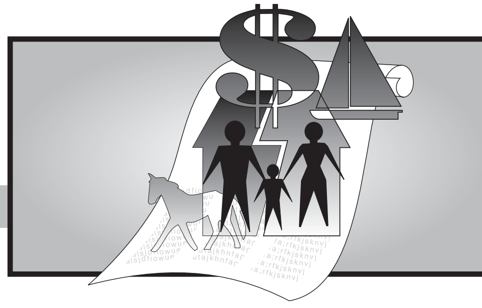
Virginia Cooperative Extension

REVISED 2002

PUBLICATION 448-060W



Managing Prosperity: Estate and Retirement Planning for all Ages

Traditional Individual Retirement Accounts (IRAs)

Alex White *

Since 1982, traditional Individual Retirement Accounts (IRAs) have been powerful retirement planning tools available to individuals. However, many Americans do not understand what an IRA is, how an IRA might help them, and if a traditional IRA is a wise investment for them. This bulletin answers some of the more frequently asked questions about traditional IRAs.

What is a traditional IRA?

A traditional IRA provides federal taxpayers with a tax-advantaged method of investing for retirement. It is intended to provide individuals with a substantial portion of their retirement living needs. Remember, Social Security benefits are meant to be a **supplement** to individual savings, not a **substitute**! By investing funds in a traditional IRA, you may be able to reduce your current income taxes, and you will be able to defer income taxes on your earnings until the future. Generally, you cannot withdraw funds from a traditional IRA before the age of 59 1/2 without facing an early withdrawal penalty.

A traditional IRA is different from a Roth IRA, Coverdell Education Savings Accounts (formerly known as Education IRAs), a SEP-IRA and a SIMPLE-IRA. For a complete reference on individual retirement accounts see IRS Publication 590 – Individual Retirement Arrangements.

Who can open an IRA?

There is no minimum age limit for opening an IRA. Anyone who is less than age 70 1/2 by the end of the year and receives "taxable compensation" during the year is eligible to open a traditional IRA. Taxable compensation simply refers to earned income, or income that is reported on Form W-2. Examples of taxable compensation include salaries, wages, commissions, self-employment income, and alimony received. Compensation does not include passive earnings such as rental income, interest income, dividend income, pension income or annuity income. You may open a traditional IRA even if you participate in another qualified retirement plan; however, your annual contributions may not be entirely tax deductible.

*Assistant Professor, Family Financial Management, Department of Apparel, Housing, and Resource Management, Virginia Tech

What are the tax benefits of a traditional IRA?

Traditional IRAs offer two significant tax benefits: **tax deductions and tax deferral.**

Tax Deductions: For many individuals, annual contributions to an IRA are tax deductible. This means their adjusted gross income (AGI) is decreased by making contributions to an IRA; thus, they can reduce the amount of income taxes they pay each year. For example, assume you are in the 28 percent federal marginal income tax bracket and the 5.75 percent Virginia marginal income tax bracket. By making a $2,000 annual contribution to your IRA, you can reduce your federal income taxes by $560 per year ($2,000 x 0.28) and your Virginia income taxes by $115 per year ($2,000 x 0.0575). Your annual IRA contributions may or may not be deductible, depending on whether or not you or your spouse were covered by an "employer retirement plan" (explained below) at any time during the year.

Tax Deferral: The earnings of a traditional IRA are not taxed until the funds are withdrawn from the account. This effectively defers, or delays, income taxes until the future. An advantage of tax deferral is that you may reduce your overall tax liability on the earnings of your IRA because you are likely to be in a lower marginal tax bracket when you retire. For example, assume the investments in your IRA earn $500 this year. You do not owe any income taxes on those earnings as long as you do not withdraw that money from your account. Tax deferral allows you to increase your investments much faster than if you invested in a taxable account. This is because you earn returns on money that otherwise would have been paid to the government in the form of income taxes.

What is an employer retirement plan?

You can easily tell if you are enrolled in an employer retirement plan by looking at the pension box of your W-2 form. If that box is checked, you were covered by the employer's retirement plan during the tax year. Social Security is not considered an employer retirement plan. Examples of employer retirement plans include:

Pensions, profit-sharing plans, stock bonus plans, money purchase plans, Keogh plans, 401(k) plans, union plans, annuity plans, 403(b) plans, 457(b) plans, Simplified Employee Pension plans (SEPs), 501(c) trust plans, and SIMPLE-IRAs.

You are not covered by an employer retirement plan. Will your entire annual IRA contribution be tax deductible?

The answer to this question depends on your federal income tax filing status. Your entire contribution is fully deductible if your filing status is: Single, Head of Household, or Qualifying Widow(er), or if your filing status is Married Filing Jointly or Separately and your spouse is not covered by a retirement plan at work. For married couples who file jointly, but one spouse is covered by a plan at work, your contributions are fully deductible as long as your Adjusted Gross Income (AGI) is less than $150,000. If your filing status is Married Filing Separately and your spouse is covered by a plan at work, your contributions are partially deductible as long as your AGI is less than $10,000.

You are covered by an employer retirement plan. Will your entire annual IRA contribution be tax deductible?

