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Individual Retirement Accounts

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Retirement poses many uncertainties, the largest of which may be financial security. In light of several years of high inflation which erodes retirement funds, the uncertainty of financial security in retirement has been heightened. For many decades, the thought of retirement has been accompanied by the certainty of a financial base provided by Social Security benefits. In recent times, there has been concern about the continued capacity of the Social Security system to provide the benefit levels that are currently projected. How can families deal with the uncertainties of financial security during retirement?

IRA: What Is It?

One answer to the previous question is provided in the form of an Individual Retirement Account (IRA). An IRA is a tax-deferred method for building up a retirement fund. IRAs were introduced in 1974. The intention originally was to make tax-deferred retirement plans available to anyone who had earned income, and who was not self-employed or covered by an employer pension plan. These basic intentions have been broadened to include more employed persons under the Economic Recovery Tax Act of 1981. IRAs are available from commercial banks, credit unions, life insurance companies, brokerage firms, savings and loans, and mutual funds.

Who Is Eligible?

Literally everyone with earnings (including the self-employed) is now eligible for an IRA. Even if an individual is covered by a pension or profit-sharing plan at work, as of January 1982, he or she can open an IRA. The yearly maximum tax-deferred contribution to an IRA is: for singles, $2,000; married, $2,250 for one-earner families and $4,000 if both spouses work.

An individual earner may contribute any amount up to $2,000 per year in an IRA. If one's total income is $2,000 or less, the entire amount may be deposited.

A single-earner family may open a spousal IRA for the non-earning spouse. The working spouse is responsible for opening that account in addition to his or her own IRA. Decisions about how the maximum $2,250 is divided between the accounts are up to the family, but no more than $2,000 may be in one account.

In the event of divorce or legal separation, the spousal IRA can be maintained, subject to these certain conditions—if the spousal IRA has been open for at least 5 years before a divorce; if the earning spouse made contributions for 3 out of those 5 years; if alimony is paid, and if the non-earning spouse can afford it, he or she may contribute up to $1,125 a year out of alimony and incidental earnings. If the formerly non-earning spouse now earns enough money in any one year, he or she can make the full $2,000 contribution to that account.[1]

How Do They Work?

There are a couple of attractive tax-deferred elements to IRAs. In the first place, the amount contributed to an IRA is tax-deferred. That is, you can deduct that amount from your taxable income for the years during which the contributions are made. If you earn $20,000 in 1982 and contribute $2,000 to an IRA, you'll owe taxes on only $18,000. The second tax advantage is that the interest earned on the money in the IRA is not taxed as current income, but is also tax-deferred.

An important point to remember in either case is that the taxes are only delayed. The funds are subject to income tax when they are withdrawn during the later years of life. Your tax rate may or may not be lower at that point in time. If it is lower, you have benefited from the tax-deferred element of an IRA in several ways: deferral of income taxes; having more funds invested to earn returns; and lower taxes when they are due.

The key in understanding the rules of an IRA is the word retirement. IRAs are tax-sheltered to encourage you to build a retirement income in addition to Social

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Security and pension plans. Thus follows the first rule: the money contributed to an IRA must remain there until you're 59½. If you withdraw it early, you will be liable for a 10 percent penalty on the amount withdrawn. In addition, the amount withdrawn will be taxed as income that year. So, if you withdraw $10,000 out of an IRA before you are 59½ years of age, you will have to pay a $1,000 penalty, then the $10,000 will be taxed at your income tax rate. If your tax rate were 25 percent, then you would potentially be liable for paying $2,500 in income tax on the $10,000 withdrawn from the IRA, as you would on any other earnings that year. Some financial institutions also charge an early withdrawal penalty. There are two exceptions to these penalties. If the funds are withdrawn in the event of death or serious disability, the penalty will not have to be paid. In addition to early withdrawal penalties, there is an overpayment penalty of 6 percent. If you deposit $2,200 in one year, they you will be assessed a $12 penalty (6 percent of $200).

In addition to the tax-deferred attraction of IRAs, there is also the potential to earn a wide range of returns on the money invested in them. In December 1981, regulators freed the interest rates banks and thrifts can pay on 18-month IRA certificates. Thus, there is the potential to earn very good returns. So, shop around. You are not limited to one IRA. You can have as many as you would like (constrained by the $2,000 yearly limit). This allows you to diversify if desired. IRA money can be deposited in any savings account or certificate of deposit. Most banks and thrift institutions offer special IRA plans, some with rates that go up and down with the market (variable rates), some with rates that are fixed for varying periods, and some with guaranteed floors (rates may vary but will stay at or above a stated rate). Plans with most banks and savings and loans have the additional security of governmental insurance.

