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Fact Sheet

# Retirement Planning—Investing in Individual Retirement Accounts

Fact Sheet 691

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Ensuring a secure retirement is an important goal for most people, yet 4 out of 10 Americans have no savings program for retirement. If you are one of these four or if you want to increase your retirement savings, this fact sheet explains how to start saving in an Individual Retirement Account and how to keep these savings tax deferred.

An Individual Retirement Account (IRA) is a tax-deferred savings plan and is available to anyone who is employed or receives alimony. IRA contributions are saved in a special account at a financial institution, which is called the custodian of the account. Most people are eligible to deduct their total IRA contributions from their income taxes. Even those who cannot make tax-deductible contributions can reap the benefit of the earnings on IRA savings not being taxed until retirement. The questions and answers that follow provide information to enable you to use an IRA to your best advantage.

## Who can contribute to an IRA?

Anyone with earned income or alimony can contribute to an IRA. However, the tax deductibility of contributions is limited if the earner participates in a qualified pension plan. A qualified plan meets U.S. Internal Revenue Service (IRS) requirements and allows employers to deduct contributions. Federal, state, and corporate pensions, tax-sheltered annuities, and Keogh plans are qualified plans. Single workers with pension plans can make tax-deductible IRA contributions if earnings are less than $25,000; married workers with pension plans can make tax-deductible IRA contributions if filing jointly with less than $40,000 in earnings. Tax deductions for pension-plan participants are phased-out as income rises.

## How much can I contribute to my IRA each year?

Workers can contribute up to $2,000 annually from earned-income and alimony income to an IRA. If less than $2,000 is earned, a worker can only contribute the amount earned from wages or alimony. For example, if you earn $875, $875 is the maximum contribution allowed. A married couple with two income earners can contribute up to $4,000 annually. A couple with a nonemployed spouse can contribute up to $2,250 annually, and the $2,250 can be split between two accounts in any amount up to $2,000. If a nonemployed spouse needs additional income after the death of an employed spouse, the major portion of IRA contributions can be put into the nonemployed spouse's account to increase the size of that spouse's retirement fund. If a nonemployed spouse is the younger of the couple, this arrangement also allows the funds to remain in an IRA for the longest period before required withdrawals must begin.

## How much of my IRA contribution can I deduct from my income taxes?

Deductible contributions provide you with tax savings because you do not have to pay taxes on the amount contributed. For example, if you are in a 15 percent income tax bracket and you contribute $1,000 to your IRA, that is $1,000 on which you do not pay taxes. You will reduce your taxes by $150 ($1,000 X .15 = $150.) In other words, the real cost of your IRA contribution is only $850. Individuals in the 28 percent tax bracket will save even more: The same $1,000 contribution will cost them only $720. Additionally, when your IRA contributions are deductible, you can increase your take-home pay by increasing the number of withholding exemptions on your W-4 form. Increasing your deductions prevents the government from holding your money without the payment of interest.

Fully tax-deferred IRA contributions are available to workers who do not have access to a pension plan. (If you do not have a pension plan, the pension box on your W-2 form will be blank.) If a single taxpayer or one employed spouse of a couple has a pension, 401(k), Keogh, or tax-sheltered annuity [403(b)], IRA tax deductions are based on income. Single taxpayers with adjusted gross incomes of $25,000 or less and married couples with adjusted gross incomes of $40,000 or less for can take full tax deductions for IRA contributions. Singles with adjusted gross incomes up to $35,000 and married couples with incomes up to $50,000 can take partial deductions, even if one or both spouses have a pension. Table 1 lists the tax deductions available for taxpayers with qualified pensions. For example, a couple who files jointly with an adjusted gross income of $45,000 can make a maximum contribution of $4,000 and deduct $2,000 or 1/2 of the contribution. If a

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single earner makes over $35,000 or a couple makes over $50,000, then there is no tax deduction available for IRA contributions.

