IRA Dos and Don'ts

You might have read a hundred articles about the value of using an IRA for part of your retirement funding. But actually investing in such a plan might be one of those tasks that keeps getting transferred from one to-do list to the next.

It's easy to see why that might happen. Even though IRAs were designed to be pretty straightforward savings vehicles, the IRA rules are confusing and off-putting under the best of circumstances. Nothing is altogether simple when the IRS is involved, so there are three key IRA types--the Roth, the deductible IRA, and the nondeductible IRA--all of which have varying pros, cons, and eligibility requirements. That can make it difficult to determine what type of IRA is right for you given your income, your time horizon, and your goals.

And even if you've identified the right IRA type, you'll have to navigate an even bigger, badder maze of choices: what type of investment to put into the IRA wrapper. Having too many options can lead to what behaviorists call "choice overload." That means that when individuals are confronted with too many options, they often choose to do nothing at all.

If you've been putting off funding an IRA, don't let choice overload bury you. You have until April 15 to make a contribution for the prior tax year, and, if you have cash on hand, you might as well fund your IRA for the current tax year at the same time.

Here are some dos and don'ts to keep in mind:

Do...

Think of the IRA as a way to take control of your investments. You know that old saying about having the wisdom to know what you can and can't control? Well, you can't control the market's ups and downs, but you certainly can make sure that your investments are as good as they can be, your investment costs are low, and that you're taking advantage of every tax-sheltered opportunity available to you. Contributing to an IRA is one such opportunity.

Use IRA calculators and/or work with a tax planner. It's important identify the IRA type that, one, you're eligible to contribute to, and two, will allow you to maximize your return once taxes are factored into the equation. Even if you're not eligible to make a direct Roth IRA contribution, be aware that you can make a backdoor IRA contribution by opening a traditional nondeductible IRA and converting to a Roth. But such a move requires several careful considerations; check with a financial pro to run the numbers for you.

Evaluate whether a conversion from a traditional IRA to a Roth makes sense. If you already have assets in a traditional IRA, the decision to convert those assets won't be an easy one because you may owe taxes at the time you convert. But if higher tax rates in the future are on your worry list, it's worth modeling out whether converting at least a portion of those IRA assets is worth your while. (Investors of any income level are now able to make a conversion.)

Look for holes. Before you pick securities for your IRA, size up your whole portfolio's stock/bond/cash/international mix and take note of any big sector or investing style biases; also
note whether you have any gaping holes in your portfolio. Alternatively, you can compare your portfolio with a target-date fund designed for someone in your same age range. If you find that you need to add to your holdings in a certain asset class or investment style, your IRA is a logical place to start.

**Pay attention to asset location.** You should try to optimize what types of securities you hold in your taxable accounts and what you hold in your tax-sheltered ones. There's no need to go out of your way to find investments that incur a lot of taxes, such as fast-turnover stock funds or high-income bond funds. But to the extent that you hold such vehicles, you may want to do so within the confines of your IRA.

**Be a contrarian.** Although you may be a long ways away from retirement, it's always worth considering whether it's a good or bad time to buy a given security. Contrarian fund investors might consider swim-against-the-tide funds run by time-tested managers.

**Don't...**

**Forget about your spouse.** Married couples that include a working and nonworking spouse can maximize their aftertax results by setting up IRAs for both individuals. A so-called spousal IRA is an option as long as you file a joint return and the working spouse has earned enough qualifying income to fund both his or her own IRA and that of the spouse.

**Assume that you need a lot of cash on hand to invest in an IRA.** Although you have to make your entire IRA contribution for the prior tax year by April 15, you can spread your current year's contributions throughout the tax year. Such a strategy, called dollar-cost averaging, helps ensure that you're not putting money to work when the market is peaking. It also makes an IRA a more affordable option for those who don't have the full contribution amount on hand. Ask your brokerage, supermarket, or fund company to help you set up regular monthly contributions to an IRA; some fund firms may let IRA investors in the door with lower minimum investments than they require for taxable accounts.

**Shelter investments with tax benefits, such as variable annuities or municipal bonds, inside an IRA.** IRAs already offer tax-deferred (or in the case of a Roth, tax-free) compounding, so there's no need to stash tax-advantaged instruments like municipal bonds or variable annuities within them. To the extent that you own them, save those tax-favored options for your taxable accounts and consider them only after you've maxed out your tax-sheltered options.

**Let assets languish in a lackluster 401(k).** Are your retirement assets sitting in your 401(k) account at your former employer? That's fine if your ex-employer fielded an ultracheap plan with great investment options, but many 401(k) plans aren't particularly distinguished and are larded with extra fees. Think about rolling the plan assets into an IRA, which opens up a huge array of investment choices. Fund companies and supermarkets should be happy to help. (After all, they'll be earning fees on your assets!)

**Put off investing in an IRA because you may need the money for a shorter-term goal.** Newer investors might steer clear of an IRA because they assume they'll be socking away the
money forever and ever. Not necessarily. In fact, you can withdraw your contributions to a Roth IRA at any time and for any reason, and you can also withdraw money from an IRA, free of penalty, in certain situations, such as to buy a first home. IRS Publication 590 provides complete details on when it's possible to tap your IRA penalty-free.

Assume that you don't need to contribute to an IRA if you already contribute to a 401(k). If you're maxing out your 401(k), pat yourself on the back; after all, you can contribute $17,500 to a 401(k) in 2013 ($23,000 if you're over 50). But even dedicated 401(k) savers might want to consider an IRA, as well. That's because IRAs can help you diversify the tax treatment of your retirement assets. For example, if you're contributing the max to a traditional 401(k), you'll owe taxes on a mother lode of assets when you retire and begin tapping the assets. Withdrawals on Roth IRA assets, meanwhile, will be tax-free. By hedging your bets among the two vehicles, you have less riding on a wager about whether tax rates will be higher or lower in the future; you also maximize your tax-deferred savings. (The Roth 401(k) is another way to hedge against the possibility of higher taxes in the future.)

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