Traditional IRAs: The Rules Revisited

It has been almost a quarter century since the popular version of the Individual Retirement Account (IRA) was born. The Economic Recovery Tax Act of 1981 opened up eligibility of IRAs to anyone under age 70½ with earned income.

Since then, the concept of the tax-advantaged retirement account has become wildly popular, and a whole new generation of IRAs has been spawned.

Now, for example, there is the Roth IRA, the Education IRA, and the non-deductible IRA. The grandfather of them all is now referred to as the "traditional" IRA, to distinguish it from the offspring.

Most financial articles in recent years have focused on the newer generation of IRAs. But over the years, Congress has fiddled with the rules concerning traditional IRAs.

This article reviews the current rules for traditional IRAs.

Traditional IRAs

A traditional individual retirement account (IRA) is a domestic trust or custodial account that can be established by an individual in order to save money for retirement on a tax-deferred basis. Some contributions may also be deducted from your taxable income in the year of contribution.

A traditional IRA is an extremely versatile and simple way to save for retirement. It is often used by those with no other tax-favored way to save for retirement. A traditional IRA also serves as the funding method for retirement plans, like SEPs and SIMPLEs, used by small business owners and the self-employed. The beauty of an IRA is that it is an extremely easy way to save for retirement, with virtually every type of financial institution standing ready, willing, and able to set one up for you.

Anyone who does not reach age 70½ by the end of the year and receives taxable compensation during the year can set up and make contributions to an IRA. Compensation is generally what you earn from working and includes wages, salaries, tips, commissions, and net income from self-employment.

Where spouses are concerned, compensation is pooled between spouses allowing both spouses to set up separate IRAs even if only one spouse is working. Although there is an upper age limit for participation, there is no minimum age requirement, with compensation being the only factor to consider.

Although relatively straightforward, there are a lot of rules involving traditional IRAs that you should be aware of in order to fully benefit from this retirement savings option.

IRA Contributions

Starting this year and through 2007, the maximum that an

individual can contribute to a traditional individual retirement account (IRA) is $4,000; in 2008, the maximum amount increases to $5,000, and in 2009 through 2010 the $5,000 maximum is increased for inflation. After 2010, the IRA limits are currently scheduled to return to the year 2001 levels, although some observers believe that future legislation may continue the increased limits.

For those who are age 50 and over, an additional catch-up contribution of $500 is allowed this year; starting in 2006, the catch-up contribution increases to $1,000.

The maximum contribution amounts over the next few years are summarized in Table 1.

Table 1. Maximum IRA Contributions

Year	Under Age 50	Over Age 50
2005	$4,000	$4,500
2006	$4,000	$5,000
2007	$4,000	$5,000
2008	$5,000	$6,000
2009	$5,000+	$6,000+
2010	$5,000+	$6,000+
2011	2001 levels	2001 levels

In 2009 and 2010, the $5,000 maximum contribution is increased by an inflation adjustment; for individuals over age 50, the maximum in those years is $5,000 increased by an inflation adjustment, plus an additional $1,000.

Contributions and Compensation

As previously mentioned, you must have compensation to make an IRA contribution. At the same time, your maximum IRA contribution limit will be reduced to the extent it falls below the overall contribution limit for the year.

For example, Hardy Boy is an industrious 19 year-old college student who earns $2,000 in 2005. The most he can contribute to his IRA in 2005 is $2,000, even though the limit for the year is $4,000 and he has the funds to make up the difference. His IRA contribution for the year is limited because his level of compensation is lower than the maximum contribution limit for 2005.

Timing

Contributions to a traditional IRA can be made for a year at any time during the year or by the due date for filing the year's tax return (usually April 15). Filing extensions are not counted.

Your IRA sponsor will send you IRS Form 5498 (or a similar statement) telling you what your contribution was for the year. If you report the contribution differently from the sponsor, you are likely to get a letter from the IRS about the discrepancy.

If an amount is contributed between January 1 and April 15, the IRA custodian must be told which year (current or previous) the contribution is for. If the sponsor isn't informed, it can assume it is a contribution for the year received and report it as such to the IRS.

