16. Individual Retirement Accounts

Introduction

Through enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Congress established individual retirement accounts (IRAs) to provide workers who did not have employment-based pensions an opportunity to save for retirement on a tax-deferred basis. U.S. tax law has substantially changed the eligibility and deduction rules for IRAs since then. The Economic Recovery Tax Act of 1981 (ERTA) extended the availability of IRAs to all workers, including those with pension coverage. The Tax Reform Act of 1986 (TRA ’86) retained tax-deductible IRAs for those families in which neither spouse was covered by an employment-based pension but restricted the tax deduction among those with pension coverage to families with incomes below specified levels. In addition, TRA ’86 added two new categories of IRA contributions: nondeductible contributions, which accumulate tax free until distributed, and partially deductible contributions, which are deductible up to a maximum amount less than the $2,000 maximum otherwise allowable. While TRA ’86 made IRAs less advantageous for some individuals, most individuals may contribute the maximum amount on a tax-deductible basis. For all individuals, IRAs remain a tax-effective way to save for retirement. However, like any other financial arrangement, IRAs require careful planning and monitoring. And because their ultimate purpose is to provide retirement income, investments need to be directed toward long-term return. This chapter offers an introduction to IRA eligibility rules, contribution limits, distributions, taxation, and investment options.¹

Eligibility

IRAs may be established under one or more of the following circumstances:

• **Individuals who are not active participants in an employment-based retirement plan**—Regardless of income level, any part-time or full-time worker who is younger than age 70 1/2 and not an active participant in an employment-based plan may establish and contribute to a personal IRA. The Internal Revenue Service (IRS) defines active participant as a person who is covered by a retirement plan: i.e., an employer or union has a retirement plan under which money is added to the individual’s account or the individual is eligible to earn retirement credits. An individual is considered an active participant for a given year even if he or she was only with the employer for part of the year. IRA investors must have earned income, which can include: (a) wages, salaries, tips, professional fees, bonuses, and other amounts received for personal services; (b) commissions and income generated through self-employment; (c) payments from the sale or licensing of property created by authors, inventors, artists, and others; or (d) alimony. Unearned income derived from real estate rents, investments, interest, dividends, or capital gains cannot be used as the basis for IRA contributions.

• **Individuals who are active participants in an employment-based plan and whose adjusted gross income (AGI) does not exceed $25,000 (single taxpayers) or $40,000 (married taxpayers filing jointly)**—These taxpayers may make a fully deductible IRA contribution. Again, contributions can only be made from earned income.

• **Individuals who are active participants in an employment-based plan and whose AGI falls between $25,000 and $35,000 (single taxpayers) and between $40,000 and $50,000 (married taxpayers filing jointly)**—These taxpayers may make a fully deductible IRA
contribution of less than $2,000 and a nondeductible IRA contribution for the balance, as follows. The $2,000 maximum deductible contribution is reduced by $1 for each $5 of income between the AGI limits. For example, a single taxpayer with AGI of $30,000 could make a $1,000 deductible IRA contribution and a $1,000 nondeductible contribution. Under a special rule, the deductible amount is not reduced below $200 if a taxpayer is eligible to make any deductible contributions. Again, contributions can only be made from earned income.

- **Individuals who are active participants in an employment-based plan and whose AGI is at least $35,000 (single taxpayers) or at least $50,000 (married taxpayers filing jointly)**—These taxpayers may only make nondeductible IRA contributions of up to $2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. Again, contributions can only be made from earned income.

- **IRAs established as rollover vehicles for lump-sum distributions from employment-based pension plans or other IRAs**—A worker who receives a distribution from his or her employment-based retirement plan, an IRA, or a Keogh can generally place the distribution in a rollover IRA without tax penalty or current taxation (see section on rollovers).

### Contribution Limits

**Maximum Deductible Contributions**—As stated earlier, IRA contributions may not exceed $2,000 per year. The amount that is tax deductible varies according to a worker’s income tax filing status, AGI, and pension coverage status. Single workers may contribute up to $2,000 or 100 percent of earned income (whichever is lower) per year if they are not active participants in an employment-based plan or if they are covered and have AGI of not more than $25,000. For those with AGI between $25,000 and $35,000, the deductible amount is prorated (see section on eligibility).

