

Individual Retirement Accounts

by Joel B. Schumacher Economics Associate Specialist, Marsha A. Goetting, Ph.D., CFP®, CFCS, Professor and Family Economics Specialist, Montana State University – Bozeman

IRAs, tax-advantaged retirement savings alternatives, have been available since 1974. This MontGuide explains Traditional and Roth IRAs, and discusses who can contribute to an IRA, how to set one up, and how much can be contributed. It also explores the tax consequences of different IRAs at different income levels.



MontGuide

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AN IMPORTANT GOAL FOR MANY PEOPLE IS A financially secure retirement. An Individual Retirement Account (IRA) is a tax-advantaged retirement savings option that is available to help Americans achieve their retirement goals. This MontGuide highlights the two basic types of IRAs: *Traditional* IRAs (deductible and nondeductible) and *Roth* IRAs.

How much can be contributed to an IRA?

A person who has earned income may contribute up to 100 percent of that income up to the maximum annual contribution limit. The annual contribution limit for 2009 is \$5,000. In future years the limit will be increased based on an inflation index in increments of \$500. (See Table 1.) Persons age 50 and older are also eligible to make an additional \$1,000 “catch-up” contribution beyond the regular limits each year.

Who can contribute to an IRA?

Generally, an individual must be under the age of 70½ and have earned income to be eligible to contribute to a *Traditional* IRA. Individuals over 70½ who are not eligible to contribute to a *Traditional* IRA may be eligible to contribute to a *Roth* IRA. The Internal Revenue Service (IRS) defines earned income as wages, salaries, tips, commissions, taxable alimony, professional fees, bonuses, and other compensation for personal services.

Farmers and other small business owners may include net income as earned income as long as they are an “active” partner. Earnings and profits from property, such as

rental income, and interest or dividend income, pension or annuity income, and Social Security income are not considered earned income.

An exception to the earned income rule is for spousal IRAs. The spouse with earned income may make annual contributions into an IRA for the spouse who does not have earned income. However, a joint federal income tax return must be filed for the tax year the contributions are made.

Where do I set up an IRA?

Federal regulations require that an IRA be managed by a custodian or trustee. Custodians include banks, credit unions, insurance companies, mutual funds and investment brokerage firms.

An investor should compare the terms offered by IRA custodians and trustees before establishing an IRA. The types of investments, rates of return, early withdrawal penalties, transaction fees, investment risks, maturity periods, personal management required, minimum opening balance requirements, management fees, and other important features may vary considerably among IRA custodians and trustees. A useful tool to help you make comparisons is the MSU Extension MontGuide *Shopping for an Individual Retirement Accounts (IRAs)* (MT200207HR).

What kinds of IRAs are available?

There are two main types of IRAs: *Traditional* (sometimes called regular or ordinary) and *Roth*. Which IRA, or combination of IRAs, is best for you depends on your financial goals, family situation, and income level.

Traditional IRAs

Contributions to *Traditional* IRAs can be either *tax deductible* or *nondeductible*. Whether or not *Traditional* IRA contributions can be claimed as a deduction on an individual or married couple’s income tax return depends on these conditions:

TABLE 1. Contribution Amounts for Individual Retirement Accounts (IRAs)

Year	Contribution Limit	Catch-up Contribution (age 50 or older)
2009	\$5,000	\$1,000
2010 and beyond	Adjusted for inflation	Adjusted for inflation

- Whether or not an individual is an active participant in an employer sponsored retirement plan
- An individual's (or couple's) income level
- An individual's filing status (single; married and filing jointly; or married and filing separately)

Active participation in an employer sponsored retirement plan If the individual and his or her spouse are not active participants in an employer sponsored retirement plan, the amount placed in a *Traditional IRA* is fully deductible for income tax purposes regardless of the amount of annual income.

EXAMPLE 1: John and Sally are not active participants in an employer sponsored retirement plan. Each can place \$5,000 in a *Traditional IRA*. Their joint income of \$65,000 is reduced by \$10,000 to \$55,000 for state and federal income tax computation purposes.

If an individual or his or her spouse are active participants in an employer sponsored retirement plan, the amount placed in a *Traditional IRA* may not be fully deductible for income tax purposes. Individuals are considered as *active participants* if they are covered under a profit-sharing plan, a 401(k) plan, a tax-sheltered annuity plan [403(b)], certain government plans, a Simplified Employee Pension plan (SEP), or a Savings Incentive Match Plan for Employees (SIMPLE). If individuals (or their spouse) are not certain whether they are an active participant in a retirement plan, they should ask their employer.

Example 2: Tim and Reese are both active participants in a company sponsored profit sharing plan. Tim and Reese's *Traditional IRA* contributions are not automatically tax deductible because both are participants in an employer retirement plan. Their contributions may still be tax deductible but they must also satisfy income restrictions.

Income levels and filing status Depending on income and filing status, an individual or married person actively participating in a retirement plan may receive a full, partial, or no tax deduction for contributions to a *Traditional IRA* for income tax purposes (Table 2).