Change of Heart

If you made IRA contributions, but change your mind, you can still withdraw them tax-free if you do so by the due date of your return for the year the contribution is made. If you have an extension to file your return, you can withdraw them by the due date of the extension. After that, it's too late. The only additional requirements are that you cannot have taken a deduction for the contribution and you must also withdraw any interest earned (though you can also take into account any associated loss as well).

IRA Deductions

Amounts you contribute to a traditional IRA may be eligible for a full or partial deduction from your taxable income for the year of contribution. If you qualify, this provides an immediate benefit because of the tax savings it provides.

The tax break you get for contributing to a traditional IRA depends on a number of factors, including your income level, filing status, and whether you are covered by an employer's retirement plan.

Tables 2 and 3 can help you figure out whether you can take a full deduction, a partial deduction, or no deduction in 2005. Table 2 is for those covered by a retirement plan at work; Table 3 is for those who are not covered by a retirement plan at work.

Nondeductible Contributions

Although your tax deduction for IRA contributions may be reduced or eliminated, you can still make a nondeductible contribution up to the annual limit (e.g., the lesser of $4,000 or your compensation for the year). You still get the benefit of having your money grow toward retirement on a tax-deferred basis.

To designate contributions as nondeductible, you must include in your annual tax return IRS form 8606. If you want to, you can also designate otherwise deductible contributions as nondeductible contributions. Failure to file Form 8606 will result in a $50 penalty unless you can prove it was due to reasonable cause. More importantly, the IRS will automatically treat contributions as deductible unless it gets Form 8606, and then the burden is on you to unravel the mess that is created when the IRS discovers the contributions were not deductible.

Early Withdrawals

Contributions you make to an IRA are generally not supposed to be available for your use until you reach age 59½. As a practical matter, though, you are always free to take out the money and use it any time you want. Making

Table 2. 2005 Deduction for Individuals Covered by a Retirement Plan at Work

Modified AGI*: At Least	But Less Than	Filing Status: Single/ Hd of House	MFJ**/ Qual Widow(er)	Married Filing Single***
$0.01	$10,000	Full	Full	Partial
$10,000	$50,000	Full	Full	None
$50,000	$60,000	Partial	Full	None
$60,000	$70,000	None	Full	None
$70,000	$80,000	None	Partial	None
$80,000	or over	None	None	None

**Modified AGI (adjusted gross income) is determined using Worksheet 1-1 in IRS Publication 590, Individual Retirement Arrangements (IRAs).*
***Even if spouse not covered by work plan.*
****If you did not live with your spouse at any time during the year, your filing status is considered (for this purpose) as single (therefore, your IRA deduction is determined under the "Single" column).*

an early withdrawal, however, will cost you and should be considered carefully before being done.

If an early withdrawal is made (with the exceptions noted below), a person has to pay regular income tax on the withdrawn amount, plus an additional 10% penalty tax on the amount that is included in gross income. After taxes and penalties are imposed, you will be lucky to see (let alone use) half the money you take out of your IRA. That is why taking an early distribution is not a recommended option, except in the most extreme circumstances.

As in so many areas of life, there are a number of exceptions to the restriction on early IRA withdrawals. Although regular tax is still imposed, the 10% penalty is not imposed in the following situations:

- You have unreimbursed medical expenses that are more than 7½% of your adjusted gross income.
- The distributions are used to pay the cost of your medical insurance after losing your job and receiving unemployment compensation for 12 straight weeks. The distributions must also be received in the year unemployment compensation is received or the following year, and no later than 60 days after you are reemployed.
- You are disabled and can furnish proof that you cannot do any substantial gainful activity because of your physical or mental condition.
- You withdraw money as the beneficiary of a deceased's IRA.
- You are receiving distributions in the form of an annuity that is part of an IRS-approved distribution method. [For more on this method, see "Withdrawing From Your IRA: A Guide to the Basic Distribution Rules," by Clark M. Blackman II and Ellen J. Boling, August 2002 *AAII Journal*, available at AAII.com.]
- The distributions are used to pay for your qualified higher education expenses (i.e., post-secondary education tuition, fees, books, supplies, and equipment, plus room and board if at least a half-time student).
- You use the distributions to buy, build, or rebuild a first home, provided the money is used to pay qualified acquisition costs before the close of the 120th day after you enter into a contract to buy the home or the building/rebuilding of the home begins.
- The distribution is due to an IRS levy. (Although not a big surprise, it's still nice that you don't have to pay a penalty to hand over all your savings to the IRS.)

