deductible IRA to reduce their taxes that year. Also, brokerage firms turn up the volume on advertising around tax time because they know accountants will be advising clients to cut taxes with IRAs.

Still, there is no need to wait for the end of the year, and you shouldn't. By investing earlier in the year, you start earning money on your investments immediately. The magic of compounding begins to turn pennies into dollars.

For purposes of doing your taxes, it doesn't matter whether you have contributed to an IRA early in the year, every month, or once a year. You just tally up all your contributions for a year and write the total on your tax return so that you can reduce your taxes.

Under tax laws, people are allowed to open an IRA every year, and they can put up to $4,000 into an old, or a new, IRA for the 2007 tax year, or $5,000 in 2008. The deadline for contributing the money comes at tax time—April 15. That's simply the cutoff date. For example, if you sit down to do your 2007 taxes in April 2008, and you haven't contributed anything to an IRA for 2007, you have until April 15, 2008 to open an IRA for the 2007 tax year.

In Jessica's case, all those $50 deposits would add up to $600 for the year. Then, while preparing her tax return, if she wanted to boost the amount a little, she could. If she had an extra $100, she could add that to her IRA. If she had an extra $2,000, she could add that. She could add any amount as long as she didn't put more than $4,000 into the IRA that year. In future years, she would have to pay attention to new limits by the government—for example, $5,000 for the 2008 tax year.

The flexibility to save small amounts throughout the year and then add more at tax time should give you the impetus to open an IRA now instead of waiting for a stash of money that might never materialize. You can go to a bank, mutual fund company, or brokerage firm, fill out the form to open the IRA, deposit whatever amount you want, and then figure out the amount you could instantly add every time you get paid. For Jessica, it was $50; for you, I hope it's even more.

Regardless, ask to be put on what's called an "automatic" system, in which the institution will remove your $50, or any other amount, from your checking account on a specific schedule. It might be once a month or every payday. Then you will constantly be adding money to your investments.

The nice feature about using an "automatic" plan is that you don't have to trust yourself to come up with $4,000, or even $600, at tax time. You are making sure that the money starts going into your retirement account from the moment you have good intentions. Given human nature, this is the one approach that seems to work most often.

Of course, you also want to put compounding to work. When there is zero in your account until tax time, you are going to go through a full year without earning a return on your money. As soon as you put your first dollar into the account, compounding flexes its muscle. So why would you wait?

If you don't think a few months matters, just remember that time is your best friend if you start early and works against you every day you wait. If you doubt it, remember the toddler who amassed $4 million on $12,000 in IRAs.

The Choice between Traditional IRA and a Roth IRA

Too many people suffer from IRA paralysis, because they can't figure out whether to choose a traditional tax-deductible IRA or a Roth IRA. I don't want you to succumb, because behavioral studies suggest you will then let months or years go by without ever deploying your first $1 into one of these money-making machines. Simply because you are mulling the choice of IRAs, you may cost yourself thousands of dollars in potential retirement money as you leave savings gathering dust in a savings account.

Consequently, if you see that you would qualify for either, and you find yourself in the throes of procrastination, take out a quarter. Call one side "Roth IRA" and the other side "traditional IRA." Then flip that quarter in the air, and whichever side turns up, go for it.

I say this because both IRAs are tremendous choices—huge tax savers, and consequently a no-brainer for growing your money. On the other hand, understanding the variations is not difficult. In a nutshell, the choice comes down to this: In addition to years of tax breaks, do you want an extra serving of tax help at the time you contribute money to an IRA, or do you want to delay it until you are retired?

The Traditional Tax-Deductible IRA

Let's start with a traditional tax-deductible IRA, because there was a time when there was only one IRA—the traditional IRA. When the first IRA was introduced several years ago, people were sold on them as a way to cut their taxes each year. And that's still the appeal today. You can open a traditional IRA, deposit money up to the government's limit for that year, and use that contribution to reduce the amount of taxes you owe Uncle Sam at tax time for that particular year.