- **Two-Earner Couples**—Where a husband and wife both have earned income, each may contribute up to $2,000 or 100 percent of earned income (whichever is lower) per year. This means that a two-earner couple may then make a combined annual deductible contribution of up to $4,000. If a husband and wife file a joint tax return and either spouse is covered by an employment-based plan, both are restricted in their eligibility to make deductible IRA contributions under the rules that apply to their combined AGI. Therefore, they are each allowed full $2,000 deductible contributions if their combined AGI does not exceed $40,000; a deductible IRA contribution of less than $2,000 and a nondeductible IRA contribution for the balance of the $2,000 if their combined AGI is between $40,000 and $50,000; and no deductible contribution if their AGI is $50,000 or above (a nondeductible IRA contribution of up to $2,000 would be allowed for each working spouse).

If a married individual files a separate tax return, the spouse’s active participation does not affect the individual’s eligibility to make deductible IRA contributions. But if a married individual files separately, the phase-out of the $2,000 deduction begins with $0 of AGI and ends at $10,000. Therefore, for each $5 of AGI above $0, the maximum $2,000 IRA deduction is reduced by $1, or 20 percent of income. For example, if a married person is an active participant, has $3,000 of income, and files a separate return, the maximum allowable IRA deduction would be $1,400 (i.e., $2,000 – $600 (0.20 x $3,000)). If the same individual had AGI of $10,000 or more, no deductible IRA contribution would be allowed.

- **One-Earner Couples**—The Small Business Job Protection Act of 1996 increased the amount that an individual may contribute to joint IRAs for the individual and the
nonworking spouse, from $2,250 to $4,000 annually. The new limit equals the maximum combined IRA contributions allowable if both spouses work, which remains unchanged.

• Nonworking Divorced Persons—All taxable alimony received by a divorced person is treated as income for purposes of the IRA deduction limit. The regular IRA eligibility rules apply.³

Minimum Contributions—No minimum IRA contributions are required, and contributions are not required to be made in every year. However, the deductible amount is not reduced below $200, even if the individual's deductible contribution is less, until the deductible amount reaches zero.

Employment-Based IRAs

An employer may contribute to an IRA that has been set up by the employee or may set up an IRA for employees. The employee’s interest must be nonforfeitable, and separate records showing the employee’s contributions and the employer’s contributions must be maintained. Although regular IRA contribution limits apply, the employer is also permitted to pay reasonable administrative expenses associated with the IRA.

Employers may also offer employees IRAs through payroll deduction arrangements. Automatic deductions from employees’ earnings would be deposited in IRAs that are set up by the company. Some employers permit employees to select among a variety of investment options. This arrangement should not be confused with an employment-based retirement plan called a simplified employee pension (SEP), in which an employer establishes an IRA for each employee and makes contributions on their behalf. SEPs have different contribution limits from IRAs and are subject to some of the same rules as other qualified retirement plans (For further discussion on SEPs, see chapter 11 and for the new SIMPLE plans, see Appendix A).

Distributions

IRA distributions must begin by April 1 of the calendar year following the calendar year in which the individual reaches age 70 1/2. If an individual elects a lump-sum payment, the full amount must be distributed. If a distribution in the form of an annuity is elected, a minimum amount must be distributed to ensure full payout over the individual's expected life (or the expected life of the individual and a named beneficiary). The minimum distribution basically is computed by dividing the opening balance at the beginning of the year by the life expectancy of the individual (or the joint life expectancy of the individual and beneficiary), determined as of the date the individual attained age 70 and reduced by one for each taxable year elapsed after age 70 1/2. (As an alternative, life expectancies can be recalculated each year.) An individual who has multiple accounts may choose the account(s) from which he or she would like to take the required distribution, instead of taking distributions from each account (see section on penalties). Distributions can be paid in the following ways:

