

WHAT YOU NEED TO KNOW ABOUT MAKING CONTRIBUTIONS TO AN IRA

By Clark M. Blackman II and Ellen J. Boling

There are several types of IRAs, each of which has unique rules pertaining to account contributions and distributions. You need to understand these rules in order to determine which one is the best retirement vehicle for you.

Individual retirement accounts provide tax-advantaged opportunities to set aside money each year for your retirement. Understanding the basics of where each type of IRA applies and the rules relating to them is imperative to effectively using these “tools”—particularly given the changes in the rules that have occurred in recent years.

You generally have three types of individual retirement accounts (IRAs) from which to choose:

- Traditional deductible IRAs,
- Traditional non-deductible IRAs, and
- 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 article will focus on what you need to know regarding contributions, leaving the complexities of distribution rules for another time.

DEDUCTIBLE IRAS

For 2002, contributions of up to \$3,000 (\$3,500 if you are age 50 or over, \$6,000 if you contribute to a spousal IRA, and \$7,000 if you are both age 50 or over) are fully deductible if you have income from employment and you are either:

- Not covered by an employer-sponsored retirement plan; or
- 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 \$54,000 to \$64,000, and for single taxpayers at income levels from \$34,000 to \$44,000.

The Economic Growth and Tax Reconciliation Act of 2001 added a provision that increases the maximum contribution amount available to those over age 50 by \$500 to a \$3,500 total possible contribution. If these conditions are satisfied, the contribution is deductible and reduces the income reportable on your tax return. Remember, however, you can never contribute more than the income you earn from working in any given year.

You and your spouse must establish *separate* IRA accounts. A total of \$6,000 in IRA contributions can be allocated between you and your spouse's accounts in any proportion (\$7,000 if both are age 50 or over), as long as the amount allocated to one spouse does not exceed \$3,000 (\$3,500 if age 50 or over). 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—although you will be, even if you were a participant for only one day during that year!

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TABLE 1. IRA CONTRIBUTIONS LEVELS FOR 2002

	Traditional Deductible IRA	Non-Deductible Traditional IRA	Roth IRA
Definition	Deductible individual retirement account established by a taxpayer with earned income.	Non-deductible individual retirement account, established by a taxpayer, that falls outside the limitations of deductibility.	Non-deductible individual retirement account established by a taxpayer who desires tax-free distributions during retirement.
Yearly Contribution Limits	\$3,000 (\$3,500 if age 50 or over) if the taxpayer is not an active participant in another 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 AGI is under the thresholds listed below.	\$3,000 (\$3,500 if age 50 or over).	\$3,000 (\$3,500 if age 50 or over).
Combined Yearly Contribution Limits Across All Plans	\$3,000 total for all traditional and Roth IRAs (\$3,500 if age 50 or over).		
2002 AGI Limitations			
AGI Phaseout Begins at:			
Married Filing Joint:	\$150,000*	None	\$150,000
Married Filing Separate:	\$0		\$0
Single:	\$34,000		\$95,000
Head of Household:	\$34,000		\$95,000
AGI Where Benefit is Completely Phased Out:			
Married Filing Joint:	\$160,000*	None	\$160,000
Married Filing Separate:	\$10,000		\$10,000
Single:	\$44,000		\$110,000
Head of Household:	\$44,000		\$110,000
	*Applies to non-active spouse if only one spouse is an active participant. If both are active participants, the phaseout begins at \$54,000 and is completely phased out at \$64,000.		
Taxation of Contributions	Deductible	Non-deductible	Non-deductible
Eligibility for Roth Rollover:	Can be converted to a Roth IRA if the taxpayer's AGI is less than \$100,000. MFS** taxpayers may not convert to a Roth IRA.	Can be converted to a Roth IRA if the taxpayer's AGI is less than \$100,000. MFS** taxpayers may not convert to a Roth IRA.	Rollover to another Roth IRA is permitted.

**MFS = Married Filing Separate

A separate phaseout limit applies to the spouse who is not an active participant when the other spouse is an active participant. The deductible IRA contribution for the non-active spouse, assuming you file jointly, is phased out at adjusted gross

incomes between \$150,000 and \$160,000. If you are married but file separately, the phaseout range is \$0 to \$10,000 of adjusted gross income. The active spouse may make some contribution if joint income is less than \$64,000.