### How does the IRS know that I have made nondeductible contributions?

When you make nondeductible contributions, you must file form 8606, “Nondeductible IRA’s,” with your Federal income tax return. Failure to do so may result in a $50 penalty. Keep a copy of these forms as you will need them when it is time to withdraw funds from your IRA.

### At what time of year should I make IRA contributions?

Ideally, you should contribute to your IRA as early in the tax year as possible. This allows the account to earn the greatest return during the year. However, you can make contributions throughout the year until April 15 of the following year. If you delayed making a contribution for the previous year, you must submit a written statement to the custodian of your IRA indicating that the contribution is for the preceding year, otherwise the contribution will be applied to the present year. To credit the contribution for the previous year, the letter must be postmarked by April 15. If there is a possibility that your check will not be delivered before the deadline, use certified or registered mail and retain the receipt for proof of the postmark date.

### Does it make any difference if I start contributing to my IRA early or late in life or stop making payments for a few years?

Because the money you invest is your IRA earns interest and is tax-free until you withdraw it, the timing of your contributions makes a big difference to the end result. Table 2 shows the results of three workers who made contributions to their IRA’s at various times of their lives.

In the example, Bob started contributing at age 22 and continued until he was 65 and retired. He contributed $88,000, and after subtracting his contributions, he had earnings of $683,011.

Jane started to contribute from her part-time jobs in high school. Once she graduated she increased her contribution to $1,000 for a few years, and then to the maximum of $2,000. She quit working once her children were born and thereafter was in and out of the labor force. During the years she worked, she contributed the maximum amount allowed. Although she invested only $39,000, her earnings grew to $413,188 after subtracting her contributions.

Kevin waited until he was 40 to invest in an IRA. Although he invested $52,000, his earnings only grew to $120,702 after subtracting his contributions. If Bob, Jane, and Kevin were able to earn 10 percent instead of 8 percent, Bob’s IRA would net $1,237,810; Jane’s, $880,739; and Kevin’s, $188,200.

### What difference does it make if I save money in an IRA or in an account that is not tax-deferred?

Tax-deferred savings grow faster than savings from after-tax earnings. When you increase the amount of time your IRA funds have to grow, this difference becomes dramatic. Table 3 shows the results of saving $2,000 annually in an interest-bearing account and paying 28-percent-marginal-rate taxes on the principal and earnings versus saving the same amount in a tax-deferred IRA. Both accounts earn 5 percent annually. After 20 years, the difference is $10,237, and after 40 years, a whopping $74,422.

### Where should I invest my IRA funds?

Your IRA custodian will place your contributions in the savings vehicle you choose. Carefully select where you invest your IRA. Your investment may be made in anything except life insurance and collectibles, such as stamps and antiques. Although many IRA’s are invested in banking institutions, at times these institutions’ interest rates are very low, causing your funds to grow slowly. To learn more about saving at a bank, request Bulletin 333 “Savings Basics” from your county Extension office.

You may want to start your IRA at a banking institution. However, when your account grows to $4,000 or $5,000, you may want to invest half of your funds in mutual funds and other investments that can provide a greater return than interest-bearing accounts. However, the risk of loss of principal will be greater as other types of investments are not insured. To learn more about mutual funds, request Fact Sheet 656 “Mutual Funds” from your county Extension office.

Another IRA investment option is a self-directed account with a stock broker. Self-directed accounts allow you to purchase stocks, bonds, real estate investment trusts, zero-coupon bonds, and unit trusts, as well as mutual funds.