• Lump-Sum Payments—The entire account balance is distributed in one sum.
• Periodic Certain—The account balance is paid in a predetermined number of fixed payments over a specified period of time.
• Life Annuity—Payments are made to retirees for their remaining lifetimes and to their beneficiaries or estates on their death, usually on a monthly basis.
• Joint and Survivor Annuity—Payments are made for the IRA holder’s remaining lifetime, usually on a monthly basis. After the IRA holder’s death, the surviving spouse
continues to receive lifetime payments. The survivor usually receives only a portion (e.g., 50 percent) of the amount paid to the primary IRA holder. In addition, the monthly income to the primary holder will be lower than under an individual life annuity; this reflects the additional cost of insuring income over two lifetimes rather than one.

**Rollovers**

The law permits individuals to roll over account balances from one IRA to another and from a qualified retirement plan to an IRA. To avoid tax penalties, the transfer of assets from one account to another must be completed within 60 days. Rollovers between IRAs—Under this arrangement, the individual may roll over his or her account balance from one IRA to another, offering greater investment flexibility. This type of rollover can occur only once annually. A transfer of IRA funds from one trustee to another, either at the individual's request or at the trustee's request, is not a rollover—it is a transfer that is not affected by the one-year waiting period.

Rollovers between Employer Plans and IRAs—If employer retirement plans provide lump-sum distributions, the amounts corresponding to pretax employee and employer contributions may be transferred to a rollover IRA. Rollover IRAs were designed specifically to provide a savings vehicle for lump-sum distributions without imposing a tax penalty. Rollovers of lump-sum distributions may be made at any age. However, if the individual is aged 70 1/2 or over, distributions must begin during the year in which the rollover is received. Lump-sum distributions from employer plans paid to a surviving spouse after an employee's death can also be rolled over into an IRA without penalty. An individual may also roll over a distribution from one employer plan into an IRA and at a later time roll over those same assets, plus any earnings, into another employer plan. In this case, the IRA acts as a conduit for the funds from one employer to another. However, the funds must be kept in a separate account and not mixed with any other funds.

**Taxation**

IRA taxation rules reflect the basic purpose of an IRA (i.e., to provide retirement income). Use of IRA savings for purposes other than retirement income, therefore, is discouraged through tax penalties. In general, penalty taxes will not apply to IRA distributions that begin no earlier than age 59 1/2 and no later than April 1 of the calendar year following the calendar year in which the individual attains age 70 1/2. Distributions in the case of death or disability and made in the form of an annuity can begin prior to age 59 1/2 without penalty. Distributions are considered income in the year received and are subject to applicable marginal income tax rates.

**Income Taxes**—Each year, tax-deductible contributions to new or existing IRAs must be made by the tax return filing date. Contributions can be made in one full payment or in installments throughout the year. The distributions are taxed as ordinary income in the year received, except for the portion of the total IRA distribution that is considered a return of the dollar amount of the nondeductible contributions, which is excludable from gross income. All IRAs (including rollover IRAs) are treated as a single contract, and all distributions from such plans in any taxable year are treated as a single distribution. If an individual withdraws an amount from an IRA that includes both deductible and nondeductible contributions, the amount excludable from gross income is determined by multiplying the withdrawal by a fraction, where the numerator is the individual's total nondeductible contributions and the denominator is the total balance (at the close of the
calendar year) of all the individual’s IRAs. For example, if an individual held four IRA accounts with a total value of $10,000, and $2,000 was the amount of the nondeductible contributions, then a withdrawal of, for example, $4,000 would be considered to consist of $800 attributable to excludable, nondeductible contributions ($4,000 x 2,000/$10,000 or 0.2) and $3,200 fully taxable as ordinary income.\(^6\)

IRA lump-sum distributions are not eligible for income averaging or capital gains treatment.

