Individual Retirement Accounts

IRAs, tax-advantaged retirement savings alternatives, have been available since 1974. This guide explains Traditional and Roth IRAs, and discusses who can contribute to an IRA, how to set one up, and how much can be contributed. It also explores the tax consequences of different IRAs at different income levels.

An important goal for many people is a financially secure retirement. An Individual Retirement Account (IRA) is a tax-advantaged retirement savings option available to help Americans achieve their retirement goals. This guide highlights the two basic types of IRAs: Traditional IRAs (deductible and nondeductible) and Roth IRAs.

How much can be contributed to an IRA?

A person who has earned income may contribute up to 100 percent of that income up to the maximum annual contribution limit. The annual contribution limit for 2014 and 2015 is $5,500. In future years, the limit will be increased based on an inflation index in increments of $500 (See Table 1.). Persons age 50 and older are also eligible to make an additional $1,000 "catch-up" contribution beyond the regular limits each year.

Who can contribute to an IRA?

Generally, an individual must be younger than 70½ and have earned income to be eligible to contribute to a Traditional IRA. Individuals over 70½ who are not eligible to contribute to a Traditional IRA may be eligible to contribute to a Roth IRA. The Internal Revenue Service (IRS) defines earned income as wages, salaries, tips, commissions, taxable alimony, professional fees, bonuses, and other compensation for personal services.

Farmers and other small business owners may include net income as earned income as long as they are an "active" partner in the business operation. Earnings and profits from property, such as rental income, interest or dividend income, pension or annuity income, and Social Security income are not considered earned income.

Table 1. Contribution Amounts for Individual Retirement Accounts (IRAs)

Year	Contribution Limit	Catch-up Contribution (age 50 or older)
2014	$5,500	$1,000
2015	$5,500	$1,000
2016 and beyond	Adjusted for Inflation	Adjusted for Inflation

An exception to the earned income rule is for spousal IRAs. The spouse with earned income may make annual contributions into an IRA for the spouse who does not have earned income. However, a joint federal income tax return must be filed for the tax year the contributions are made.

Where do I set up an IRA?

Federal regulations require that an IRA be managed by a custodian or trustee. Custodians include banks, credit unions, insurance companies, and investment brokerage firms.

An investor should compare the terms offered by IRA custodians and trustees before establishing an IRA. The types of investments, rates of return, early withdrawal penalties, transaction fees, investment risks, maturity periods, personal management required, minimum opening balance requirements, management fees, and other important features may vary considerably among IRA custodians and trustees. A useful tool to help you make comparisons is the *Shopping for an Individual Retirement Account* (IRA) guide (MF3211).

What kinds of IRAs are available?

There are two main types of IRAs: Traditional (sometimes called regular or ordinary) and Roth. Which IRA, or combination of IRAs, is best for you depends on your financial goals, family situation, and income level.

Traditional IRAs

Contributions to Traditional IRAs can be either tax deductible or nondeductible. Whether or not Traditional IRA contributions can be claimed as a deduction on an individual or married couple's income tax return depends on these conditions:

- Whether or not an individual is an active participant in an employer-sponsored retirement plan.

- An individual's (or couple's) income level.
- An individual's filing status (single; married and filing jointly; or married and filing separately).

Active participation in an employer-sponsored retirement plan. If the individual and his or her spouse are not active participants in an employer-sponsored retirement plan, the amount placed in a Traditional IRA is fully deductible for income tax purposes regardless of the amount of annual income.

Example 1: John and Sally are not active participants in an employer-sponsored retirement plan. In 2014, each could place $5,500 in a Traditional IRA. Their joint income of $65,000 is reduced by $11,000 to $54,000 for state and federal income tax computation purposes.

If an individual, or his or her spouse, are active participants in an employer-sponsored retirement plan, the amount placed in a Traditional IRA may not be fully deductible for income tax purposes. Individuals are considered as active participants if they are covered under a profit-sharing plan, a 401(k) plan, a tax-sheltered annuity plan [403(b)], certain government plans, a Simplified Employee Pension plan (SEP), or a Savings Incentive Match Plan for Employees (SIMPLE). If individuals (or their spouses) are not certain whether they are active participants in a retirement plan, they should ask their employers.

Example 2: Tim and Reese are both active participants in a company-sponsored profit-sharing plan. Tim and Reese's Traditional IRA contributions are not automatically tax deductible because both are participants in an employer retirement plan. Their contributions may still be tax deductible, but they must also satisfy income restrictions.

Income levels and filing status. Depending on income and filing status, an individual or married person actively participating in a retirement plan may receive a full, partial, or no tax deduction for contributions to a Traditional IRA for income tax purposes (Table 2).

