Morgan Stanley

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# Understanding Traditional and Roth IRAs

SUMMARY

An Individual Retirement Account (IRA) is a powerful savings vehicle that can help you meet your financial goals. As shown in the chart on page 2, either a Traditional IRA or a Roth IRA gives you significant benefits when compared with a taxable account. An IRA can also help you achieve many other financial goals, including estate planning, education funding, a first-time home purchase, charitable giving and payment for extraordinary medical and disability expenses.

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# Traditional and Roth IRAs: Key Differences

For over a quarter of a century, the Traditional IRA has been one of the most popular ways to save for retirement. Contributions made to this account may be tax deductible and have the potential to reach substantial amounts over time through tax-deferred growth.

The Roth IRA is an alternative savings vehicle created by the Taxpayer Relief Act of 1997. Similar to the Traditional IRA, Roth IRAs can be an effective way to build funds for retirement or other intermediate and long-term financial goals. However, a Roth IRA is different from a Traditional IRA in that the account is funded with after-tax contributions; this allows for tax-free distributions during retirement with no required minimum distributions at age 70½.

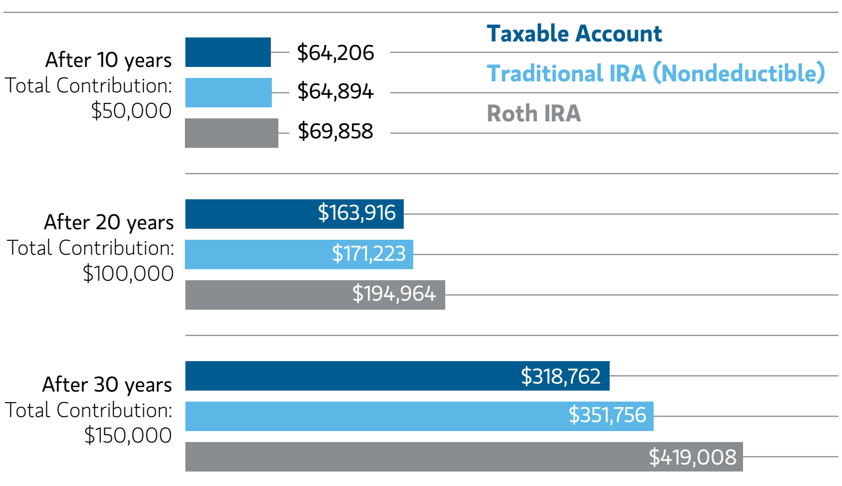
**ELIGIBILITY.** If you or your spouse has earned income, you may contribute to a Traditional IRA as long as you do not reach age 70½ by the end of the contribution year. Contributions to a Roth IRA may continue beyond age 70½. The amount you can contribute is based on your earned income.

If you aren't eligible to contribute to a Roth IRA, you still can convert existing retirement savings in a Traditional IRA or a former employer's retirement plan to a Roth IRA. For more details on whether a Roth Conversion is appropriate for you, see page 3.

**MAXIMUM CONTRIBUTION.** The annual maximum contribution for either type of IRA is $5,000 or 100% of earned income, whichever is less. There is also an annual catch-up contribution permitted, in the amount of $1,000, for individuals age 50 and older. Thus, starting at age 50, savers can increase their annual contribution to $6,000.

## IRAs: The Tax-Advantaged Way to Save

*Regardless of whether you choose a Traditional or Roth IRA, the potential for tax-deferred growth of your IRA funds gives you the potential to save more for retirement, on an after-tax basis, than the same amount of funds in an account that generates taxable income each year.*




Assumptions: $5,000 annual IRA contribution.
6% annual rate of return.
25% ordinary income tax bracket.

Source: For illustrative purposes only.
Not representative of any specific investment.