Say you earn $20,000 a year on your job, and you decide to put $3,000 into a traditional IRA this year. Because you did this, you are going to reduce your income when you fill out your tax return for this year. In effect, you tell the government at tax time that you didn't really make $20,000. Instead, your income was only $17,000, because you removed $3,000 to start the IRA.

Since your income is no longer $20,000, the government is going to tax you on only $17,000. So instead of having to pay $1,355 in taxes, you will pay only $905. By opening an IRA, you cut your tax bill down by $450. If you want to try this calculation, go to www.dinkytown.com and use the tax estimator.

To look at it another way, because you saved $450 in taxes that year, it only cost you $2,550 to open your IRA—not $3,000.

Getting the tax break in a single year is a good deal. Of course, if you contribute again the next year, you can cut your income and taxes again. You can do this year after year—every time you make a contribution you reduce your taxes at year-end.

But the benefit is so much more than that. Year after year, Uncle Sam also keeps his hands off everything that's invested in the tax-deductible IRA. If your $3,000 earns $100, you will have $3,100 in your IRA, and you won't get taxed on any of it. If, years later, it's grown to $50,000, you still won't need to pay taxes on it. Consequently, your savings—free of taxes—will grow with gusto thanks to the power of compounding on a pot of money that never gets whittled away by taxes.

That original $3,000 should turn into about $49,000 tucked away in your IRA for 35 years, but if you hadn't held the tax man at bay, you would have accumulated only about $24,000. (I'm assuming you are in the 25 percent tax bracket and earn 8 percent annually on your investments.)

Now, here's where that traditional IRA takes a turn you might not like. The gig comes to an end when you retire. That's when Uncle Sam's bill starts coming due. Remember, you have been saving throughout your working years in an IRA so that you could start giving yourself a paycheck each year of retirement. As you go into that period of your life, Uncle Sam starts showing up every time you pay yourself. There's nothing you can do about it. He will tax any money you remove from the IRA. Of course, if you don't need the cash early in retirement and you just leave it in the IRA, you still won't owe any taxes on your savings.

But Uncle Sam wants to make sure he gets a piece of the action, so he won't let you duck him forever. Once you turn 70½, he will require you to remove a portion of your IRA money—whether you need it or not—every year. Then Uncle Sam will take his share of that money, taxing it just as he would a paycheck. Still, the money remaining in your IRA—no matter how large—continues to grow without getting taxed.

So that's how a traditional tax-deductible IRA worked when it was first introduced and still works today. It starts out with a tax break the year you contribute, it protects you from taxes throughout your savings years, and then in retirement you start giving some of the money back to Uncle Sam and your state tax coffers, too.

The Roth IRA

All said, the traditional IRA is a great deal for saving. But a few years ago, along came something even better—the Roth IRA. I think of it as the new and improved IRA.

Now, assuming that you meet the income levels and other criteria explained throughout this chapter, you have a choice between a traditional tax-deductible IRA and a Roth IRA.

With a Roth IRA, you do not get an upfront tax break the year you open one or when you make a contribution. So if you were earning $20,000 and put $3,000 into a Roth IRA, you would not cut your taxes by $450 that year. You would miss out on the basic attraction of a traditional IRA—that easy opportunity to cut your taxes in a single year.

On the other hand, after your money is in a Roth IRA, you get the same goodies as with a traditional IRA. In other words, year after year the pot of money grows and you pay no taxes on the money in the account. If $3,000 turns into $3,100, you pay no taxes. If it turns into $30,000, you still pay no taxes, and so on through the years.

Now comes the really terrific part. When you retire, you still pay no taxes. It is here that the Roth IRA starts to act very differently from a traditional IRA. It becomes the Superman of IRAs—delivering a stupendous deal.

Everything you've built up in the Roth IRA is yours free and clear, forever. You will never owe taxes on any of it. You could have $1 million or $10 million at 65, 85, or any age. Every cent will be yours.

Uncle Sam won't make you take a penny out of your Roth IRA at age 70½, or ever, because he has no claim on it. If you remove $1 million a year, it's all yours. If you remove $100, or $3 million, it's all yours. If it stays invested, it's all yours. Even if you die and it goes to your spouse, children, or any heir, they won't have to pay taxes on any of it either.