Table 2. Modified Adjusted Gross Income Limits for Deductible Traditional IRA Contributions

	Eligible for a Full Deduction	Eligible for Partial Deduction (phase-out range)
2014 Single	$60,000	$60,001–$70,000
2014 Married, filing jointly	$96,000	$96,001–$116,000
2015 Single	$61,000	$61,001–$71,000
2015 Married, filing jointly	$98,000	$98,001–$118,000

Example 3: Craig and Mary, married and filing jointly in 2014, have a modified adjusted gross income of $70,000. Both are covered by retirement plans at work. Because their income falls below the limit (Table 2), they can receive a full deduction on their income tax return for the $5,500 each places in a Traditional IRA. Their Kansas and federal income taxes would be computed on $59,000, not $70,000 ($70,000 – $11,000 = $59,000).

In 2014, a single person whose income is less than $60,000 is eligible for a full income tax deduction. Married couples filing jointly are eligible for a full income tax deduction if their joint modified adjusted gross income is less than $96,000, even if both spouses are active participants in an employer-sponsored retirement plan. (See Table 2.)

Partial tax deduction for IRA. If individuals are active participants in a retirement plan and their incomes fall within the ranges shown in Table 2, a portion of their Traditional IRA contribution may be deductible. The deductible amount of a Traditional IRA for income tax purposes is calculated based on IRS formulas. The IRS tables and worksheets for figuring reduced IRA deductions can be found in IRS Publications 590A and 590B, *Individual Retirement Arrangements (IRAs)*, which can be ordered from the IRS toll-free at 1-800-829-3676 or downloaded from the IRS website: *www.irs.gov*.

Deferral of income tax for Traditional IRAs. If the eligibility rules described previously are met and income is less than the phase-out ranges shown in Table 2, the amount contributed to a Traditional IRA may be deducted from gross income when computing Kansas and federal income taxes. In addition, all accumulated earnings while money is in a Traditional IRA are tax deferred.

Example 4: Keri has placed $2,000 annually in her IRA for 10 years. The balance on the account is $25,156. Her earnings of $5,156 are growing tax-deferred and are not included as income when she calculates her Kansas and federal taxes each year.

Note: The payment of Kansas and federal income tax is only deferred, not eliminated, on Traditional IRAs. When the IRA money is withdrawn, the amount is added to that person's income for that year and taxed accordingly. Because withdrawals from a Traditional IRA are typically taken during retirement when income is reduced, the tax

Example 5: Bruce, age 65, withdrew $15,000 from his Traditional IRA in 2014. The $15,000 is added to his income of $44,000. Bruce pays Kansas and federal income taxes on $59,000 ($44,000 income + $15,000 IRA withdrawal = $59,000). In 2014, Bruce's taxable income is $15,000 higher due to his IRA withdrawal.

rate on the money may be lower than when the IRA owner and/or spouse were employed.

Nondeductible Traditional IRAs. Individuals who are covered by an employer retirement plan, but are not eligible for the deductible Traditional IRA, can contribute to a nondeductible Traditional IRA. With a nondeductible IRA, individuals contribute tax-paid dollars and any taxes on earnings are deferred until withdrawal. Cost basis needs to be tracked for nondeductible contributions to accurately compute taxes on the earnings when distributions begin. Cost basis is a record of nondeductible contributions that have been made to an IRA since the account was initially opened.

Example 6: Dave's filing status in 2014 is single. He earns $82,000 and is an active participant in a retirement plan at work. Dave is not eligible to make a tax deductible contribution to a Traditional IRA because his income exceeds the limit of $70,000 (Table 2). He could establish a nondeductible IRA and his earnings would be tax deferred.

Individuals who make nondeductible contributions to a Traditional IRA must attach Form 8606 to their tax returns. An individual should keep copies of all IRS 8606 forms as proof of nondeductible IRA contributions.

Note: Avoid commingling deductible and nondeductible contributions or keep careful records to show taxable amounts once distributions begin.

Roth IRAs

Contributions to a Roth IRA are not tax deductible but the earnings from a Roth IRA are tax-free. The contribution limits are the same as for Traditional IRAs (Table 1). The income limits are higher for Roth IRAs than for Traditional IRAs. The age restriction that prohibits contributions to Traditional IRAs after an individual reaches age 70½ does not apply to Roth IRAs.

2014 income eligibility. Individuals are allowed to contribute up to $5,500 (those 50 years or older can contribute an extra $1,000) to a Roth IRA if they meet certain income restrictions. Full contributions can be made by single persons with incomes of up to $114,000 or by married couples with incomes of up to $181,000. Partial contributions are allowed for individuals or married couples with higher incomes. The income limits for 2014 and 2015 are provided in Table 3. Persons earning more than these limits may want to consider a nondeductible IRA.

