Traditional IRAs

By Denise Appleby

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Introduction

There is no question that the world of retirement and retirement plans is a confusing one. With so many options to choose from, how does an individual know which one is best for his or her situation? This tutorial looks at the Traditional Individual Retirement Account - otherwise known as the Traditional IRA. We will go through how it works, how to set one up and even how distributions are taxed.

Why Establish a Traditional IRA?
A Traditional IRA is an excellent supplement to an individual's retirement income. Making contributions is discretionary, so individuals can choose when they want to fund their Traditional IRA.

Contributions to a Traditional IRA may be tax deductible, and the earnings grow on a tax-deferred basis. This means that assets in the Traditional IRA are not taxed until they are withdrawn, allowing the owner to defer paying taxes until retirement, when he or she may be in a lower tax bracket, depending on his or her income and the tax rate that applies. Contributions are subject to statutory limits.
Eligibility Requirements

Who Can Establish a Traditional IRA?
Any individual who has taxable compensation or self-employment income (earned by sole proprietors and partners) for the year, and will not reach age 70.5 by the end of the year may establish and fund a Traditional IRA.*

*These restrictions apply only to IRA-participant contributions made for the year. There are no age limitations or income requirements for establishing a Traditional IRA for the purpose of receiving assets transferred from another Traditional, SEP or SIMPLE IRA, or for the purpose of a rollover from a qualified plan, 403(b), or governmental 457(b) plan.

Compensation Defined
For an individual working for an employer, the kinds of compensation that are eligible to fund a Traditional IRA include wages, salaries, commissions, bonuses and other amounts paid to the individual for services performed for his or her employer. At a high level, eligible compensation is any amount shown in Box 1 of the individual's Form W-2.

For a self-employed individual or partner in a partnership, eligible compensation is the net earnings earned from the individual's business less any deduction allowed for contributions made to other retirement plans on the individual's behalf, further reduced by 50% of the individual's self-employment taxes.

Other compensation that is eligible for participant contribution to a Traditional IRA includes taxable amounts received as a result of a divorce decree.

Ineligible Compensation
The following sources of income are examples of compensation that are not eligible to be used for contributing to a Traditional IRA:

- Rental income or other profits from property
- Income from interest and dividends
- Pension or annuity income
- Deferred compensation
- Income from some partnerships
- Income or amounts that can be excluded from income

Establishing an IRA
A Traditional IRA must be established with an institution that has received IRS approval to offer IRAs. These include banks, brokerage companies, federally insured credit unions, savings & loan associations and any other IRS-approved
A Traditional IRA can be established at any time. Contributions for a tax year, however, must be made by the IRA owner's tax-filing deadline, which is usually April 15 of the year following the tax year. The IRA must be opened in time to receive the IRA contribution. Tax filing extensions do not apply to IRA contributions.

There are two basic documents that must be given to the IRA owner when establishing an IRA:

- **The IRA Disclosure Statement**: This statement explains the rules and regulations of the IRA in clear, nontechnical language. The IRA owner must be provided with the disclosure statement at least seven days before the IRA is established. Alternatively, the document may be supplied at the time the IRA is established, but the IRA owner must be given seven calendar days within which the IRA can be revoked.

- **The IRA Adoption Agreement and Plan Document**: This is the contract between the IRA holder and the financial institution. The IRA plan document explains the provisions of the IRA, including the allowable investments, contribution limits, rules for deducting an IRA contribution, distribution rules and the rights of the IRA owner. The IRA is not considered "established" until the IRA owner signs the agreement.

**Contributions**

**Funding an IRA**
A Traditional IRA can be funded by several sources and means:

- IRA participant contributions
- Spousal IRA contributions
- Transfers
- **Rollover** contributions

**IRA Participant Contributions**
On an annual basis, an individual may contribute 100% of compensation up to the following amounts:
<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Regular Contribution Limit</th>
<th>Tax Year</th>
<th>Additional Catch-Up Contribution Limit</th>
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<td>$500</td>
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<td>2006</td>
<td>$4,000</td>
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<tr>
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</tr>
<tr>
<td>2010</td>
<td>$5,000</td>
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</tr>
<tr>
<td>2011</td>
<td>$5,000</td>
<td>2011</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Figure 1: Traditional IRA Contributions Limits

Individuals who are age 50 and older by the end of the year for which the contribution applies can make additional catch-up contributions. For instance, an individual who is under age 50 in 2011 may contribute up to $5,000 for tax year 2011, but an individual who is age 50 or older by the end of the year may contribute up to $6,000.