IRA Rollovers

The definition of an IRA rollover differs slightly from the way it is defined elsewhere, as, for example, with 401(k) rollovers. A transfer of funds directly between trustees is not considered an IRA rollover, but rather a trustee-to-trustee transfer. A trustee-to-trustee transfer is always tax-free and can be done an unlimited number of times.

A rollover is a distribution to you of cash or other assets from one retirement plan to another retirement plan. A rollover may occur between IRAs, or between an IRA and an employer's plan. A rollover is tax-free provided the entire rollover contribution is made by the 60th day after you receive a distribution. Any amount not rolled over in time is treated as an early withdrawal and taxable in the year distributed (not after the 60-day period expires).

When rollovers are made between traditional IRAs, there is a one-year waiting period before another rollover of a distribution can be made. The one-year period begins on the date you receive the IRA distribution, not on the date you roll it over. Also, the one-year period applies to each IRA you own.

For example, Justin Case established three traditional IRAs, IRA-1, IRA-2 and IRA-3, in three different banks. Justin decides to combine the assets in IRA-1 and IRA-2 into one IRA, IRA-4. On July 31, he withdraws the amounts in IRA-1 and IRA-2 as part of a rollover. He deposits the amount from IRA-1 into

IRA-4 on August 29 and the amount from IRA-2 on September 21. Justin cannot make another rollover of the assets distributed from IRA-1 and IRA-2 and rolled over to IRA-4 until July 31 of the following year.

On September 1, Justin takes a rollover distribution from IRA-3 that he deposits in IRA-4 on October 31. He cannot make another rollover of that amount until September 1 of the following year.

Rollovers to Roth IRAs

An individual whose adjusted gross income (AGI) does not exceed $100,000 for the tax year can roll over amounts from a traditional IRA to a Roth IRA. For a married couple, amounts from a traditional IRA can be rolled over into a Roth IRA if the couple's AGI does not exceed $100,000 and they file a joint tax return.

A person's AGI is determined before the inclusion in income of any amount as a result of the conversion. Married individuals who file separately cannot make qualified rollovers from a traditional IRA to a Roth IRA.

Reporting Requirements

Any rollovers you make involving a traditional IRA must be reported on your tax return for the year the distribution is made. Rollovers from a traditional IRA to the same or another traditional IRA are reported on separate lines from rollovers from an employer retirement plan to a traditional IRA.

Inherited IRAs

If you inherit a traditional IRA from a spouse, you can roll it over to your own IRA or rename it as your own IRA. If a traditional IRA is inherited from somebody other than your spouse, you cannot roll it over or allow it to receive rollover contributions from you. Instead, you are required to withdraw and pay tax on the inherited IRA assets.

Transfers Related to Divorce.

Just like any other item of property being fought over, a traditional IRA may be transferred between divorcing spouses. The transfer is totally tax-free if it is transferred under a divorce or separate maintenance decree or a written document related to such a decree.

The two commonly used methods to make the transfer are changing the name on the IRA or making a direct transfer of IRA assets to the receiving spouse's IRA. The date of transfer determines when the transferred IRA or IRA assets belong to the receiving spouse.

IRA Mandatory Distributions

Keeping your money in an individual retirement account too long is an even worse crime than taking it out too early, as far as the IRS is concerned. You must either receive the entire balance of your IRA or start receiving periodic distributions from it by April 1 of the year following the year in which you reach 70½ (a.k.a., the required beginning date for IRA distributions). For any year after you turn 70½, the required minimum distribution must be made by December 31 of that later year.

For example, Ima Winner reached age 70½ on August 20, 2005. For 2005 (her 70½ year), she must receive the required minimum distribution from her IRA by April 1, 2006. She must receive the required minimum distribution for 2006 (the first year after her 70½ year) by December 31, 2006.

The penalty for keeping your money in a traditional IRA too long is severe. An excise (penalty) tax of 50% is imposed on the amount that is not distributed as required. Then, of course, a regular tax is imposed once a distribution is finally made. After the dust settles, you will be lucky to have a quarter of the required distribution amount to put in your pocket. At this rate, the odds of coming away with more money are better if you withdraw all your IRA savings and spend it gambling in Las Vegas or at your local casino. (This is not a recommended option, either.)

