

# Individual Retirement Accounts<sup>1</sup>

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## What Is an Individual Retirement Account (IRA)?

An individual retirement account (IRA) is a good tool to build retirement funds. This type of account has been offered since 1974 and is an investment or savings product (mutual funds, stocks, bonds, certificates of deposit) that comes with special tax advantages. An IRA can be opened through a financial institution such as a bank, credit union, mutual fund company, or brokerage firm. Two common types of IRAs are the traditional IRA and the Roth IRA. Others such as SEP and SIMPLE IRAs are typically a job-associated benefit. IRAs come with tax advantages, but the timing of the tax advantage for a Roth IRA is different from that of a traditional IRA. Since these products have tax advantages, the federal government has set limits on the amount of money that can be contributed each tax year to an IRA. In 2012, for people under age 50, the contribution limit is \$5,000. Contributions to your IRA can be tax deductible or non-deductible. If you choose to deduct your IRA contribution, you can do so directly on IRS Form 1040.

## Words Used Often

**Owner** – This is the person who owns the IRA.

**Disbursement** – This is the payout of the IRA; when the IRA funds are given to their owner.

**Contribution** – This is the payment to your IRA; the act of adding funds to the account.

**Conversion** – This is the changing of a traditional IRA to a Roth IRA.

**Beneficiary** – This is the person the owner of the IRA names to receive the IRA funds in the owner's stead. The owner chooses this person to receive their disbursement in case of the owner's early death.

**Withdrawal** – The act of taking funds out of one's IRA.

**Qualified Distribution** – A payment or distribution from a Roth IRA that is tax- and penalty-free. A qualified distribution must meet specific requirements.

## Traditional IRA

The traditional IRA has two different forms: account and annuity. An IRA annuity is different because only one manager tracks it. An IRA annuity is not transferable by the owner. Also, the owner or the owner's beneficiary must receive the distribution of the account. Contributions to a

1. This document is FCS5258, one of a series of the Department of Family, Youth and Community Sciences, University of Florida, UF/IFAS, Gainesville 32611. First published September 2003. Revised March 2012. Please visit the EDIS website at <http://edis.ifas.ufl.edu>.
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traditional IRA can be filed as either deductible or non-deductible. Tax-deductible contributions will reduce your adjusted gross income for the tax-filing year. The amount that is tax deductible will depend on whether you (and/or your spouse) are covered by a retirement plan at work and your adjusted gross income. A person is allowed to contribute to their traditional IRA up to the age of 70½.

A traditional IRA may be tax deductible for the tax year in which you contribute.

For example: In 2011 your taxable income is \$40,000 and you contribute \$5,000 to a traditional IRA by the tax-filing deadline. This may reduce your taxable income to \$35,000 and thus will also reduce the amount of federal income taxes that you pay. If you are not covered by an employer-sponsored retirement plan, contributions are fully deductible regardless of income. If you are covered by an employer-sponsored retirement plan, how much of the \$5,000 you can deduct will depend on your income.

The advantage of the traditional IRA is that your deductible contributions and your earnings grow tax-free. You will not have to pay taxes until you withdraw the money. The logic with a traditional IRA is that at retirement your income will likely be reduced so you will be in a lower tax bracket and thus pay less income tax on the money.

## Roth IRA

Roth IRAs came about in 1997, by the Taxpayer Relief Act. A Roth IRA is different from a traditional IRA because contributions are not deductible. The advantage of Roth IRAs is that earnings grow tax-free and qualified disbursements are also tax-free.

For example: In 2011 you contribute \$5,000 to a Roth IRA by the tax-filing deadline. The \$5,000 contribution is not tax deductible and will not reduce the amount of federal income taxes owed for that tax-filing year. However, you will not have to pay taxes on your distributions as long as you follow the rules described below in the early withdrawal penalty section. So if your investments do well and your \$5,000 grows to \$10,000, you will have avoided paying taxes on the \$5,000 of earnings. However, if your investments do not do well and the values of your contributions shrink, then you will have paid taxes on a larger sum of money.

The Roth IRA shares the same maximum contribution limit as the traditional IRA as discussed in the next section. Another advantage to Roth IRAs is that a contributor is not limited by age. This means a person can continue

to contribute to their Roth IRA after the age of 70½. In addition, there is no requirement to take minimum distributions when the account holder reaches 70½, so it may be a good way to transfer money to heirs.

## Contributions

The same largest contribution limit applies to both a traditional the IRA and the Roth IRA. The contribution limit at the beginning of the decade was \$2,000. In 2012, for individuals under age 50 the maximum contribution limit increased to be the smaller of \$5,000 or the amount of taxable income. This limit can be split between a traditional and a Roth IRA, but the combined limit is \$5,000. The maximum deductible contribution to a traditional IRA and the maximum contribution to a Roth IRA may be reduced depending on a tax filer's modified adjusted gross income (AGI).

A "Catch-up Limit" is allowed for those who reach the age of 50 before the current taxable year. When this happens, a person can add an extra \$1,000 to their normal contribution of \$5,000. This gives them a total of \$6,000.