Now, that's one magnificent deal! When you are retired and living on a fixed income, you won't have any control over whether your property taxes shoot up or whether your medical bills triple or quadruple, or whether car prices go through the roof and your old wreck breaks down. But you will have one sure thing: your Roth IRA. No matter what you have accumulated in it, every penny will be there for you—with no tax man dipping in each year for a cut.

I think that certainty alone makes the decision between a traditional IRA and a Roth IRA simple: Go with the Roth.

Some accountants have done elaborate calculations to help people decide whether they'd be best off with a traditional IRA or a Roth IRA. The simple rule of thumb is this: If you think you will be in a lower tax bracket when you

retire than you are now, you should go with a traditional IRA and get your tax break up front instead of when you retire. You can use Internet calculators to see where you fall. Do a Google search for "which IRA is best" and try the calculator at www.smartmoney.com.

But here's the catch with the calculations: They assume that current tax rates stay intact and that you can anticipate what percent of your income you will owe in taxes when you retire. I am persuaded by Ed Slott, a certified public accountant and IRA expert, that planning based on today's tax system will probably be folly. With a large federal budget deficit, Congress is likely to raise taxes at some point. Even if you anticipate low taxes during retirement, that may not be correct. Consequently, Slott tells everyone—regardless of income—to select a Roth IRA and insulate themselves from the possibility of high taxes during retirement.

His argument convinced me. Of course, some skeptics argue that the government could also renege on its promise to keep its hands off Roth IRA money years from now, but people familiar with the public-policy process tell me that would be a broken promise with gigantic ramifications from unhappy voters. People realize that tax rates are not guaranteed, that government can tinker with them whenever they want. Yet breaking an outright promise—like the one attached to a Roth—is fraught with trouble.

So if you want a simple solution, rather than flipping a coin, go with the Roth IRA, leave your money in it until you are 59½, and enjoy tax-free savings for all the days of your life.

Slott, in his book *Parlay Your IRA into a Family Fortune,* calls Roth IRAs "The Ninth Wonder of the World."

He told me once that he thought young people were foolish to be sucked into the small tax savings they can get upfront from a tax-deductible IRA. Maybe they save $450 on taxes one year on their first $20,000-a-year job, but when they are retired and it's turned into $41,000, they could end up giving away 30 percent of that in taxes.

Consequently, why not just go with this: There is nothing better than no taxes after you are retired. And that's precisely the deal that the Roth IRA offers you.

The Choice between a 401(k) and a Roth IRA

In the best of all worlds, you would be so well paid and have such a commitment to keeping up your lifestyle when you retire that you would use both

of these fabulous tools to the hilt. I'm not delusional, however. Only 10 percent of people hit the $15,500 limit on their 401(k)s.

Most people can't, or won't, do more. On average, Americans put 6 percent of their income away in 401(k)s—enough to survive with a roof over their heads and food on the table, but not extras. Many could do more, which is why I wrote this book—to nudge and help you through it in easy ways.

Remember, when the Employee Benefits Research Institute asked people of all income levels whether they could afford to put $20 *more* into a retirement account each month, the majority said yes.

Still, many Americans cannot put $15,500 into the 401(k) and also maximize a Roth IRA, so inevitably that raises a question: Which one do you use?

There's a simple process to follow: First, don't leave money on the table if your employer is offering it. Contribute at least enough to your 401(k) to get every drop of matching money possible. The only exceptions would be if your 401(k) plan is a mess—with an array of awful mutual funds and high fees, or if you believe that your employer may not be putting the money into the 401(k) as required by law. Fraud is unusual, so there's no need to fixate on this. You would get hints if it were happening to you—money not showing up on time or incorrect and late statements from your account.

Assuming your 401(k) is solid, you proceed to the next step after you have put enough money into your 401(k) to get matching money for the year. At that point, with your match intact, you could stop contributing temporarily to the 401(k) and start routing money into a Roth IRA. When you've met the $4,000 maximum contribution for the Roth, then you would return to the 401(k) and fill it to the hilt. In other words, if the limit in your 401(k) plan is $15,500, go for it. Some people skip this last step, thinking there's no benefit because their employer isn't matching the contributions. They are wrong: The goal is to build up a nice retirement stash with the help of the tax system. So that means putting as much as possible into both a 401(k) and an IRA.