TABLE 2. 2009 Modified Adjusted Gross Income* Limits for Deductible Traditional IRA Contributions

	Eligible for a Full Deduction	Eligible for a Partial Deduction
Single	\$55,000 or less	\$55,001 to \$65,000
Married, filing jointly	\$89,000 or less	\$89,001 to \$109,000

*Generally, to determine Modified Adjusted Gross Income, the following items are added to the adjusted gross income shown on the tax return: any IRA deduction, any foreign earned-income exclusion, any foreign housing exclusion, any interest exclusion on U.S. savings bonds to pay higher-education expenses and any adoption-assistance program exclusion. For a more detailed explanation, consult your tax advisor.

A single person whose income is less than \$55,000 is eligible for a full income tax deduction. Married couples filing jointly are eligible for a full income tax deduction if their joint modified adjusted gross income is less than \$89,000, even if both spouses are active participants in an employer-sponsored retirement plan. (See Table 2)

EXAMPLE 3: Craig and Mary, married and filing jointly in 2009, have a modified adjusted gross income of \$70,000. Both are covered by retirement plans at work. Because their income falls below the limit (Table 2), they can receive a full deduction on their income tax return for the \$5,000 each places in a *Traditional IRA*. Their Montana and federal income taxes would be computed on \$60,000, not \$70,000 (\$70,000 – \$10,000 = \$60,000).

Partial tax-deduction for IRA If individuals are active participants in a retirement plan and their incomes fall within the ranges shown in Table 2, a portion of their *Traditional IRA* contribution may be deductible. The deductible amount of a *Traditional IRA* for income tax purposes is calculated based on IRS formulas. The IRS tables and worksheets for figuring reduced IRA deductions can be found in IRS publication 590, *Individual Retirement Arrangements (IRAs)*, which can be ordered from the IRS toll-free at 1-800-829-3676 or downloaded from the IRS Web site: www.irs.ustreas.gov

Deferral of income tax for Traditional IRAs If the eligibility rules described previously are met and income is less than the phase-out ranges shown in Table 2, the amount contributed to a *Traditional IRA* may be deducted from gross income when computing Montana and federal income taxes. In addition, all accumulated earnings while money is in a *Traditional IRA* are tax-deferred.

EXAMPLE 4: Keri has placed \$2,000 annually in her IRA for 10 years. The balance on the account is \$25,156. Her earnings of \$5,156 are growing tax-deferred and are not included as income when she calculates her Montana and federal taxes each year.

Note: The payment of Montana and federal income tax is only *deferred*, not eliminated, on *Traditional IRAs*. When the IRA money is withdrawn, the amount is added to that person's income for that year and taxed accordingly. Because withdrawals from a *Traditional IRA* are typically taken during retirement when income is reduced, the tax rate on the money may be lower than when the IRA owner and/or spouse were employed.

EXAMPLE 5: Bruce, age 65, withdrew \$15,000 from his *Traditional IRA* in 2009. The \$15,000 is added to his income of \$44,000. Bruce pays Montana and federal income taxes on \$59,000 (\$44,000 income + \$15,000 IRA withdrawal = \$59,000). In 2009, Bruce's taxable income is \$15,000 higher due to his IRA withdrawal.

Nondeductible Traditional IRAs Individuals who are covered by an employer retirement plan, but are not eligible for the deductible *Traditional* IRA, can contribute to a nondeductible *Traditional* IRA. With a nondeductible IRA, individuals contribute tax-paid dollars and any taxes on earnings are deferred until withdrawal. Cost basis needs to be tracked for non-deductible contributions to accurately compute taxes on the earnings when distributions begin. Cost basis is a record of nondeductible contributions that have been made to an IRA since the account was initially opened.

EXAMPLE 6: Dave’s filing status in 2009 is single. He earns \$82,000 and is an active participant in a retirement plan at work. Dave is not eligible to make a tax deductible contribution a *Traditional* IRA because his income exceeds the limit of \$65,000 (Table 2). He could establish a nondeductible IRA and his earnings would be tax deferred.

Individuals who make nondeductible contributions to a *Traditional* IRA must attach Form 8606 to their tax returns. An individual should keep copies of all IRS 8606 forms as proof of nondeductible IRA contributions.

Note: Avoid commingling *deductible* and *nondeductible* contributions or keep careful records to show taxable amounts once distributions begin.

Roth IRAs

Contributions to a *Roth* IRA are not tax deductible but the earnings from a *Roth* IRA are tax-free. The contribution limits are the same as for *Traditional* IRAs (Table 1). The income limits are higher for *Roth* IRAs than for *Traditional* IRAs. The age restriction that prohibits contributions to *Traditional* IRAs after an individual reaches age 70½ does not apply to *Roth* IRAs.

2009 Income eligibility Individuals are allowed to contribute up to \$5,000 (those 50 years or older can contribute an extra \$1,000) to a *Roth* if they meet certain income restrictions. Full contributions can be made by single persons with incomes of up to \$105,000 or by married couples with incomes of up to \$166,000. Partial contributions are allowed for individuals or married couples with higher incomes. The limits for 2009 are provided in Table 3. Persons earning over these limits may want to consider a nondeductible IRA.