**Table 1. Tax deductions for Individuals Participating in a Qualified Pension Who Deposit $2,000 Annually into an IRA**

| Single Returns | | Joint Returns | | |
|---|---|---|---|---|
| | | | Deductible Amount | |
| Adjusted Gross Income | Deductible Amount | Adjusted Gross Income | Two Earners | One Earner |
| $25,000 | $2,000 | $40,000 | $4,000 | $2,250 |
| 26,000 | 1,800 | 41,000 | 3,600 | 2,025 |
| 27,000 | 1,600 | 42,000 | 3,200 | 1,800 |
| 28,000 | 1,400 | 43,000 | 2,800 | 1,575 |
| 29,000 | 1,200 | 44,000 | 2,400 | 1,350 |
| 30,000 | 1,000 | 45,000 | 2,000 | 1,125 |
| 31,000 | 800 | 46,000 | 1,600 | 900 |
| 32,000 | 600 | 47,000 | 1,200 | 675 |
| 33,000 | 400 | 48,000 | 800 | 450 |
| 34,000 | 200 | 49,000 | 400 | 225 |
| 35,000 | 0 | 50,000 | 0 | 0 |

Although municipal bonds are not prohibited as an IRA investment, they are not appropriate because the interest is not taxable. To learn more about these investments, request Bulletin 356 Investment Basics from your county Extension office.

Investors in mutual funds or stocks may want to make contributions throughout the year to take advantage of dollar cost averaging. Dollar cost averaging requires that you buy shares of stock or mutual funds at regular intervals, such as once a month. In the months when the price of the share drops, you will be able to buy more shares with the same amount of money. When the share price is high, the same amount of money will buy fewer shares. Over time, the cost of your IRA will be less than if you bought all your shares at one time when the price was high. Contributions may be made each year until the year you reach 701/2.

Some mutual fund companies and brokerage houses offer IRA's without a yearly maintenance fee once the IRA