## Contribution AGI Phase-out Limit

Roth IRAs do have AGI (Adjusted Gross Income) Phase-out Limits. This can limit the amount of contribution a person can make, depending on their AGI. If a person has an AGI below the limit minimum, they can contribute the full amount. For example, if an individual filing as single has an AGI less than \$107,000, they can contribute the full \$5,000 to their Roth IRA. If that individual has an AGI above the limit maximum, they may not contribute that year. For example, if that single tax filer has an AGI of \$122,000 or more, they are not allowed to add anything for that year. Yet, if one has an AGI that is between the phase-out limit then they can calculate their limited phase-out contribution. An example of this would be as follows: a single filing taxpayer has an AGI between \$107,000 and \$122,000. This person must calculate their phase-out contribution to find out the largest possible contribution for that year. Below is a table with the filing status and the Contribution AGI Phase-out Limits for 2012.

Contribution AGI Phase-out Limit	
Filing Status	Phase-out Contribution Limit
Single	\$107,000 – 122,000
Married Filing Jointly	\$169,000 – 179,000
Married Filing Separate	\$0 – 10,000

## Distributions

**Traditional IRA:** When a traditional IRA is disbursed, the funds are generally taxed as ordinary income. This can change depending on whether the IRA was contributed to through tax-deferred earnings. If this is the case, the distribution will take into account the return of adjusted basis. When the owner of a traditional IRA reaches the age of 70½ they must start receiving the required minimum distribution of their IRA. If an owner does not take the required distributions, they are subjected to a penalty tax that must be paid to the IRS. This tax is called an excise tax and is 50% of the amount not distributed as required.

**Roth IRA:** Unlike the traditional IRA, qualified distributions are not taxed as ordinary income. In fact, they are not taxed at all! If qualified distributions are received, then an owner does not need to include the distributions in their gross income. Tax-free distributions of Roth IRA earnings must be made at least 5 years after it was first contributed to and must meet one of the four requirements: 1) done on or after the owner reaches the age of 59½; 2) made to a beneficiary of the deceased owner; 3) the owner has become disabled; or 4) for a first time home purchase (up to \$10,000). If an owner has had the account for at least 5 years and meets one of the four requirements, then they are not subject to the Early Withdrawal Penalty, which is explained next.

## Early Withdrawal Penalty

Since these accounts come with tax advantages and are designed to help individuals save for retirement, there are penalties for early withdrawals of funds.

**Traditional IRA:** If you are under age 59½, withdrawals from a traditional IRA are taxed at your federal income tax rates for that tax year. In addition, you also pay a 10% penalty unless the withdrawal is for a qualifying exception, which is described below.

**Roth IRA:** Since taxes have already been paid on the contributions, there are no penalties or taxes charged on the withdrawal as long as you take out only the contributed funds and leave the earnings in the account. If you withdraw earnings and are under age 59½ there is a 10% penalty and you will also need to pay income taxes on the withdrawal.

Examples of Qualifying Exceptions:

There are a few exceptions to the early withdrawal penalty rules. These include death, disability, medical expenses

that exceed 7.5% of adjusted gross income (AGI), higher education expenses, and first time home purchase (up to \$10,000). With these, one can make an early withdrawal, within a limitation, without being penalized. In addition, if annuitized periodic payments are taken according to IRS rules, an exception may apply. You may want to consult an accountant or tax advisor before making such an arrangement.

## Conversion

An individual can transfer funds from a traditional IRA into a Roth IRA. This is known as a Roth conversion. Income taxes will be owed on the converted amount and must be paid in the tax filing year in which the conversion is made. The amount converted is added to all other taxable income for that year, so it may cause a tax filer to bump up to a higher tax bracket. A main reason for converting is that an individual expects to be in a higher tax bracket when they withdraw the money. Another reason is to leave money to heirs and, as discussed, there are no minimum distributions required when the account holders reach age 70½. Any individual, regardless of income, can convert a traditional IRA to a Roth. Prior to 2010 there was an income limit, but it no longer applies on conversions.

## Early Death

If you die before you have received all of your IRA funds, your IRA goes to the beneficiary(s) you have chosen. The beneficiary(s) then has several options, depending on their wishes and the rules of your IRA manager. Since some of these options offer special tax treatments. Your beneficiary may want to consult an accountant or tax advisor.

## Which Should You Pick?

- There are several factors to consider when deciding whether to contribute to a traditional or Roth IRA. Below are a few of those considerations. Do you want to pay taxes now or later?
- If you think you will be in a higher tax bracket when you withdraw the money, it may be wise to consider paying your IRA taxes before putting the money in rather than after. In other words, this means putting money into a Roth IRA.
- If you expect to be at a lower tax rate when you withdraw the money then you may want to consider a traditional IRA. How long do you plan to continue to contribute to the account?

- If you plan to contribute after the age of 70½ then it would be wise to consider a Roth IRA because they allow for contributions after the age 70½. The traditional IRA does not allow for contributions to the account after age 70½.
- What is your current AGI?
- If you have an AGI that is above the Contribution AGI Phaseout Limits of the Roth IRA, then you would not be able to add to your IRA. If your AGI remains above the limit, you will not be able to add to a Roth IRA, so a traditional IRA would be the way to go.

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