Calculating the Distributions

If you decide not to receive the entire balance in your IRA by the required beginning date, you must start to receive periodic distributions over one of the following periods:

- Your life,
- A period that does not extend beyond your life expectancy,
- The combined lives of you and your designated beneficiary (i.e., the per-

Table 3. Deduction for Individuals Not Covered by a Retirement Plan at Work

Modified AGI*:		Filing Status			
At Least	But Less Than	MFJ, Spouse Covered By Work Plan	Single/ Hd of House	MFJ or MFS, Spouse Not Covered by Work Plan/Qual Wid	MFS, Spouse Covered By Work Plan**
$0.01	$10,000	Full	Full	Full	Partial
$10,000	$150,000	Full	Full	Full	None
$150,000	$160,000	Partial	Full	Full	None
$160,000	or over	None	Full	Full	None

**Modified AGI (adjusted gross income) is determined using Worksheet 1-1 in IRS Publication 590, Individual Retirement Arrangements (IRAs).*
***You are entitled to the full deduction if you did not live with your spouse at any time during the year.*

Warning: Do-It-Yourself!

Given the importance of at least taking the required periodic distributions, don't rely on the IRA custodian to figure out and inform you of how much to take out. There have been a number of cases where the IRA holder had to pay the ultimate price for an IRA custodian's mistake.

Instead, figure out the required distribution amount yourself and build in an added cushion by withdrawing more. Another alternative is to withdraw portions or the entire amount from a traditional IRA and deposit the amount into a Roth IRA until you need it.

son you name to receive your IRA upon your death), or

- A period that does not extend beyond the joint life and last survivor expectancy of you and your designated beneficiary

You don't need a crystal ball to figure out the life expectancies you need. The IRS publishes a life expectancy table and a joint life and last survivor expectancy table for this purpose (in IRS Publication 590).

To figure the required distribution for each year, divide the IRA account balance as of the close of business on December 31 of the preceding year by your applicable life expectancy or the combined life expectancy of you and your beneficiary. The IRA account balance is adjusted for any contributions or distributions that count for the year.

If a beneficiary is other than a spouse and the beneficiary is more than 10 years younger than you, a minimum distribution incidental benefit (MDIB) table must be compared with the regular life expectancy table and the lower number used for the beneficiary's age.

For example, Major League reached 70½ in 2005 and must begin receiving distributions from his IRA by April 1, 2006. His wife and beneficiary, Ivy, turned 57 in 2005. Major's IRA account balance as of December 31, 2004, is $29,000. Based on their ages at the end of 2005, the joint life expectancy for Major (age 71) and Ivy (age 57) is 29 years. The required initial minimum distribution is $1,000 ($29,000 divided by 29 years) and is made from Major's IRA in 2006 by April 1.

At the end of 2005, Major's IRA balance has grown to $29,725. To figure out the minimum distribution that must be made by the end of 2006, the $29,725 must be reduced by the minimum distribution amount for the previous year ($1,000) that was paid in 2006. Major's required distribution amount for 2006 is $1,026 ($28,725 divided by 28 remaining years).

Multiple IRAs

If you have more than one traditional IRA, you have to figure out the required minimum distribution for each IRA. However, the total required distributions can be taken from any of the IRAs as long as the total amount is met.

For example, Cara Lott will turn 70½ on September 2, 2005. She has two traditional IRAs, one with $10,000 and another with $20,000. The minimum amount that must be distributed from each IRA by April 1, 2006 (based on a distribution period of 27.4 years) is $365 and $730 respectively.

Cara decides to have all of the required distributions come from the smaller IRA because it offers a lower rate of return. After the required distribution is made, she is left with $8,905 in the first IRA and $20,000 remaining in the second. She can continue this process until the smaller account is depleted, and then turn to the second IRA. ▲

This article is excerpted from the CCH Financial Planning Toolkit, published by CCH Inc., a provider of business, legal and tax information and software.

Reproduced with permission from CCH Financial Planning Toolkit™ www.finance.cch.com, published and copyrighted by CCH Tax & Accounting.