Example 7: Gary deposited $3,000 annually in a Roth IRA for 20 years ($60,000 in deposits). Assume in 2029, his balance is $80,611. While he paid taxes on each $3,000 annual contribution, his earnings ($20,611) are tax-free ($80,611 – $60,000 = $20,611). If Gary had contributed to a deductible Traditional IRA instead of the Roth IRA, he would owe Kansas and federal taxes on both the contributions and earnings when he withdraws the money.

Table 3. Modified Adjusted Gross Income Limits for Roth IRA Contributions

	Eligible for a Full Deduction	Eligible for a Partial Deduction
2014 Single	$114,000	$114,001–$129,000
2014 Married, filing jointly	$181,000	$181,001–$191,000
2015 Single	$116,000	$116,001–$131,000
2015 Married, filing jointly	$183,000	$183,001–$193,000

What if I need my IRA money?

Because IRAs are designed to encourage Americans to save money to supplement their Social Security and pension income during retirement, the Internal Revenue Service generally assesses a 10 percent penalty on early distributions (withdrawals) when the owner is under age 59½ unless the withdrawal meets certain conditions.

There are two requirements to qualify for tax-free withdrawals of the income a Roth IRA has earned. First, the Roth IRA must meet the "five-year test." In other words, the withdrawal must be five years after the first year for which Roth IRA contributions were made. Second, one of the following conditions must apply:

1. The individual is over age 59½.
2. The individual has become disabled.
3. The individual is using the funds for a first-time home purchase. (Lifetime limit of $10,000)
4. The individual is deceased and the IRA is distributed to the beneficiary.
5. The withdrawal is for qualified higher education expenses or one of seven other exceptions (see IRS Publications 590A and 590B for more information).
6. Payment of qualified, unreimbursed medical expenses greater than 7.5 percent of adjusted gross income.
7. Payment of qualified health insurance premiums while unemployed for 12 or more weeks.
8. When the withdrawals are made based on the owner's or owner's and beneficiary's life expectancies.

Withdrawals that do not meet these requirements are subject to 10 percent penalty. To avoid the 10 percent penalty on withdrawals from a Traditional IRA one of the conditions listed above (1 through 8) must be met.

Can I move my IRA to another financial institution?

IRA contributions that are placed in custodial accounts at financial institutions, insurance companies, or investment brokerage firms may be moved from one custodian or trustee to another. Because there is no distribution, the transfer is tax free. However, the custodian may assess a fee or penalty for the transfer.

When can I make an IRA contribution?

Contributions can be made from January 1 of the tax year until April 15 of the year following tax year for which the contribution will be reported. If a contribution is made for the previous year any time between January 1 and April 15, the owner should notify the IRA custodian that the contribution is for the preceding year. This will allow the custodian to correctly report the tax year that applies to each deposit.

What happens to an IRA in case of divorce?

An IRA is an asset just like any other marital investment owned by either spouse. The money in a Traditional IRA, nondeductible IRA, or Roth IRA can be directly transferred, tax free, to an IRA owned by the former spouse or a separate IRA can be established. The action must be according to the terms of the qualified domestic relations order (QDRO). The benefits of separate IRAs for divorced spouses is that the funds could be later rolled over into an owner's retirement plan.

Can I roll over my IRA into my retirement plan at work?

A person can roll over, tax free, a distribution from an IRA into a qualified plan, including a deferred-compensation plan of a state or local government (section 457 plan) or a tax-sheltered annuity (section 403[b] plan). The distribution that a person can roll over is the part that would otherwise be taxable (includable in income). Qualified plans may, but are not required to, accept these rollovers.

Can I roll over withdrawals from my retirement plan into my IRA?

Kansas and federal income taxation on withdrawals from tax-deferred employer sponsored retirement plans can be prevented by transferring the funds directly into an IRA. When an individual leaves a job and transfers the balance of the retirement plan to an IRA, the check for the funds should be made out to the custodian or trustee of an individual's IRA. Otherwise, the employer must withhold 20 percent of the amount withdrawn for the payment of federal income taxes.

Summary

IRAs are useful tools to help Kansans meet their retirement savings goals. IRA contribution limits and income limits for eligibility purposes are adjusted annually. Individuals interested in IRAs should ensure that they are up to date on current IRA rules. Additional information can be obtained from retirement professionals such as certified public accountants, and certified financial planners.

Disclaimer

This publication is designed to provide educational information on IRAs, not to render legal, accounting, or other professional advice. If legal advice or other expert tax assistance is required, the services of a competent professional (attorney, certified public accountant, or certified financial planner) should be sought.

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MF3212 May 2015