**Table 2. Three workers' IRA contributions earning 8 percent annually**

| | Bob | | Jane | | Kevin | |
|---|---|---|---|---|---|---|
| **Age** | **Year-End Contribution** | **Value** | **Year-End Contribution** | **Value** | **Year-End Contribution** | **Value** |
| 16 | -0- | -0- | $500 | $540 | -0- | -0- |
| 17 | -0- | -0- | $500 | $1,123 | -0- | -0- |
| 18 | -0- | -0- | $1,000 | $1,080 | -0- | -0- |
| 19 | -0- | -0- | $1,000 | $2,246 | -0- | -0- |
| 20 | -0- | -0- | $2,000 | $4,586 | -0- | -0- |
| 21 | -0- | -0- | $2,000 | $7,113 | -0- | -0- |
| 22 | $2,000 | $2,160 | $2,000 | $9,842 | -0- | -0- |
| 23 | $2,000 | $4,493 | -0- | $10,629 | -0- | -0- |
| 24 | $2,000 | $7,012 | -0- | $11,480 | -0- | -0- |
| 25 | $2,000 | $9,733 | -0- | $12,398 | -0- | -0- |
| 26 | $2,000 | $12,672 | -0- | $13,390 | -0- | -0- |
| 27 | $2,000 | $15,846 | -0- | $14,461 | -0- | -0- |
| 28 | $2,000 | $19,273 | -0- | $15,618 | -0- | -0- |
| 29 | $2,000 | $22,975 | -0- | $16,868 | -0- | -0- |
| 30 | $2,000 | $26,973 | -0- | $18,217 | -0- | -0- |
| 31 | $2,000 | $31,291 | -0- | $19,674 | -0- | -0- |
| 32 | $2,000 | $35,954 | -0- | $21,248 | -0- | -0- |
| 33 | $2,000 | $40,991 | -0- | $22,948 | -0- | -0- |
| 34 | $2,000 | $46,430 | -0- | $24,784 | -0- | -0- |
| 35 | $2,000 | $52,304 | $2,000 | $28,927 | -0- | -0- |
| 36 | $2,000 | $58,649 | $2,000 | $33,401 | -0- | -0- |
| 37 | $2,000 | $65,500 | $2,000 | $38,233 | -0- | -0- |
| 38 | $2,000 | $72,900 | $2,000 | $43,451 | -0- | -0- |
| 39 | $2,000 | $80,893 | $2,000 | $49,088 | -0- | -0- |
| 40 | $2,000 | $89,524 | $2,000 | $55,175 | $2,000 | $2,160 |
| 41 | $2,000 | $98,846 | $2,000 | $61,749 | $2,000 | $4,493 |
| 42 | $2,000 | $108,914 | $2,000 | $68,848 | $2,000 | $7,012 |
| 43 | $2,000 | $119,787 | $2,000 | $76,516 | $2,000 | $9,733 |
| 44 | $2,000 | $131,530 | $2,000 | $84,798 | $2,000 | $12,672 |
| 45 | $2,000 | $144,212 | -0- | $91,581 | $2,000 | $15,846 |
| 46 | $2,000 | $157,909 | -0- | $98,908 | $2,000 | $19,273 |
| 47 | $2,000 | $172,702 | -0- | $106,821 | $2,000 | $22,975 |
| 48 | $2,000 | $188,678 | -0- | $115,366 | $2,000 | $26,973 |
| 49 | $2,000 | $205,932 | -0- | $124,596 | $2,000 | $31,291 |
| 50 | $2,000 | $224,566 | -0- | $134,563 | $2,000 | $35,954 |
| 51 | $2,000 | $244,692 | -0- | $145,328 | $2,000 | $40,991 |
| 52 | $2,000 | $266,427 | $2,000 | $159,114 | $2,000 | $46,430 |
| 53 | $2,000 | $289,901 | $2,000 | $174,004 | $2,000 | $52,304 |
| 54 | $2,000 | $315,253 | $2,000 | $190,084 | $2,000 | $58,649 |
| 55 | $2,000 | $342,634 | $2,000 | $207,451 | $2,000 | $65,500 |
| 56 | $2,000 | $372,204 | $2,000 | $226,207 | $2,000 | $72,900 |
| 57 | $2,000 | $404,141 | -0- | $244,303 | $2,000 | $80,893 |
| 58 | $2,000 | $438,632 | -0- | $263,848 | $2,000 | $89,524 |
| 59 | $2,000 | $475,882 | -0- | $284,955 | $2,000 | $98,846 |
| 60 | $2,000 | $516,113 | -0- | $307,752 | $2,000 | $108,914 |
| 61 | $2,000 | $559,562 | -0- | $332,372 | $2,000 | $119,787 |
| 62 | $2,000 | $606,487 | -0- | $358,962 | $2,000 | $131,530 |
| 63 | $2,000 | $657,166 | -0- | $387,679 | $2,000 | $144,212 |
| 64 | $2,000 | $711,899 | -0- | $418,693 | $2,000 | $157,909 |
| 65 | $2,000 | $771,011 | -0- | $452,188 | $2,000 | $172,702 |
| **Less total contributed** | | **($88,000)** | | **($39,000)** | | **($52,000)** |
| **Net earnings** | | **$683,011** | | **$413,188** | | **$120,702** |

**Table 3. IRA versus taxable return [a]**

| Years | Taxable Returns (28% income tax bracket) | Tax-Deferred IRA Returns [b] |
|---|---|---|
| 10 | $24,420 | $26,414 |
| 20 | 59,201 | 69,438 |
| 30 | 108,740 | 139,522 |
| 40 | 179,279 | 253,679 |

[a] Calculations are based on a 5 percent annual rate of return and annual $2,000 contributions.
[b] Upon withdrawal, taxes will be paid on both contributions and earnings.

balance reaches a preset limit. Maintenance fees typically run $10 to $50 annually. Avoiding these fees allows your IRA to grow faster. If your IRA custodian charges a fee, you can have the fee taken directly from the earnings or you can pay the fee separately. When paid separately, the fee may be deducted as an investment expense (as a miscellaneous deduction) if you itemize your income taxes. This strategy reduces your taxes and helps your IRA to grow.