The route I've laid out—using a 401(k), then a Roth IRA, and then back to the 401(k)—will work only for a disciplined person who will, in fact, follow up by opening a Roth IRA and feeding it regularly. If you can't trust yourself to do that, fill the 401(k) to the brim before doing anything else because it's there at work. You can set it up once and simply make contributions without thinking about them. In addition, when you hear you are getting a raise, it's easy to tweak the 401(k) forms at work so that part of that raise goes immediately toward funding your future.

The most important consideration for you is to make sure you get the money into a tax-sheltered account such as an IRA or 401(k) so that you don't spend it, and also so that it grows free of taxes.

If you have been kind to yourself by funding both a 401(k) and a Roth IRA, when you retire you will have the best of all worlds. The Roth will provide a pot of money that won't be taxed no matter how long you live, and your 401(k) will be another reliable source of money—but one that will require you to pay taxes. Every time you withdraw 401(k) money during retirement, you will have to pay taxes on it just like a regular paycheck.

Pushing IRAs and 401(k)s to the Limit

After you have a fully funded Roth IRA, if you can put any additional money aside—and you should—devote it to your 401(k). The additional money won't earn you a greater match from your employer, but it will give you a break on your taxes and continue to let compounding do its magic for you while holding Uncle Sam at bay.

And for people who have incomes too high to open Roth IRAs, it's critical to use a 401(k) to the maximum—putting up to $15,500 into it this year, or up to $20,500 if you are over 50.

Rules You Must Live By

One of the reasons IRAs are so confusing for people is that Congress keeps changing the rules. Today's rules may change later, so before opening an IRA, make sure that your age, income, job benefits, and other factors still permit you to take the actions you want. You can read all the current rules in the IRS Publication 590 at www.irs.gov/publications/p590/index.html or a simple version at www.rothira.com.

The following lists the main rules you must follow—rules that will either give you the right to proceed or hold you back on one or both IRAs. I am using 2007 limits to explain how the rules work, but keep in mind that the numbers you see in the examples will change in future years as the government adjusts them for inflation.

Can You Get a Tax Deduction from a Traditional IRA?

Not everyone can get a tax deduction by opening a traditional IRA. It depends on your income and whether you have a pension, profit-sharing plan, 401(k), or other retirement savings plan at work.

Most employers don't offer pensions. And half don't offer a 401(k), 403(b), or similar retirement savings plans. So if you work for one of these

companies, you are free to open a traditional IRA and deduct it from your taxes. The reason is simple: You are on your own to provide for your retirement, so the government gives you an incentive to help yourself.

But if you have the benefit of some type of pension or retirement savings plan at work, the government is less interested in helping you out. So your income level counts. You can't deduct a contribution to a traditional IRA for 2007 if you are single and making over $62,000. And if your income is somewhere between $52,000 and $62,000, you can contribute, but you can't get a deduction for the full amount typically allowed for an IRA contribution—or $4,000 in 2007.

If you are married, this gets a little more complicated. If a couple's combined income is $103,000 or over, and they each have either pensions or retirement savings plans at work, they cannot deduct traditional IRAs from their income. And at $83,000 they have to start cutting back on what they can deduct. But if one spouse has a pension or retirement plan at work and the other doesn't, the spouse without the plan doesn't have to worry about the $83,000 to $103,000 cutoff. He or she can open an IRA and deduct the full amount if the couple's income is no greater than $156,000. If it's higher than that, the spouse might still qualify for a reduced deduction. But when a couple's modified adjusted gross income is over $166,000, no deduction is allowed.

What a maze of numbers! I wish I could make it easier, but Uncle Sam requires that you live within the rules.

Just to make things more complicated, these income levels aren't actually what your salary is. Instead, they relate to income levels after certain deductions occur. That means your salary is probably higher than the cutoffs, so you might have more leeway to use an IRA than you think. If you use a tax preparation software like "Turbo Tax," it tells you where you stand so you don't have to wonder about your income level qualifying. Of course, an accountant or www.irs.gov can also help. And since the government can change income limits, check on them each year.