You can also establish an IRA through a brokerage firm. In such a case, the money invested in the IRA could be used to buy stocks, bonds, or almost any other investment ventures available through the brokerage. The inherent danger of investing in these types of securities is the risk involved. While the return to your money could be high, the chances of a loss are greater than with more secure savings plans. Another investment alternative is a mutual fund. And still another is with insurance companies. Insurers offer several types of annuities as IRAs. They are not unlike traditional annuities offered by life insurance companies.

You are permitted to shift your IRA money from one program to another every 12 months. If you transfer an IRA from one financial institution to another, you can request that your funds be sent directly to another financial institution. However, if you receive the money directly, you must reinvest it within 60 days.

And yet a third advantage of an IRA is that they are mobile. If you change employment or are transferred from one part of the country to another, your IRA can be transferred to an IRA in your new locale.

How and Where to Invest in an IRA

When considering avenues through which to establish an IRA, costs should be considered. Because of federal regulations, you need a trustee to set up an IRA. The trustee, in a sense, manages your IRA. That means going to a bank, thrift institution, brokerage firm, mutual fund or insurance company. You may be charged a trustee's fee for safeguarding your money. Commercial or savings banks and credit unions offer the lowest cost investment alternatives. They generally charge no fee to open an account, but charge a nominal custodial fee. Also, some offer other banking services free of charge (i.e. free checking).

Services offered by brokerage firms can be very costly. Included in the costs are commissions, start-up fees, and an annual custodial fee. Generally, there's a commission every time you buy or sell. Funds put into commercial securities and other such investments are not federally insured.

Mutual funds offer instant diversification. Investment in a wide variety of stocks, bonds, and money market instruments, as well as other investments, can be made through a mutual fund. Again, one drawback to this investment avenue for an IRA is that these funds are not insured. With some mutual funds there's no sales fee, possibly no fee for opening an account, or switching between funds. There is, in most cases, an annual fee for custodial services.

Lastly, insurance companies offer several types of annuities for IRAs. The main attraction is a guaranteed income each year after retirement for however long you may live. There are both fixed and variable rate annuities being offered. The fixed rate has a stated rate of interest which accrues to the annuity fund. The variable rate is usually tied to a mutual fund; thus, the rate of return depends on the return to the mutual fund. Fees that accompany the establishment of an annuity are quite high. Charges are usually in the form of front-end loads which are made up of start-up fees, commissions, and maintenance fees. A yearly maintenance fee is also often charged for an annuity.

Withdrawal Procedures

Money may legally be drawn out of an IRA when the owner of the account reaches 59½. Some problems may be encountered, depending on the investment instrument in which the IRA exists. Some bank IRAs may be tied up in 2½-year savings certificates. If the end of the 2½ years doesn't end simultaneously with age 59½, then withdrawal may be delayed. Some annuities cannot be touched until age 65. So be sure and read the annuity contract before setting up an IRA annuity fund.

The full amount of each withdrawal is added to your other income for that year and taxed as regular income. Beginning at age 70½, you must start making withdrawals. Amounts of withdrawals must be large enough to deplete the fund over your lifetime,[2] as determined by an IRS table, or over the joint lifetime of you and your spouse. There are heavy tax penalties for withdrawing less than the proper amount.

Is An IRA For You?

As the preceding discussion indicates, there are many advantages which accompany investment in an IRA. Tax-deferment, potentially high rates of return, and mobility combine to make IRAs very attractive retirement alternatives for families. At the same time, families should be very careful when shopping for IRA investments. Be sure to check other retirement plans available to you. Employers often offer retirement plans as attractive fringe benefits. If you are covered by a company retirement plan and feel it is adequate, then you may not want to invest in an IRA.

In order to maximize retirement benefits, families should compare IRA alternatives for costs, rate of return, withdrawal penalties, dates of maturity, solvency of the company, federal insurance, and mobility of the account. Be sure to read the contract very carefully and ask questions about parts you don't understand before you commit yourself to a particular plan.

Since financial institutions are engaged in intense competition for money through IRAs, families benefit from higher interest rates and more attractive terms than in the past. However, one of the most important benefits to families may be that of financial security in old age. Individual Retirement Accounts provide opportunity to move in the right direction, if used properly, toward helping deal with the uncertainties of financial security in old age.

References

[1] Quinn, Jane Bryant. "All You Need to Know About the New IRAs," *Newsweek,* December 21, 1981, pp. 66-67.

[2] Due to the leniency of estate tax laws, if the fund is not depleted prior to death, one's IRA can be passed to a spouse free of estate tax. In the event of the simultaneous death of both spouses, an IRA fund of $550,000 in 1983; $650,000 in 1984; $800,000 in 1985; $1 million in 1986; and $1.2 million thereafter, can be transferred to children without being subject to estate tax.

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