

IRA AND RETIREMENT PLAN TAXATION YOU MAY BE PAYING TOO MUCH

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When you put money into your IRA or retirement plan, the money was deducted from your taxable income that tax year. You have never paid income tax on that money. We call this money tax-deferred. The money is going to be taxed when it comes out of the IRA. If it comes out before age 59 1/2, the money will be subject to a 10% early withdrawal penalty.

If you own stocks or bonds in your IRA or retirement plan, as most people do, you need to be focused on the income tax that will eventually be paid. By the way, stock or bond mutual funds are just another form of stock or bond ownership, so this article applies to mutual fund holdings as well.

Usually when you own stocks (or bonds) and they go up in price, you pay income tax at ordinary income tax rates on the increase in the value of the shares owned. If the shares are owned longer than a year, you pay income tax on the shares at a special lower capital gains rate. This is meant to encourage people to hold stock for the long term and allow the economy to use money invested in stocks to finance new equipment and machinery of the company for which the stock was issued.

The rules work differently, however, with respect to retirement fund money. Because the money that you put in has never been taxed, when it comes out, usually way past one year after purchase, it is still taxed at the ordinary income tax rates. The holding period to achieve the lower capital gains rate does not begin until the money is taken out of the retirement plan. In other words, when you take stock out of a retirement plan (even if you do not sell it) you pay income taxes on the increased value of the stock from the date that you purchased it in the retirement plan. Then, when the stock is sold, you pay income taxes on the increased value of the stock from the date that you took it out of the retirement plan. These should be viewed as two separate transactions. If stock is taken out of a retirement plan and immediately sold (or sold within one year), it really makes no difference because the income tax rates on these two separate transactions are the same, so it appears that you are paying tax on the difference between the original purchase price within the retirement plan and the value on the date that you sell the stock after you take it out of the retirement plan.

The difference would manifest itself if you withdraw stock from your retirement plan, held it one year, and then sold it later. In that case, upon withdrawing the stock from the retirement plan you should pay ordinary income tax rates on the increased value of the stock since the day of purchase within the retirement plan, and, then, capital gains tax rates on the increase in the value of the stock from the date that you took it out of the retirement plan until the day it is sold.

CAUTION. Most brokerage firms and mutual fund companies do not properly account for these transactions. What typically happens is a broker or mutual fund company will issue a 1099 upon distribution of an interest in a retirement plan. This 1099 will reflect the increased value of the investment from the date that it was purchased within the retirement plan to the date that you withdraw it from the retirement plan. So far, so good. Income tax should be paid on this distribution. When the stock or mutual funds are later sold, however, the broker or mutual fund does not adjust the holding period to begin again on the date that the investment was initially distributed out of the retirement plan. This means that upon later sale of the stock, the holding period is determined as if the stock were owned outside of the retirement plan from the very first day it was purchased. This leads to capital gains tax on the eventual proceeds from sale if the stock has been held longer than a year since original purchase, but it also leads to payment of tax twice on the value that accumulated while the stock was held by the retirement plan.

The legal name for the value used to determine tax liability is called basis. Simply put, most mutual funds and brokerage houses do not adjust the basis in their computer records when they distribute stock out from a retirement plan. It is up to an accountholder to be alert and avoid double payment of income tax when previously owned retirement investments are sold after distribution.

Most accountants are thrilled that a client provides them with basis records from the broker and blindly use this information to calculate income taxes owed. Brokers and mutual funds, if questioned, will simply give out the unadjusted historical basis

information from their client records. Therefore, the onus falls on the accountholder to make sure that they are not paying an incorrect tax.

To make matters worse, if your tax return contains mistakes based on the misinformation as set forth above, this may have affected your adjusted gross income which is the figure used on your tax return to calculate all sorts of other deductions, such as child tax credits, education credits, deductions, exemptions, and other tax breaks which may have been incorrectly calculated and which may have been lost as a result.

With a Roth IRA, the problem is even worse. When the information is incorrectly reported by your broker or mutual fund, you will end up paying tax on the appreciation in the Roth IRA, which should have never been taxed at all.

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