Is Your Income Too High for a Roth IRA?

One of the reasons I like Roth IRAs is that the rules are so simple. Instead of running through a maze of do's and don'ts about qualifying, there is just one simple question to answer: Is my income within the limits? And very few people have to worry about this, because the maximum income is fairly high for Roth IRAs. So if you have been thinking about opening a traditional IRA and have a workplace pension plan that will interfere with a deduction, just

turn to a Roth IRA. Remember, if you have a pension, 401(k), or other retirement plan at work, you are free to open a Roth IRA, and you should.

Given 2007 limits on contributions, you could put up to $4,000 into a Roth IRA for the year if you are single and have a modified adjusted gross income no higher than $99,000. Between $99,000 and $114,000, you would have to ratchet back the amount you put into a Roth, but you could still make a contribution of some amount. With married people, you would start ratcheting back a full contribution when your income crossed the $156,000 threshold. Yet, you could still contribute some amount to a Roth as long as your income stayed within the maximum $166,000. Under current tax laws, the limits are supposed to be adjusted annually based on inflation, so as the years go by, search the IRS website to see how far you can go with each year's contributions.

There's also a formula behind how these so-called phaseouts work to limit contributions after a person's income crosses from the low end of the range—such as $99,000 for a single person—and approaches the high end, or $114,000. You can find it at www.irs.gov. But I'll give you a quick understanding here. It has to do with where your income stands between the complete phaseout point and the start of the phaseout. Say, for example, that you are married and file your taxes jointly with your spouse. Together, the two of you have a modified adjusted gross income of $161,000. That's half of the way up to the $166,000 cutoff from $156,000. So your limit on what you can put into your Roth IRA is cut by a half. Instead of putting $4,000 into one that year, you can put in $2,000.

How Much Can You Contribute?

The answer: Only as much as you earn from a job.

For example, if you are in junior high and have been mowing lawns this year and will make $75 for the year, you could put the entire $75 into an IRA. But if you've been putting gifts from relatives into a savings account for years and have $4,000 in it, you can't pull the $4,000 out of the account and open an IRA with it. You are limited to the $75 you earned from working.

But let's say you earn something more than $4,000. Then you have to stay within the $4,000 limit. Example: You make $20,000 on your job and don't need any of it to live on because someone in your family is bankrolling you. Perhaps you'd like to put the full $20,000 into an IRA. But you can't.

Watch these limits, though. Congress is always changing them. As of this writing, the limits for IRAs are supposed to jump in 2008 to $5,000 for people under 50. For people 50 and up, it will be $6,000.

Do You Meet Age Requirements?

There are a couple of ages that are key: 70½ and 59½. But just to drive you nuts, the ages don't apply in the same way to traditional IRAs and Roth IRAs.

After age 70½, you can no longer contribute to a regular IRA, and you must start taking money out at that point. But 70½ doesn't apply in any way to a Roth IRA. As long as you have any income from working—even income as small as working as an election judge once a year—you can make a new contribution to a Roth IRA, no matter what your age.

Then there's the issue of removing money from an IRA. Typically, anyone can start removing money from a Roth IRA after age 59½. But there's another rule tagged onto the 59½ age. The money must also have been in the Roth for five years before the earnings on it are removed.

So if you put money into a Roth IRA at age 50 and want to remove it at age 59½, that will be fine. But if you open a Roth IRA at 58, you have to wait until you are 63 to remove anything beyond your original contribution.

Last-Minute Regrets: I Want My Money Back

I hate to tell you the following, because I don't want you to use it. But I also know that this could make you a lot more relaxed about putting money into an IRA or Roth IRA. So here goes.

If you find out you can't live without the money you put into your IRA or have second thoughts about the amount you deposited, you can change your mind under several common circumstances.

If you find out you need the money to pay for college for yourself, your child, or a spouse, feel free to dip into the account. It doesn't matter what your age is. You won't have to pay the typical 10 percent penalty the IRS charges if you take money out of an IRA before you are 59½. You will just have to pay taxes on the money you have removed.