### What happens if I need my IRA money before retirement?

You must leave your money in your IRA until you are 591/2 or pay a 10 percent penalty for withdrawals before that time, as well as an income tax payment on the amount withdrawn. If you decide to withdraw funds to transfer them to another IRA investment, it is critical that you complete the transfer within 60 days of the withdrawal. Failure to complete the transfer within 60 days will invoke the 10 percent penalty (unless you are age 591/2 or older). Additionally, the IRS allows you to withdraw funds from your IRA for 60 days only once every 365 days. If you have multiple IRA accounts, each account is treated separately for the 60-day withdrawal rule. As an alternative to withdrawing funds, you may ask your custodian to transfer the funds directly to the new custodian, which is called a direct transfer.

If you need your IRA funds before you turn 591/2 because you have lost your job or taken an early retirement and need to supplement your pension, it is possible to avoid the early withdrawal penalty. You will not, however, be able to withdraw all the money at once. Rather you will have to take payments at least once a year over your life expectancy or a joint life expectancy with your spouse or another person. When you start payments early, they must continue until age 591/2. If you will turn age 591/2 in less than 5 years when you start your IRA, the payments must continue for a full 5 years. For example, if an individual starts payments at age 57, even though that person will turn 591/2 in 2 years, the payment must continue until the person is 62. Failure to follow this rule will invoke the 10 percent early withdrawal penalty on the total amount withdrawn. However, if you become totally disabled, you can draw on your IRA at any age without penalty.

### What is the difference between a rollover and a direct transfer?

A rollover is the receipt of eligible retirement plan proceeds by the plan participant (employee). The participant then transfers the funds into an IRA. A direct transfer, on the other hand, is a transfer made directly from an eligible plan to an IRA, without passing the funds through the hands of the participant. Direct transfers may be made at any time, but rollovers must be accomplished within 60 days, as previously discussed. Both methods retain the tax deferral of transferred funds.

### If I leave my current place of employment, can I avoid paying income taxes on withdrawals from a qualified pension plan, 401(k) or 403(b)?

You can prevent immediate taxation on withdrawals from a qualified pension plan and tax-deferred plans (401(k) or 403(b)) by transferring the funds directly into an IRA. The IRA may be a rollover or conduit. A rollover IRA follows the rules discussed previously. A conduit IRA (an IRA that does not contain regular yearly contributions) allows you to transfer these funds to a new employer's plan. When you leave a job and roll over benefits to a conduit IRA, the check for your funds should be made out to the custodian company of your conduit IRA. The direct transfer from your employer into the rollover or conduit IRA is critical. If you do not make a direct transfer, your employer must withhold 20 percent of the amount withdrawn for the payment of income taxes.

If your employer puts your name on the check and withholds the 20 percent, you can still rollover the total withdrawal. However, you must replace the 20 percent your employer withheld from your own funds. If you cannot raise the additional 20 percent, you will pay income taxes on the 20 percent you did not rollover (because your employer withheld the 20 percent). When you put the additional 20 percent from your own funds in your IRA, you can claim the 20 percent as a credit on your income tax return. The IRS will then send you a refund. For example, if your account balance is $50,000, and your employer wrote the check to you for $40,000 and withheld $10,000 (or 20 percent), you must now either pay taxes on the $10,000 or put $10,000 of your own money into your new IRA.

### What happens if I divorce before I reach retirement age?

Your IRA is an asset just as any other investment you own. It may be transferred to your spouse without penalty in the divorce settlement under a qualified domestic relations order.

## Conclusion

The rules for investing in an IRA are straightforward. Where to invest your IRA requires learning about savings and investments. Care must be taken to follow the rules exactly when rolling over funds in an employer plan to an IRA. The time to start investing in an IRA is now. When you are ready to start withdrawing funds from your IRA, request Fact Sheet 692 "Retirement Planning: Withdrawals From Individual Retirement Accounts" from your local Extension office.

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