All IRA participant contributions must be made in cash (which includes checks). This means an IRA owner cannot make contributions in the form of securities.

**Spousal IRA Contribution**

An individual may make an IRA contribution on behalf of his or her spouse who makes little or no income. Spousal IRAs are subjected to the same rules and limits as that of regular Traditional IRA participant contributions. The spousal IRA contributions must be made to a separate IRA for the receiving spouse, as IRAs cannot be held as joint accounts.

For an individual to be eligible to establish a spousal IRA, he or she must meet the following requirements:

- The couple must be married and file a joint tax return.
- The individual making the spousal IRA contribution must have eligible compensation.
- The total contribution for both spouses must not exceed the taxable compensation reported on their joint tax return.
- Contributions to one IRA cannot exceed the contribution limits detailed in the above chart.

**Transfers**

A transfer is a non-reportable, nontaxable movement of assets between similar
types of retirement plans. An IRA owner may transfer assets between Traditional IRAs and SEP IRAs or from SIMPLE IRAs to Traditional and SEP IRAs.

Generally, assets are transferred for the purpose of consolidating assets or changing financial institutions.

A transfer of IRA assets may also be made from one spouse's (or former spouse's) IRA to another, providing the transfer is permitted in accordance with a court approved divorce decree or a legal separation agreement.

There is no limit on the number of times an IRA holder may transfer assets between IRAs.

SIMPLE IRA assets cannot be transferred to a Traditional IRA or an SEP IRA until two years after the employer first made a contribution to the individual's SIMPLE IRA.

Rollovers
An individual may make rollover contributions to his or her Traditional IRA. A rollover is a tax-free movement of assets between retirement plans, but unlike a transfer, the transaction is reportable: the distribution is reported to the IRS and the IRA owner on IRS Form 1099-R, and the contribution on IRS Form 5498. An IRA owner may roll over one distribution from an IRA within a 12-month period.

A rollover contribution may originate from the following:

- A distribution from the same Traditional IRA, another Traditional IRA, an SEP IRA or a SIMPLE IRA that meets the two-year requirements. Rollover contributions must be made within 60 days after the IRA holder receives the distributed assets.
- A direct rollover or indirect rollover from a qualified plan, 403(b) plan or a governmental 457(b) plan. There is no time limit for depositing assets representing a direct rollover. Indirect rollover amounts must be deposited within 60 days of receipt.

Deducting IRA Contributions
An individual may be able to get a tax deduction for his or her IRA participant contribution. The ability to deduct a Traditional IRA contribution is determined by the following:

- The individual's tax-filing status
- The individual's modified adjusted gross income (MAGI)
- The individual's active-participant status
If allowed a deduction, the individual, depending on the above, will be permitted a full or partial deduction. We summarize how the above factors determine deductibility in Figure 2, below.

Active Participant Defined
Generally, active-participant status depends on whether the IRA owner participates in an employer-sponsored retirement plan, which includes the following:

- Qualified plans, such as profit-sharing plans, defined-benefit plans, money-purchase pension, target-benefit plans and 401(k) plans
- SEP IRAs
- SIMPLE IRAs
- 403(b) plans
- Qualified annuity plans
- Employee-funded pension trusts (created before June 25, 1959)
- Plans established for employees by the United States, a state or political subdivision of the United States, or an agency or instrumentality of the United States or any of its subdivisions

The rules that define an active participant vary among the different types of plans. For example, an individual is usually considered an active participant in a profit-sharing plan for the same year in which his or her employer deposits the contribution to the employer's profit-sharing account, even if the contribution is being made for a different year.* This is not the case for a money-purchase pension plan. With this type of plan, the individual is considered an active participant for the year for which the contribution is made, regardless of when it was deposited.