Again, the answer depends on your filing status and your AGI. For those who file Single or Head of Household, your entire contribution is fully deductible as long as your AGI is less than $34,000 (increasing to $50,000 by 2005). For those filing Married Filing Jointly or Qualifying Widow(er), your contribution is fully deductible as long as your AGI is less than $54,000 (increasing to $80,000 by 2007). If you file Married Filing Separately, your contribution is only partially deductible as long as your AGI is less than $10,000.

How much can you contribute to a traditional IRA in one year?

The maximum annual contribution is the lesser of 100 percent of your compensation for the year or the amount shown below:

Tax year	IRA Limit	IRA Limit for taxpayers age 50 and over
2001	$2,000	$2,000
2002	$3,000	$3,500
2003	$3,000	$3,500
2004	$3,000	$3,500
2005	$4,000	$4,500
2006	$4,000	$5,000
2007	$4,000	$5,000
2008	$5,000	$6,000

Thus, if you only earned $1,000 last year, the maximum IRA contribution you can make is $1,000 for that tax year. Remember, you cannot make contributions to a traditional IRA if you are over the age of 70 1/2 by the end of the year.

In what assets can IRA contributions be invested?

An IRA is not an investment asset, it is a retirement investment plan. You must decide in what assets your annual contributions are going to be invested. The most common investment assets for IRAs are corporate stocks, bonds, mutual funds, and certificates of deposit (CDs). Realize that each of these assets has different potential returns and different levels of risk. In general, corporate stocks have higher historical earnings than other investments, but they are also more risky than the other investments. It is your responsibility to choose your investment assets – it is strongly recommended that you obtain professional advice if you are uncomfortable with financial decisions.

Are the funds in an IRA guaranteed against loss?

The answer to this question depends on how you have your funds invested. Always remember the risk-return tradeoff – the higher the earnings potential of the asset, the higher the risk that you face. If you have all of your funds invested in U.S. Treasury securities or CDs, then your funds are essentially guaranteed against loss. The downside to this strategy is that you will probably not earn a high rate of return. To receive a higher rate of return, you will usually have to invest in higher risk assets, such as corporate stocks, bonds, or mutual funds. Realize that your money is "at risk" with these assets – you may lose all or part of your investment.

Can a non-working spouse make IRA contributions?

Yes, as long as the working spouse received compensation (earned income) during the year. The maximum annual contribution for a non-working spouse is the lesser of the total compensation reported as gross income (minus any IRA contributions) or the amount shown in the table above. This means that the maximum annual contributions for a married couple in tax year 2002 is $6,000 – a maximum of $3,000 to the working spouse's IRA and $3,000 to the non-working spouse's IRA.

Can you make annual contributions that are less than the maximum allowed?

Yes. You do not have to make the maximum annual contribution. However, if you make less than the maximum contribution in one tax year, you cannot make more than the maximum contribution in a following year in an attempt to "catch up."

Once an IRA is established, do you have to make contributions every year?

No. You do not have to make IRA contributions every year, even if you are eligible.

Do you have to make a "lump sum" contribution one time per year, or can you make monthly contributions?

You may make IRA contributions whenever you like throughout the year. You can make monthly contributions if you prefer. Regardless of how often you make your contributions, you must stay under the maximum annual contribution limit.

What is the deadline for making annual contributions?

Contributions for a certain tax year must be made by the deadline for filing your federal income taxes. This deadline is usually April 15 of the following year. For example, if you would like to make an IRA contribution for tax year 2002, the last possible date that you can make your contribution is April 15, 2003.

When can you begin to withdraw funds from an IRA?

You may begin to withdraw funds from your traditional IRA without penalty at age 59 1/2. You will pay ordinary income taxes on the amount you withdraw from your account. For example, assume you are 60 years old and in the 15 percent tax bracket. If you withdraw $10,000 from your traditional IRA, you will owe $1,500 in federal income taxes.

You must begin to withdraw funds from a traditional IRA at age 70 1/2. The IRS has a formula for determining the minimum amount you must withdraw each year after you reach age 70 1/2.

What are the penalties if you withdraw money from an IRA before the minimum age?

Generally speaking, if you withdraw funds from your traditional IRA before the age of 59 1/2, you will incur an early withdrawal penalty plus ordinary income taxes on the amount you withdraw. The early withdrawal penalty is 10 percent of the amount withdrawn. For example, assume you are 50 years old, in the 15 percent tax bracket, and you withdraw $10,000 from your IRA this year. You will owe $1,000 in early withdrawal penalties, plus $1,500 in ordinary income taxes. Thus, out of a $10,000 withdrawal, you will be left with $7,500 after penalties and income taxes.

There are exceptions to the age 59 1/2 rule. You may be able to withdraw funds from an IRA before age 59 1/2 in the following situations:

- you have un-reimbursed medical expenses that are more than 7.5 percent of your adjusted gross income the withdrawals
- you take are less than the cost of your medical insurance you are disabled
- you are the beneficiary of a deceased IRA owner
- you receive your withdrawals in the form of an annuity (constant payments over a specified period of time)
- the withdrawals are less than your qualified higher education expenses
- you use the distributions (up to $10,000) to buy, build or rebuild a first home

See IRS publication 590 (Individual Retirement Arrangements) for more detailed information.