TABLE 3. 2009 Modified Adjusted Gross Income* Limits for Roth IRA Contributions

	Eligible for a Full Deduction	Eligible for a Partial Deduction
Single	\$105,000 or less	\$105,001 to \$120,000
Married, filing jointly	\$166,000 or less	\$166,001 to \$176,000

*Generally, to determine Modified Adjusted Gross Income, the following items are added to the adjusted gross income shown on the tax return: any IRA deduction, any foreign earned-income exclusion, any foreign housing exclusion, any interest exclusion on U.S. savings bonds to pay higher-education expenses and any adoption-assistance program exclusion. For a more detailed explanation, consult your tax advisor.

EXAMPLE 7: Gary deposited \$3,000 annually in a *Roth* IRA for 20 years (\$60,000 in deposits). Assume in 2029, his balance is \$80,611. While he paid taxes on each \$3,000 annual contribution, his earnings (\$20,611) are tax-free (\$80,611 – \$60,000 = \$20,611). If Gary had contributed to a deductible *Traditional* IRA instead of the *Roth* IRA, he would owe Montana and federal taxes on both the contributions and earnings when he withdraws the money.

What if I need my IRA money?

Because IRAs are designed to encourage Americans to save money to supplement their Social Security payments and pension plans during retirement, the Internal Revenue Service generally assesses a 10 percent penalty on early distributions (withdrawals) when the owner is under age 59½ unless the withdrawal meets certain conditions.

There are two requirements to qualify for tax-free withdrawals of the income a *Roth* IRA has earned. First, the *Roth* IRA must meet the “five year test.” In other words, the withdrawal must be five years after the first year for which *Roth* IRA contributions were made. Second, one of the following conditions must apply:

1. The individual is over age 59½.
2. The individual has become disabled.
3. The individual is using the funds for a first-time home purchase. (Lifetime limit of \$10,000)
4. The individual is deceased and the IRA is distributed to the beneficiary.
5. The withdrawal is for qualified higher education expenses or one of seven other exceptions (see IRS Publication 590 for more information).
6. Payment of qualified unreimbursed medical expenses greater than 7.5 percent of adjusted gross income.
7. Payment of qualified health insurance premiums while unemployed for 12 or more weeks.
8. When the withdrawals are made based on the owner’s or owner’s and beneficiary’s life expectancies (substantially equal periodic payments).

Withdrawals that do not meet these requirements are subject to 10 percent penalty.

To avoid the 10 percent penalty on withdrawals from a *Traditional* IRA one of the conditions listed above (1-8) must be met.

Can I move my IRA to another financial institution?

IRA contributions that are placed in custodial accounts at financial institutions, insurance companies, mutual funds or investment brokerage firms may be moved from

one custodian or trustee to another. Because there is no distribution, the transfer is tax free. However, the custodian may assess a fee or penalty for the transfer.

When can I make an IRA contribution?

Contributions can be made from January 1st of the tax year until April 15 of the year following tax year for which the contribution will be reported. If a contribution is made for the previous year any time between January 1 and April 15, the owner should notify the IRA custodian that the contribution is for the preceding year. This will allow the custodian to correctly report the tax year that applies to each deposit.

What happens to an IRA in case of divorce?

An IRA is an asset just like any other marital investment owned by either spouse. The money in a *Traditional* IRA, nondeductible IRA, or *Roth* IRA can be directly transferred, tax free, to an IRA owned by the former spouse or a separate IRA can be established. The action must be according to the terms of the qualified domestic relations order (QDRO). The benefits of separate IRAs for divorced spouses is that the funds could be later rolled over into an owner's retirement plan.

Can I roll over my IRA into my retirement plan at work?

A person can roll over, tax-free, a distribution from an IRA into a qualified plan, including a deferred compensation plan of a state or local government (section 457 plan) or a tax-sheltered annuity (section 403[b] plan). The distribution that a person can roll over is the part that would otherwise be taxable (includible in income). Qualified plans may, but are not required to, accept these rollovers.

Can I roll over withdrawals from my retirement plan into my IRA?

Montana and federal income taxation on withdrawals from tax-deferred employer sponsored retirement plans can be prevented by transferring the funds directly into an IRA. When an individual leaves a job and transfers the balance of the retirement plan to an IRA, the check for the

funds should be made out to the custodian or trustee of an individual's IRA. Otherwise, the employer must withhold 20 percent of the amount withdrawn for the payment of federal income taxes.

Summary

IRAs are useful tools to help Montanans meet their retirement savings goals. IRA contribution limits and income limits for eligibility purposes are adjusted annually. Individuals interested in IRAs should ensure that they are up to date on current IRA rules. Additional information can be obtained from retirement professionals such as certified public accountants, certified financial planners and others.

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- Montana Credit Union Network
- Montana Bankers Association
- Montana Society of Certified Public Accountants

Disclaimer

This publication is designed to provide educational information on IRAs, not to render legal, accounting or other professional advice. If legal advice or other expert tax assistance is required, the services of a professional attorney, certified public accountant, or certified financial planner should be sought.



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