The same holds true if you are buying your first home and need the cash. You can take $10,000 out of the account. Married people can get their hands on a total of $20,000 if they each have their own IRA.

And if you lose your job and need to buy health insurance, you can tap your IRA penalty-free, too.

People with Roth IRAs have even more flexibility. Besides the right to take money out of IRAs for college, homes, and health insurance, they can yank any of the original money they deposited and use it for anything at any time.

Say you are 35, and you put $4,000 into a Roth IRA today, and a week from now, a friend finds a great fare over the Internet to Europe. You can remove the entire $4,000. You won't have to pay a penalty or pay taxes because—unlike a traditional IRA—you never got a tax break upfront with the Roth IRA. You put the $4,000 in your Roth after paying taxes on it.

So it's yours—free for the taking at any time.

If, however, you had the $4,000 in your account for a few months, and it had grown to $4,100, you would not be able to remove the $100 for your European vacation. That's because you didn't pay taxes on the $100, and your deal with Uncle Sam is the following: Leave all earnings from your Roth in your account until you are at least 59½. As a result, if you removed the $100, you would have to pay both a 10 percent penalty on it and income taxes.

So relax about missing your money in an IRA, and especially a Roth IRA. It's more accessible than you might have thought.

Special Help for Low-Income People

If your income is low and you don't think you can scrounge up anything to put into a retirement account, don't give up.

I have a deal for you—a gift from the federal government, or free money…maybe as much as $1,000 if you put $2,000 into an IRA. Lesser amounts are also OK, but if, for example, you come up with $500 for an IRA, the government won't give you $1,000. Maybe you will qualify for $100 in free money.

Depending on your income (after certain deductions) and the amount of money you put into an IRA, the government might give you 50 percent, 20 percent, or 10 percent of the money you have deposited.

Anytime you can get free money, it's worth pursuing, especially when it's for a good cause—your future.

This free money comes to you via the "Saver's Credit." You ask for it when you prepare your tax return at the end of a year. The government wants you to save for retirement, so the IRS will give you a refund if you contribute to either an IRA or your 401(k), 403 (b), or other retirement plan at work.

That, of course, depends on your income. If you are single, your income has to be under $26,000. If married, it must be under $52,000. (And, of course, check as the years go by in case the government raises the limits.) Also keep in mind that you need to be working, not a full-time student.

Often young people qualify when starting their first jobs because their incomes are low. Sometimes they can borrow from a parent or relative, fund an IRA, and get money from the government so that their financial commitment is pretty small.

Even if your income is slightly higher than the limits above, you might be able to squeeze into this deal. Remember, earlier in this chapter I explained that when you put money into an IRA or 401(k) you cut your income down. So conceivably a single person could have an income around $28,000 and contribute $3,000 to a traditional IRA so that their income would be less than the $26,000 cut-off. Then they could get a $300 Saver's Credit refund.

Anyone who can't come up with cash out of their pocket to fund an IRA might also try this technique: Complete your tax return a couple of months before the April 15 deadline, and report on the return that you are opening an IRA.

Perhaps your plan is to put $1,000 into the IRA. You would report a $1,000 IRA on your tax return. But you wouldn't put any money into the account then. Instead, you would wait until the government processed your return, gave you the Saver's Credit, and sent you a refund. After the refund arrived, you could use it to fund the IRA. Just be clear on this: You will face a penalty if you don't actually put the money into the IRA by that year's April 15 tax deadline. So don't forget or change your mind in midstream.

For more information on the Saver's Credit, get IRS Publication 560, Chapter 5 and Form 8880.

Even if you don't qualify for a Saver's Credit, paying your taxes early is a good way to come up with cash for an IRA. If you are entitled to any refund, don't spend it. As soon as the check arrives, put it into the IRA. This way, you will never miss the money and it will turn into thousands.

Help for Affluent People

What if you make too much money for a Roth IRA?

If your income is too high for a Roth IRA, there is still a way to keep Uncle Sam at bay so that your retirement savings will blossom. Just open a taxable IRA. They are called "non-deductible IRAs."