An example of how the phase-out works for married filing joint taxpayers if one spouse is an active participant and one is not:

You and your spouse file a "Married Filing Jointly" tax return (Form 1040). Together, your adjusted gross income (line 38 of your 1040) is \$153,500, which is \$3,500 above the beginning of the phaseout range of \$10,000. The active spouse is ineligible for a *deductible* contribution since your income exceeds \$64,000. Of the \$3,000 contribution allowable for the non-active participant spouse, you may deduct 65% [$\$3,500 \div \$10,000 = 35\%$; $100\% - 35\% = 65\%$], or \$1,950. The 35% that is not deductible may be contributed as a nondeductible IRA contribution (discussed below).

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 (so, in other words, April 15). It is always recommended you make your contribution as early as possible (the first business day of January is best) to maximize the tax-deferred benefit of the income earned on your contribution.

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 \$3,000 (less any deductible IRA contributions) to a nondeductible IRA. That amount is increased to \$3,500 (less any *deductible* IRA contributions) if you are age 50 or older. And the contribution may be up to \$6,000 for 2002 if you have a spousal IRA and \$7,000 if both of you are age 50 or over.

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

several 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). Again, the same recommendation to contribute as early in the year as possible applies here as well.

ROTH IRAS

The newest type of IRA is a Roth IRA, named for the senator who proposed the law that created 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.

Annual Contributions: Similar to traditional IRAs, the maximum annual contribution is the lesser of your earned income or \$3,000 (\$3,500 if age 50 or over). Any contribution made to a traditional IRA reduces the allowable Roth contribution. The allowable contribution is phased out for married couples filing jointly at income levels from \$150,000 to \$160,000 and for single people at income levels from \$95,000 to \$110,000.

The Roth IRA is funded solely with aftertax (non-deductible) contributions. But unlike current nondeductible IRAs, it exists as a separate account and offers the possibility of receiving tax-free (as opposed to "tax-deferred") earnings.

Contrary to traditional IRAs, you can make annual contributions to a Roth IRA even if you are (1) a participant in a qualified retirement plan, or (2) over the age of 70½.

You can make contributions to a Roth IRA for a year at any time during the year or by April 15 of the following year. Again, earlier is better.

Rollover Contributions: You may

convert or "roll over" 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. 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, but there is no early withdrawal penalty (a 10% penalty typically applies to a premature distribution—before age 59½—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 his/her 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.

Why do a rollover?

Qualified distributions from a Roth IRA are totally excluded from income tax. To be treated as "qualified," the distribution must occur at least five tax years after the first Roth contribution is made and must meet one of the four requirements listed below:

- It is made on or after the individual reaches age 59½;
- It is made to a beneficiary on or after the individual's death;
- The individual becomes disabled; or
- The distribution, up to \$10,000, is to be used for qualified first-time homebuyer expenses.

The possibility of qualified distributions can be a compelling reason for folks who will be subject to income taxes in retirement.

RECENT IRA LEGISLATION

The Economic Growth and Tax Relief Reconciliation Act of 2001

created a number of favorable changes in regards to IRAs, some of which have already been mentioned. The adjusted gross income limitations continue to be indexed with inflation, but the 2001 Act has increased the amount that individuals and couples may contribute annually until 2008, when the contribution levels will be indexed for inflation in \$500 increments thereafter:

Years	Maximum Contribution
2002–2004	\$3,000
2005–2007	\$4,000
2008 and after	\$5,000 (inflation-adj.)

The 2001 Act also created a "catch-up provision," allowing taxpayers aged 50 or older to contribute additional amounts to IRAs:

Years	Catch-Up Contribution
2002–2005	\$500
2006 and after	\$1,000

The 2001 Act introduced a non-refundable credit for IRA contributions that may be claimed for certain qualifying taxpayers (in addition to the above-the-line deduction for traditional IRAs). The credit rate is a maximum of 50% of the IRA contribution, but is available only to "married filing jointly" taxpayers with a modified adjusted gross income of less than \$50,000 (lower limits apply to other filing statuses). The credit also cannot be claimed by individuals under the age of 18, dependents, or full-time students. The credit itself is fairly complex, and although most individuals with higher incomes will fail to qualify for the credit, it may be advantageous to discuss it further with your tax adviser.