# Guidelines for Choosing Your IRA

How do you choose between the current benefits of a tax-deductible Traditional IRA and the future tax-free income of a Roth IRA at retirement? Factors to consider include your age at time of funding, current and projected tax brackets, potential growth rates and whether you and/or your spouse are covered by a retirement plan at work. A Morgan Stanley Financial Advisor can produce an analysis for you that will show the anticipated growth of a contribution to both a Traditional IRA and to a Roth IRA. Additionally, here are several helpful guidelines to help you make your choice:

**FUND A TRADITIONAL IRA WHEN:**

- Your modified adjusted gross income (MAGI) is too high to make a full contribution to a Roth IRA.
- You are eligible for an income tax deduction on your Traditional IRA contribution and you expect to be in a lower tax bracket in retirement.

**FUND A ROTH IRA WHEN:**

- You are not eligible for a deduction on a Traditional IRA.
- You are eligible for an income tax deduction on a Traditional IRA contribution, but expect to be in a higher tax bracket in retirement.

**CONVERT TO A ROTH IRA WHEN:**

- Your Traditional IRA consists of mostly nondeductible contributions or has little or no growth, making your tax liability on the conversion low.
- You are able to pay the tax liability incurred on the Roth IRA conversion with funds outside the IRA.
- You don't anticipate needing the funds for quite some time. Consider how far away you are from retirement. The longer your time horizon, the more time your Roth IRA will have to recover from the taxes paid at conversion and the longer the account will benefit from years of potential tax-free growth.
- If you think tax rates will increase or that you may be in a higher tax bracket in retirement, you may prefer to pay taxes now on your retirement savings, rather than in retirement.

**IMPORTANT FACTORS TO CONSIDER WHEN CONVERTING TO A ROTH IRA**

- You will need to pay taxes on the taxable amount (including deductible contributions and earnings) when you convert, but the premature distribution penalty won't apply.
- It's important to identify funds outside your current retirement plan that can be used to pay the taxes due on the conversion to a Roth IRA. Tapping into the amount converted from a Traditional IRA or employer-sponsored retirement plan to pay taxes will reduce the amount available in the Roth IRA to potentially earn tax-free income — and trigger a 10% penalty if you're under age 59 ½ (unless an exception to the penalty tax is available).
- If you have pretax and after-tax funds in a Traditional IRA, there are certain rules that determine how these funds can be converted. Your tax advisor can help you determine which funds can be converted and the amount of taxes due on a conversion.

If the investment markets decline after conversion, resulting in a decrease in the value of the converted assets, you have the option of recharacterizing the account back to a Traditional IRA — in essence, undoing the conversion. The Roth IRA recharacterization must be completed by your tax-filing deadline, plus extensions, for the year of conversion.

**GET HELP MAKING YOUR DECISION**

To help you understand how a Roth conversion may impact your financial situation, a Morgan Stanley Financial Advisor can provide a personal Roth Conversion Illustration Report for you. This report explores your specific circumstances, factoring in such variables as the amount to be converted, the distribution year, your date of birth and where you are in the retirement planning cycle. Based on this input, the report shows hypothetical after-tax future values of an IRA balance, comparing the outcomes of a Traditional IRA with those of a Roth IRA. You'll also be able to see the wealth planning advantages of "stretching" a Roth IRA over multiple generations. As with all tax-related issues, you should also discuss your situation with your tax advisor.

# Taxes and Penalties on Distributions: Traditional and Roth IRAs

Generally, all distributions from Traditional IRAs are subject to income taxes, except for the portion attributed to nondeductible contributions.

**FOR DISTRIBUTIONS TAKEN BEFORE AGE 59½, A 10% PENALTY IS ASSESSED, WITH THE FOLLOWING EXCEPTIONS:**

- Disability.
- Distributions to beneficiaries upon IRA holder's death.
- Unreimbursed medical expenses exceeding 7.5% of AGI.
- The purchase of medical insurance after receiving unemployment compensation for more than 12 weeks.
- Qualified education expenses for the IRA holder or immediate family.
- Purchase of a first home ($10,000 lifetime limit).
- Withdrawals under a 72(t) or Substantially Equal Periodic Payments schedule.
- Portion of the distributions consisting of nondeductible contributions.
- Qualified reservist distributions.

**REQUIRED MINIMUM DISTRIBUTIONS.** Upon reaching age 70½, annual required minimum distributions must begin from a Traditional IRA. The first distribution, however, may be postponed until April 1 of the following year.