At first this might seem worthless because you don't get a tax break at the outset, and you don't set yourself up immediately to get the beauty of tax-free money when you retire. You do, however, get to keep Uncle Sam from taxing any money you earn in that IRA while it stays invested over the years.

And through a new law that goes into effect in 2010, you are going to have options that people at your income level never had in the past. Starting then, you will be allowed to convert a taxable IRA into a Roth IRA, no matter what your income is.

You will have to pay taxes on the money in the IRA when you make the conversion. After that, however, you will have all the benefits of a Roth IRA. You will never have to pay taxes on the money growing within that Roth IRA, and when you retire, every penny will be yours. If it's worth $20,000, $2 million, or even more, Uncle Sam will never touch a cent in the account or anything you remove during retirement.

There is another alternative, too.

Some employers are offering what is called a Roth 401(k) alongside your regular 401(k) at work. If your employer offers it, there are no income requirements for using the Roth option. So even if you make too much money to open a Roth IRA now, you can use a Roth 401(k) at work. And if you do, all the money you make in it over the years will be yours free and clear when you retire. Uncle Sam won't touch a penny, ever.

That's very different from a regular 401(k). When you remove money from the typical 401(k), you must pay taxes on the money you withdraw.

So if you have a Roth 401(k) at work, this is an attractive choice as long as you can live without the immediate tax break you get with a regular 401(k). You can put up to $15,500 for the 2007 tax year into a Roth 401(k), or $20,500 if you are over 50. But be aware that before making those contributions, you pay your taxes on that income in full. Your tax break comes during your retirement years, not the year you make your contributions.

What Comes First: College or Retirement Saving?

In the best of all worlds, parents would save for their children's college education in addition to retirement.

College is expensive—currently about $80,000 for four years of tuition, room, and board at a public university, and over $160,000 at many private colleges. Few parents can save enough for the full package. If you have limited resources and must choose between funding your retirement and funding college, emphasize funding your 401(k) and IRA over the college account.

There are good reasons why: If you have spent a good chunk of your savings on your children's education, and you are 75, can't work, and have

depleted your retirement savings, you can't go to a bank and take out a loan for food, utilities, and medicine.

But for college, students can get relatively large low-interest, federally subsidized student loans to pay part of the cost. So, obviously, loans can help make up for what you can't handle.

That, of course, could leave your children with debts as they begin their working years. The average college student with loans leaves college with about $20,000 in student-loan debt, which is a hefty sum. It's understandable to want to save your children from such a fate, and you should if you can. But keep in mind that college graduates have at least 10 years after school to pay off the low-interest loans. And during their working years, they generally will be in a better position to handle that burden than you will be to handle the life of a 75-year-old without savings.

Beyond that fact of life, however, there are other reasons to place retirement saving first, and college saving second.

If you have retirement saving well under control by the time the children start college, you can cut back on saving somewhat while they are in college and use a larger portion of your paycheck to pay for tuition during those few years.

Also, most students need some financial aid. But based on the quirky college-aid formula that is used to grant aid, families with large college saving funds can erode their opportunities for sizable aid packages. Yet, typically, colleges do not reduce aid based on well-endowed 401(k) plans or IRAs. So making retirement saving a priority can make college more affordable for middle-class families.

Don't take this for granted, however, especially if your income is well over $100,000. Then, you might find financial aid in short supply, and you will need all the savings you can accumulate. You can check now to see how likely your family might be to qualify for financial aid. Try the How Much Aid Can You Expect worksheet at www.smartmoney.com. Find it under Personal Finance and then College Planning.

If You Operate a Small Business

Often, small-business people get buried in the ongoing stress of running their businesses and feeding their families. They promise themselves to think about retirement saving "soon," and then *soon* can come decades later.

Since planning for retirement too frequently comes late in life, alternatives that are available need to be used to the max. So putting $4,000 or $5,000 a year into a Roth IRA is going to help. If you open a Roth for a spouse that will be even better. But you need to go further.

Consider the following options, but keep in mind that for a business, the decisions are more complex than for an individual. You must consider not only your income, but matters such as how many employees you have, what you might be able to contribute in good years and bad years, and the ease of handling a business retirement savings plan.