Can you make non-deductible contributions to an IRA?

Yes, you can make non-deductible contributions to a traditional IRA. If your contributions are partially deductible or non-deductible, you can make contributions to a non-deductible traditional IRA. These contributions will not reduce your annual income tax liability, but the earnings of the non-deductible IRA will grow tax deferred. If you do this, be sure to designate the IRA specifically as non-deductible. Do not mix deductible and non-deductible contributions within one IRA. You will greatly ease the record keeping efforts by maintaining a separate non-deductible IRA.

For many Americans, the Roth IRA is a better choice than a non-deductible traditional IRA. Contributions to a Roth IRA are not tax deductible, but the earnings are tax free. Please see VCE Publication 448-062W on the Web for more information on Roth IRAs.

Can children have a traditional IRA?

There is no minimum age limit for opening an IRA, so children may open an IRA if they have earned income during the year. The income they earn must be consistent with the job/duties they perform.

Can funds from another retirement plan be converted into a traditional IRA?

In most cases, yes. This is called a Rollover IRA – you are "rolling" funds from one retirement plan into an IRA. You may roll over all or part of the funds from an existing IRA with no penalty, as long as the funds are transferred "trustee to trustee." You cannot deduct the amount that you roll over from your income taxes.

If you receive eligible rollover distributions from an employer's retirement plan, such as a 401(k), or 403(b), you may roll these funds into a traditional IRA with no penalty. Ask the administrator of your employer's retirement plan for written details of the rollover process.

Where can you open a traditional IRA?

You can open an IRA at commercial banks, federally-insured credit unions, savings and loan associations, or any entity approved by the IRA to act as a trustee or custodian. This includes certain investment brokers and insurance agents. Make sure that you specify the tax year for which you are making the contributions. For example, if you make an IRA contribution on March 1, 2003 for tax year 2002, be sure the contribution form clearly indicates that your contribution is for tax year 2002.

Can you have more than one IRA?

Yes, you may have as many IRAs as you like. However, total annual contributions to all IRAs cannot exceed the maximum annual contribution limit. For example, assume you have a traditional IRA with a bank and another IRA with a savings and loan. The maximum annual contribution you can make for tax year 2002 is $3,000. That means you can contribute $1,500 to each IRA, or $2,000 to one and $1,000 to the other, or any combination that does not exceed $3,000 in that tax year.

You should have a separate IRA if you are making non-deductible contributions. This will greatly ease the record keeping efforts when you begin to withdraw funds from accounts.

Can you have other retirement investments and IRAs at the same time?

Yes. You can have a traditional IRA at the same time you participate in other retirement plans. However, your contributions may not be tax-deductible, depending on your filing status and adjusted gross income.

You can have a Roth IRA and a traditional IRA at the same time. You can make contributions to both IRAs in the same year, as long as the total combined contributions do not exceed the maximum annual contribution limit.

Are traditional IRA contributions eligible for the Saver's Tax Credit?

Yes, as long as you are eligible for the saver's credit for tax years beginning after December 31, 2001. The saver's tax credit is a nonrefundable income tax credit for eligible taxpayers who make voluntary contributions to qualified retirement plans. An income tax credit directly reduces your annual income tax liability. This means that you may be able to reduce your annual income taxes even further by making a contribution to a traditional Roth IRA. See IRS Publication 553 "Highlights of Tax Changes" for more information.

Watching your IRA grow

Time is your best friend in investing. The earlier you start, the larger your IRA will be when you retire. The following table illustrates the potential growth of maximum annual contributions (indexed to inflation in $500 increments, assuming an annual inflation rate of 3 percent) to investment assets with various average annual rates of return. Please note that investments that earn higher rates of return tend to be more risky.

Further Information

For further information about traditional Individual Retirement Accounts (IRAs), see the following sources:

<u>Individual Retirement Arrangements (IRAs)</u>. Publication 590. Department of the Treasury, Internal Revenue Service. 2001.

IRS – The Digital Daily website:
http://www.irs.gov/cover.html

Virginia Department of Taxation website:
http://www.tax.state.va.us/index.htm

Alex White, Ph.D. can be reached at (540) 231-4368 (phone) or moneyguy@vt.edu (email).

Years to Retirement	Average Annual Rate of Return				
	3%	6%	9%	12%	15%
5	$18,496	$20,110	$21,848	$23,720	$25,734
10	$47,625	$55,449	$64,694	$75,616	$88,517
15	$86,332	$108,160	$136,557	$173,582	$221,921
20	$136,673	$184,674	$253,651	$353,348	$497,998
25	$201,561	$294,167	$441,530	$678,533	$1,062,377
30	$283,346	$447,863	$738,428	$1,260,149	$2,206,834
35	$386,312	$662,404	$1,204,868	$2,295,602	$4,520,077
40	$514,989	$959,698	$1,933,680	$4,132,586	$9,186,100