**Estate Taxes**—The entire value of an IRA is included in the deceased participant’s gross estate.

**Penalties**—Under certain circumstances, tax penalties apply, as follows.

- Contributions in excess of the maximum limits described above are subject to a 6 percent excise tax on any excess contribution for each year the amount remains in the account. If an individual contributes more than the permissible amount, he or she can avoid the 6 percent tax penalty by withdrawing the excess, plus any earnings by the tax return due date in the year the contribution is made.
- Distributions prior to age 59\(\frac{1}{2}\) are subject to a 10 percent penalty tax, unless they are taken as part of a series of equal payments made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his or her beneficiary, or the IRA owner dies or becomes disabled. Neither a rollover between IRAs nor the portion of an early withdrawal that is attributable to nondeductible contributions is subject to the tax.\(^7\)
- After April 1 of the calendar year following the year in which the individual turns age 70\(\frac{1}{2}\), failure to make required minimum distributions will subject amounts that should have been withdrawn to a 50 percent excise tax.
- If total distributions from an IRA and any qualified employer retirement plan exceed $155,000 in 1996 (indexed to the consumer price index annually), a 15 percent excise tax is imposed on the excess with certain exceptions for lump sums and for grandfathered amounts.

**Investments**

IRA savings can be invested in retirement accounts and retirement annuities. The institutions that offer IRA investment vehicles include banks, brokerage houses, insurance companies, savings and loan associations, credit unions, mutual fund companies, other investment management organizations, and the federal government. IRA contributions can be placed in more than one account, provided the total annual contribution limits are not exceeded. Collectibles such as art, antiques, rugs, stamps, wines, and coins—other than certain U.S.-minted gold or silver coins and state-issued coins circulated after November 10, 1988—are not permissible IRA investments.

An IRA investor should understand the risks and limitations of the various investment options. Financial institutions are required to explain how their IRAs work and their financial ramifications. Before choosing an IRA, some important questions should be considered and answered. For example: What are the investor’s retirement income needs?

- Should he or she invest in low-risk choices or can he or she afford to undertake potentially higher risks that may produce higher returns?
- What are the administrative fees or commissions charged on the type of IRA under consideration?
- Is there a minimum deposit requirement?
- What is the interest rate and how is it computed? Is it likely to fluctuate over the worker’s lifetime?
• Can the investment be quickly converted into cash in an emergency? Is there a penalty charge for early withdrawal (separate from the income tax penalty)?
• Should IRA contributions be made early or late in the tax year? (If money is invested early, it accumulates interest longer. But if money is invested late, individuals have use of their money throughout the year and may have a better idea how much they can invest in an IRA.)

Conclusion

IRAs can be an important addition to retirement savings opportunities. They are particularly useful for persons who do not have employer pension coverage and for highly mobile workers with minimal or no pension benefits due to limited service in any one job. The amount of retirement income generated by an IRA will depend on a variety of factors, including contribution amounts, the participant’s age when the IRA is established, the rate of investment return, and the participant’s age at retirement.

1 The Small Business Job Protection Act of 1996 allows employers with 100 or fewer employees to set up a savings incentive match plan for employees (SIMPLE) IRA. Details of this new pension plan for small employers are provided in Appendix A. This chapter refers solely to IRAs other than those used in SIMPLE plans.

2 Special rules apply to families with two wage earners. For more detail, see the discussion of maximum deductible contributions in the following section on contribution limits.

3 Contributions to spousal accounts are not permitted after the elder spouse reaches age 70\(\frac{1}{2}\). If the employee-spouse is younger, he or she can continue only his or her own IRA after the other spouse reaches age 70\(\frac{1}{2}\).

4 The Internal Revenue Service has ruled that IRA funds may be used for short-term loans provided they are redeposited in the same or another IRA within 60 days of withdrawal. Only one such transaction is permitted per IRA in any 12-month period.

5 The future tax treatment of IRA distributions is unclear in many state and local jurisdictions, although some have announced that they will follow federal tax law.

6 Different, more complex, rules apply to amounts withdrawn as annuities.

7 Effective for tax years beginning after December 31, 1996, individuals may make penalty free withdrawals from IRAs to pay for medical expenses in excess of 7.5 percent of adjusted gross income.