Talk to a certified public accountant to understand what matches your business and personal needs best. (Details are available in IRS Publication 3998 at www.irs.gov, and the American Institute of Certified Public Accountants provides information at www.aicpa.org. Search for "IRAs and 401(k)s: How to Pick the Best Plan.")

Here's some basic information to get you started.

Individual 401(k) or Solo 401(k)

If you are a sole proprietor and long for the days when you worked for someone else and had a 401(k) at work, long no more. You can treat yourself to the very same thing.

They are relatively new, but tax laws have been allowing self-employed people since 2001 to create what are called Individual 401(k) plans, or Solo 401(k) plans, or Single-Participant 401(k) plans. These can include a Roth 401(k) feature, so you can save money and know that it will be yours free and clear of taxes when you retire.

The problem with starting a 401(k) plan for an independent businessperson can be costs and IRA reporting requirements. Administrative fees are relatively high. Yet the benefit can be tremendous, because people can shelter huge amounts of money from taxes. That, of course, lets the person who ignored saving for years build up a nest egg quickly.

Self-employed people can save more than with most alternatives, because they have two ways of stashing away money without paying taxes on it. A person's total contribution can be as much as $45,000 currently, and can ratchet up annually with inflation. There are also "catch-up," or extra contributions, allowed for people over 50—$5,000 a year.

You get the maximum amounts through two different contributions. As a self-employed person, you are like anyone else with a 401(k). You can have money withheld from your paycheck. So in 2007, that would mean as much as $15,500, or $20,500 if you are over 50.

Then you can boost that again, as your own employer. In that role, you are entitled to contribute another 20 percent of your net self-employed income. So if you happen to make $147,500, you could contribute $29,500 to your solo 401(k). With that, along with the $15,500 you took out of your paycheck, you would reach the $45,000 maximum allowed.

Because of the large sums of money, the plans are attracting a wide range of financial companies. Among those offering them are Fidelity Investments, T. Rowe Price, and Charles Schwab. Make sure you compare costs, because they can seriously eat away at the potential for your money to grow. And pay attention to the calendar. To make a contribution this year, you must set up the plan by December 31.

Also, revisit the maximum contribution limits I have provided, because the government adjusts them on the basis of inflation.

SEP-IRA Simplified Employee Pension Plan

If you can't afford to stash away a lot of money and want an easy-to-handle plan that won't require annual filings, there are special IRAs for businesses that may be just the ticket.

With a SEP-IRA, or Simplified Employee Pension, you can contribute up to 25 percent of your business's net income as long as you don't exceed the $45,000 limit.

In lean years for your business, there is no requirement to make any contribution whatsoever. But if you have employees—even part-time employees—you must make contributions for them, too.

You don't have to do much thinking ahead to contribute to a SEP. If you are approaching an April 15 tax filing deadline and realize you'd like to shelter income, you can respond at the last minute.

Having a SEP is similar to having a traditional IRA except that you can contribute a lot more and shelter it from taxes. To get started, simply contact a mutual fund company, brokerage firm, bank, or other financial institution.

SIMPLE IRA (Savings Incentive Match Plan for Employees)

The name of this IRA tells all. It truly is simple to open, is inexpensive, and doesn't burden busy business owners with IRS reporting requirements.

Unlike with the other plans, however, business owners have to pay attention to the calendar. You must open a SIMPLE IRA by October of the year you want to contribute. (Use IRS Form 5304-SIMPLE or Form 5305-SIMPLE. Financial institutions will process most of the paperwork for you.)

And if you have employees who have earned at least $5,000 a year, you must allow them to contribute to a SIMPLE plan and provide matching funds between 1 and 3 percent of compensation.

Although this IRA is indeed simple, the drawback is the limit on contributions. You cannot shelter as much income from the IRS. This year, the limit on contributions is $10,500, although you can go to $13,000 if you are over 50.

The Next Step

Now that you are stashing away good sums of money into IRAs and 401(k)s, the next step is to make sure your savings harness their full growth potential. That means investing well. And the next few chapters will enable you to do it.