WHAT YOU NEED TO KNOW ABOUT INDIVIDUAL RETIREMENT ACCOUNTS

By Clark Blackman and Ellen J. Boling

There are three types of IRAs to choose from, each with unique rules pertaining to contributions and distributions. You need to understand these rules in order to determine which is best for you. Part 1 of a two-part series focuses on contributions.

Individual retirement accounts provide tax-advantaged opportunities to set aside money each year for your retirement. When IRAs originally appeared, the choice was relatively simple: You could choose between contributing to an IRA, or not contributing.

But the IRA universe has expanded, and the choices today are more complicated. You generally have three types of individual retirement accounts (IRAs) from which to choose:

- Traditional deductible IRAs
- Traditional non-deductible IRAs
- Roth IRAs

Each type of IRA has unique rules pertaining to account contributions and distributions. You need to understand these rules in order to determine which IRA, if any, is the best retirement vehicle for you.

This column is the first part of a two-part series on IRAs. Part 1 focuses on limitations and the taxability of IRA *contributions*. The next column will focus on the limitations and taxability of IRA *distributions*.

CONTRIBUTIONS

- *Traditional Deductible IRAs***:** Contributions of up to $2,000 ($4,000 if you have a spousal IRA) are fully deductible if you have employment income, as long as you are not covered by an employer-sponsored retirement plan, or you are covered by an employer-sponsored plan (this means you are an active participant) but your adjusted gross income is below certain levels. The deduction is phased out for married couples filing jointly at income levels from $52,000 to $62,000 in 2000 and for single taxpayers at income levels from $32,000 to $42,000. If these conditions are satisfied, the contribution is deductible and reduces the taxable income on your tax return.

  You and your spouse must establish separate IRA accounts. A total $4,000 IRA contribution can be allocated between you and your spouse's accounts in any proportion, as long as the amount allocated to one spouse does not exceed $2,000. However, the combined contribution cannot be higher than the combined earnings (i.e., wages) of you and your spouse in the year for which the contribution is made. Your spouse will not be considered to be an active participant merely because you are covered by an employer-sponsored retirement plan. A separate phaseout limit applies if you are not an active participant, but your spouse is. The deductible IRA contribution in this case, assuming you file jointly, is phased out at adjusted gross income between $150,000 and $160,000. If you are married but file separately, the phaseout is between $0 and $10,000 of adjusted gross income.

  You may make contributions to your traditional deductible IRA for a year at any time during the year or by the due date for filing your return for that year, not including extensions—in other words, April 15 is the final

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TABLE 1. A SUMMARY OF IRA CONTRIBUTION LIMITATIONS AND TAXABILITY

	Traditional Deductible IRA	Non-Deductible Traditional IRA	Roth IRA
General			
Definition	Deductible individual retirement account established by a taxpayer	Non-deductible individual retirement account established by a taxpayer	Non-deductible individual retirement account established by a taxpayer
Taxpayer Contributions Allowed	Yes	Yes	Yes
Employer Contributions Allowed	No	No	No
Eligible for Rollover	Can be converted to a Roth IRA if the taxpayer's adjusted gross income is less than $100,000. However, Married Filing Single taxpayers may not convert to a Roth IRA.	Can be converted to a Roth IRA if the taxpayer's adjusted gross income is less than $100,000. However, Married Filing Single taxpayers may not convert to a Roth IRA.	Rollover to another Roth IRA is permitted.
Taxation of Contributions	Deductible	Non-deductible	Non-deductible
Contribution Limitations			
Taxpayer Contribution Yearly Limits	$2,000 if the taxpayer is not an active participant in another retirement plan with his or her employer. If the taxpayer or the taxpayer's spouse is an active participant, the taxpayer can only make a contribution if his or her adjusted gross income is below thresholds listed below.	$2,000	$2,000
Combined Yearly Contribution Limits Across All Types of IRAs	$2,000 total for all traditional and Roth IRAs	$2,000 total for all traditional and Roth IRAs	$2,000 total for all traditional and Roth IRAs
Adjusted Gross Income Limitations			
2000 Maximum Adjusted Income Where Phaseout of Benefit Begins	Married Filing Joint: $150,000* Married Filing Single: $0 Single: $32,000 Head of Household: $32,000 *If only one spouse is an active participant in an employer-sponsored plan. If both spouses are active participants, amount becomes $52,000	None	Married Filing Joint: $150,000 Married Filing Single: $0 Single: $95,000 Head of Household: $95,000
2000 Adjusted Gross Income Where 100% of Benefit is Phased Out	Married Filing Joint: $160,000* Married Filing Single: $10,000 Single: $42,000 Head of Household: $42,000 *If only one spouse is an active participant in an employer-sponsored plan. If both spouses are active participants, amount becomes $62,000	None	Married Filing Joint: $160,000 Married Filing Single: $10,000 Single: $110,000 Head of Household: $110,000

deadline. As a general rule, you will want to make the contribution at the earliest possible date to take full advantage of the tax deferral benefit.