With a Roth IRA, contributions can be withdrawn tax free at any time, while earnings can be withdrawn tax free if certain conditions are met.

**TAX-FREE WITHDRAWALS.** For the purpose of taxation, all distributions are considered to come from contributions first and earnings last. Since contributions are nondeductible, they are tax free and penalty free upon withdrawal at any time. Accumulated earnings may be subject to taxation according to the following rules.

**TAX FREE AND PENALTY FREE IF HELD FOR FIVE YEARS OR MORE IN CONJUNCTION WITH ONE OF THE FOLLOWING CONDITIONS:**

- Over age 59½.
- Used for first-time home ownership ($10,000 lifetime limit).
- Due to disability.
- Distributed to beneficiaries upon IRA holder's death.

**ORDINARY INCOME TAX ON EARNINGS WHEN:**

- One of the above exceptions applies but account is held for less than five years.
- Used for qualified higher-education expenses incurred by the IRA holder or an immediate family member.
- Used to cover unreimbursed medical expenses exceeding 7.5% of AGI.
- Used to purchase medical insurance after receiving unemployment compensation for more than 12 weeks.
- Withdrawals under a 72(t) or Substantially Equal Periodic Payments Schedule.
- The distribution is a qualified reservist distribution.

**ORDINARY INCOME TAX AND 10% PENALTY ON EARNINGS WHEN:**

- None of the above exceptions apply.

**REQUIRED MINIMUM DISTRIBUTIONS.** Unlike a Traditional IRA, there are no required minimum distributions after age 70½ for the owner or spousal beneficiary with a Roth IRA.

**SPECIAL WITHDRAWAL RULES FOR ROTH IRA CONVERSIONS.** A distribution from a Roth IRA containing converted funds may be subject to certain taxes and penalties.

**WITHDRAWAL OF CONVERTED AMOUNT.** If the federal income tax on the conversion has been paid, a distribution of the conversion amount will be federal income tax free. Earnings on the conversion amount would generally be taxable if held for less than five years. The 10% penalty tax could apply to the entire converted amount if the IRA holder is under age 59½ and the IRA account is maintained for less than five years, unless an exception applies. Special rules apply for measuring and determining any applicable five-year period. Consult your tax advisor for more information.

**WITHDRAWAL OF EARNINGS AND GROWTH:**

- Same rules as Roth IRA.

# Four Ways to Power Up Your IRA Savings

Once you have decided which IRA is right for you, the next step is to ensure you take full advantage of the benefits these vehicles can provide. Consider one or more of the following suggestions:

**1. BABY BOOMERS CAN PLAY "CATCH-UP."** The "catch-up" contributions give many Baby Boomers approaching retirement the ability to make up for missed contributions. To be eligible, you must turn 50 by the end of the contribution year, not necessarily when the contribution is made. For example, an IRA holder who turns age 50 on December 31 will be eligible for a catch-up contribution for that year, even if the funds are deposited earlier in the year.

**2. DOUBLE THE FAMILY NEST EGG WITH SPOUSAL CONTRIBUTIONS.** Spousal contributions are a way for a wage earner to put aside funds for a nonworking spouse's retirement. A couple may contribute the annual maximum in each spouse's IRA as long as one spouse earns at least as much as the combined contributions.

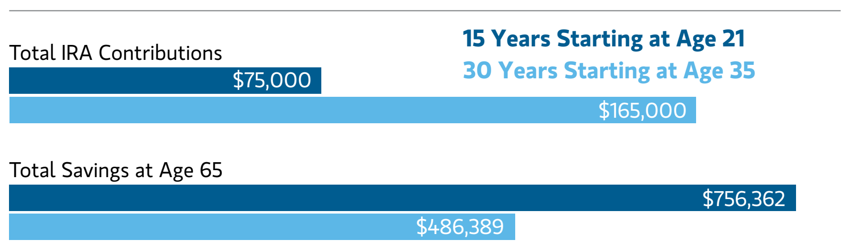
**3. TAKE ADVANTAGE OF AN EARLY START.** Investing more money at an earlier age will give your retirement assets more time to grow.