DISTRIBUTIONS

Although the distribution aspect of IRAs is not the focus of this article, it should be noted that IRA distributions (for Roth, traditional deductible, and traditional non-deductible

IRAs) may begin at age 59½ without triggering the 10% penalty tax (although there are exceptions that allow earlier distributions without the penalty).

Distributions from traditional deductible and traditional non-deductible IRAs are taxed as ordinary income and are not eligible for favorable capital gains rates, regardless of the length of holding period of the investments in the IRA. Distributions must begin at 70½ for traditional deductible and traditional non-deductible IRAs, or a 50% penalty tax will be assessed on the amount that should have been distributed. This is not the case with Roth IRAs, which have no required distribution age.

IRAS FOR CHILDREN

A parent or grandparent may help their child or grandchild begin funding an IRA if that child has earned income for the year up to the maximum contribution amount (\$3,000 for 2002). By gifting the allowable amount to the child, the parents encourage a long-term savings strategy.

This program may be advisable because it not only starts the child's retirement program, but it also shows the importance of early planning for retirement. For example, if an 18-year-old made a \$3,000 contribution to an IRA each year, the amount available at age 65 would be almost \$1,000,000, assuming a 7% compounded rate of return was earned.

EDUCATION IRAS

Coverdell Education Savings Accounts (Coverdell ESAs), formerly called Education IRAs, went through a major renovation under the recent tax act. A Coverdell ESA differs from a regular IRA in that it is used to pay for "qualified" education expenses, as opposed to an IRA which is used for retirement. Also, the annual contribution is \$2,000 per account beneficiary beginning in

2002.

Contributions to Coverdell ESAs aren't deductible, but withdrawals can be made tax-free if used for qualified education expenses, which before 2002 were limited only to qualified college expenses. Today, ESAs can be used for primary and secondary education expenses as well.

After 2001, the adjusted gross income phase-out range has been increased to between \$190,000 and \$220,000 for joint returns, and \$95,000 to \$110,000 for single individuals.

One word of caution, however, should be made to lower- and middle-income parents: The Coverdell ESA is set up in the child's name, and could possibly cause the child to lose more in financial aid than you'll save in taxes due to the way financial aid formulas are calculated!

ROLLOVERS INTO IRAS

For some people, it may be advantageous to consider rolling over their qualified retirement plan savings (e.g., 401(k)) into an IRA. There are a number of things to consider before doing so, and it may result in favorable or unfavorable tax consequences based on each individual's situation. Generally, an IRA can provide more flexibility in terms of investments, but you may lose the use of a special tax strategy if your 401(k) contains a significant amount of highly appreciated employer stock. We suggest discussing this topic further with your tax or financial planning adviser if you have any questions or wish to pursue the matter.

STARTING AN IRA

For those just beginning to make contributions to an IRA, investments should be chosen based on what the individual feels comfortable investing in and the investor's "risk tolerance."

Opening an IRA is fairly simple—

most banks, discount brokers, and mutual fund companies will open an account for modest contribution amounts. These sponsors have easy-to-follow programs that can be of great assistance to someone getting started.

There are many different investment options in IRA accounts, and most people choose simple forms of investment initially. There are some 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, etc., but certain partnership investments are allowable if they have been approved. You may never borrow from your IRA, use it as collateral, or buy securities on margin within the account.

Be aware that although virtually all negotiable, marketable securities may be held in an IRA, some IRA sponsors may be more flexible than others in what they will allow. Make sure you understand the limitations and rules of the IRA investments offered by the sponsor that will hold your IRA.

CONCLUSION

The Economic Growth and Tax Relief Reconciliation Act of 2001 brought a number of favorable changes to IRAs, but the key to success in any retirement program is starting early and making contributions on a regular basis.

With several IRA alternatives, choosing which type of IRA to contribute to is no easy task. 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 and/or access to your money. ■