- *Traditional Non-Deductible IRAs***:** Even if you do not satisfy the requirements that allow a tax deduction for your IRA contribution, you may still contribute up to $2,000 (less any deductible IRA contributions) to a traditional non-deductible IRA. The contribution may be up to $4,000 for 2000 if you have a spousal IRA as well. Although the contribution is not deductible from your income, the earnings on the contribution are not taxed until they are withdrawn from the IRA. This often-overlooked opportunity for tax-deferred compounding can provide significant benefits if used consistently for a number of years.

  Traditional IRAs, both deductible and non-deductible, require that *contributions* stop and *distributions* begin when the taxpayer reaches age 70½.

  You may make contributions to your traditional non-deductible IRA for a year at any time during the year, or by the due date for filing your return for that year, not including extensions (April 15). Here again, to maximize the tax benefits you should make your contribution as early in the year as possible.

- *Roth IRAs***:** The newest type of IRA is a Roth IRA, named for the senator who proposed the law creating it. A Roth IRA is similar to a traditional non-deductible IRA, with a few key differences.

  You have two options for contributing to a Roth IRA: annual contributions and rollover contributions.

  The maximum annual contribution to a Roth IRA is similar to that of traditional IRAs—the lesser of your earned income or $2,000. However, any contribution made to a traditional IRA reduces the allowable Roth contribution. The deduction is phased out for married couples filing jointly at income levels from $150,000 to $160,000 and for single taxpayers at income levels from $95,000 to $110,000. The Roth IRA is funded solely with aftertax (non-deductible) contributions, but unlike current non-deductible IRAs, it exists as a separate account and offers the possibility of tax-free earnings.

  However, unlike traditional IRAs, you can make annual contributions to a Roth IRA even if you are a participant in a qualified retirement plan, and even if you are over age 70½.

  You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (not including extensions).

  You can also contribute to a Roth IRA by making a rollover contribution. You may convert an existing traditional IRA into a Roth IRA during any tax year in which your modified adjusted gross income (not counting the converted amount) does not exceed $100,000. However, married individuals filing separately are not eligible to convert, regardless of their income level. In most cases, the rollover amount is included in gross income—in other words, you must pay taxes on the rollover—but there is no early withdrawal penalty (a 10% penalty typically applies to a premature distribution from a traditional IRA).

  The adjusted gross income thresholds prohibit higher-income taxpayers from taking advantage of the Roth IRA, although they can still make a contribution to a traditional non-deductible IRA. If a taxpayer (under age 59½) converts a traditional IRA to a Roth IRA in a year when adjusted gross income exceeds the $100,000 limit, the conversion will be treated as a taxable distribution, and the 10% early withdrawal penalty *will* apply, unless a reconversion takes place before the tax return is filed.

Table 1 summarizes IRA contribution limitations and taxability.

INVESTMENT RESTRICTIONS

There are a few limitations on the types of investments that may be put into IRA accounts. In general, you are not allowed to contribute physical assets such as land, homes, collectibles (except for certain IRS approved U.S. coins), etc. Certain partnership investments are allowable if they have been approved.

Be aware that although virtually all negotiable, marketable securities may be held in an IRA, some custodians (broker/dealers, banks, etc.) may be more flexible than others on what they will allow.

CONCLUSION

With several IRA alternatives, choosing which type of IRA to contribute to is not easy. Factors you must consider include:

- Your expected income tax rate in the year of contribution,
- Your expected tax rate in the year of distribution,
- Available investment returns for assets inside or outside an IRA, and
- Your desired flexibility/access to your investment.

Given the significant and sometimes irrevocable nature of the decisions you need to make, it is necessary to thoroughly understand and research all of the potential outcomes.

In the next article, we will address the basics of IRA distributions. ◆