The illustration below shows the potential value of contributing to an IRA early in one's career. Because of the tax-deferred compounding potential of IRA contributions, this 21-year-old who contributed the maximum amount of $5,000 annually to an IRA for 15 years at a 6% hypothetical annual rate of return, saved 50% more with half the number of contributions as someone who started contributing later in life ($5,000 until age 50; $6,000 afterwards).

**4. FUND YOUR IRA EARLY IN THE YEAR.** While the deadline to make your IRA contribution is always April 15 of the next year, you can fund your IRA as early as January 1 of the current year. By doing so, you will capture an additional 15 months' worth of interest or earnings. Over time, this can result in a dramatic difference.

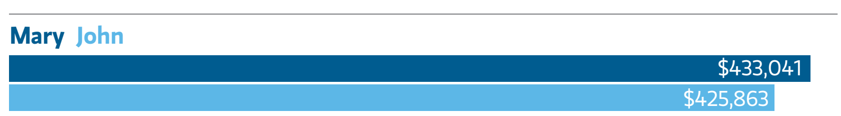
In the second illustration below, Mary makes her annual IRA contributions on January 1, while John waits until April 15 of the following year. If they both contribute $5,000 annually for 30 years, and earn a hypothetical 6% annual rate of return, Mary can accumulate more than $7,000 in additional gains just for funding early.

## Value in Starting an IRA Early




Assumption: 6% annual rate of return.
Source: For illustrative purposes only. Not representative of any specific investment.

## Added Value in Early Annual Contributions




Assumption: 6% annual rate of return.
Source: For illustrative purposes only. Not representative of any specific investment.

# Why Consolidating Makes Sense

If you're like most people, you probably have multiple retirement accounts—IRAs you may have opened over the years or account balances you may have left in the plans of former employers. Together, these assets may represent a significant sum. Here are some good reasons to consider consolidating these accounts:

- **Comprehensive investment strategy** — It can be difficult to maintain an investment strategy that accurately reflects your goals, timing and risk tolerance when assets are spread among multiple financial institutions. With a single account, you can more easily assess whether your portfolio aligns with your retirement goals.
- **Greater investment flexibility** — A self-directed IRA, such as the one offered by Morgan Stanley, generally offers you the ability to choose from a wide range of investment products, including stocks, bonds, mutual funds, annuities and more.
- **Simplified tracking** — It is easier to monitor your progress and investment results when all your retirement savings are in one place, because you will receive one statement instead of several. That simplifies your life while conserving paper, which helps protect the environment.
- **Lower costs** — Reducing the number of accounts you own may also reduce your account fees and other investment-related charges.

Dealing with one account rather than several also simplifies the distribution process—including complying with complex minimum distribution rules when you reach age 70½. Also, you avoid the risk of losing track of your retirement accounts or access to the account assets should your former employer merge with another company or go out of business.

# How to Consolidate

If you wish to consolidate your IRA assets at Morgan Stanley, you can initiate a transfer or a rollover. In an IRA transfer, you may instruct your current IRA custodian to transfer cash and/or securities directly to Morgan Stanley. You may elect unlimited transfers within one year. In a rollover, your current IRA custodian will distribute cash and/or securities directly to you. Within 60 calendar days, you must deposit the same assets into your new IRA. Failure to deposit your IRA distribution within the 60-day window will trigger ordinary income taxes and a possible 10% penalty on the taxable portion of the distribution. This option is only available once during any 12-month period for each IRA.

A Morgan Stanley Financial Advisor can help you assess your alternatives so you can make decisions based on what's best for you. Make an appointment now to review your retirement savings strategy.

**KEY FEATURES OF MORGAN STANLEY IRA STATEMENTS**

Withdrawals are clearly marked. Federal taxes withheld from withdrawals are shown.

Minimum distribution requirements are indicated for assets held within IRAs at Morgan Stanley.

Transfers and rollovers from outside accounts are shown in a separate category.

Year-end fair market values of IRA assets are displayed.

Statements are sent out quarterly, or monthly, if there is activity in the account during that month.

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