* Employers have until their tax-filing deadline plus extensions to make contributions; therefore, a contribution for 2011 may be made in 2012.

Usually, the employer will indicate, by checking the "Retirement Plan Box" on the individual's Form W-2, whether the individual is an active participant for the relevant year. Individuals should check with their employers to be sure.

Table 2 below summarizes the deductibility limits for Traditional IRA contributions made for tax year 2011.

Because the rules differ for each spouse when one is an active participant, use the chart from the perspective of the individual for whom you are trying to determine deductibility. For instance, if an individual is not an active participant and files a joint tax return with a spouse who is an active participant, the individual may be able to deduct the entire amount contributed to his or her Traditional IRA, but the spouse might not be able to deduct his or her own...
contribution. In this case, the ability to deduct each spouse’s IRA contribution is determined by his or her MAGI.

<table>
<thead>
<tr>
<th>Tax-Filing Status</th>
<th>Active Participant Status</th>
<th>Modified Adjusted Gross Income</th>
<th>Deduction Allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single or Head of Household</td>
<td>Individual is not active</td>
<td>No Limit</td>
<td>Full Deduction</td>
</tr>
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<td></td>
<td>Individual is active</td>
<td>$56,000 or less</td>
<td>Full Deduction</td>
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<tr>
<td></td>
<td></td>
<td>More than $56,000 but less than $66,000</td>
<td>Partial Deduction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$66,000 or more</td>
<td>No Deduction</td>
</tr>
<tr>
<td>Married Filing Jointly</td>
<td>Individual is not active</td>
<td>No Limit</td>
<td>Full Deduction</td>
</tr>
<tr>
<td></td>
<td>Individual's spouse is not active</td>
<td>$90,000 or less</td>
<td>Full Deduction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than $90,000 but less than $110,000</td>
<td>Partial Deduction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$110,000 or more</td>
<td>No Deduction</td>
</tr>
<tr>
<td></td>
<td>Individual is active</td>
<td>$169,000 or less</td>
<td>Full Deduction</td>
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<tr>
<td></td>
<td></td>
<td>More than $169,000 but less than $169,000</td>
<td>Partial Deduction</td>
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<td></td>
<td></td>
<td>$169,000</td>
<td>No Deduction</td>
</tr>
<tr>
<td>Married Filing Separately</td>
<td>Deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>---------------------------</td>
<td>-----------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual is not active Individual's spouse is not active</td>
<td>No Limit</td>
<td>Full Deduction</td>
<td></td>
</tr>
<tr>
<td>Individual is active*</td>
<td>$10,000 or less</td>
<td>Partial Deduction</td>
<td></td>
</tr>
<tr>
<td>Individual is not active Individual's spouse is active**</td>
<td>$10,000 or more</td>
<td>No Deduction</td>
<td></td>
</tr>
</tbody>
</table>

Figure 2: Traditional IRA Deductibility Limits for 2011

* If the individual and his or her spouse did not live together at any time during the year, the individual is considered ‘single’ for tax-filing purposes and should use the guidelines for a single taxpayer.

** If the individual and his or her spouse did not live together at any time during the year, the individual is allowed a full deduction.

Example: Spouses With Differing Participant Status

John is not an active participant, and he files a joint tax return with his spouse, Mary, who is an active participant. They are able to claim a full deduction for John’s IRA contribution if their modified adjusted gross income is less than $169,000. However, they can claim a full deduction for Mary’s IRA contribution only if their MAGI is $90,000 or less.

Figuring the Deductible Amount

Individuals whose incomes fall within the phase-out ranges can partially deduct
contributions made to a Traditional IRA. The following formula determines the amount of the contribution that is deductible:

\[(\text{Highest Dollar Limit of MAGI Range} - \text{MAGI}) \times \frac{\text{Contribution Limit}}{\text{Highest dollar limit of phase-out range} - \text{Lowest dollar limit of phase-out range}}\]

**Example: AGI Within the Phase-Out Range**

Jack and Jill are married and file a joint tax return for 2011. Jack is an active participant, but Jill is not. Their modified adjusted gross income is $95,000, which falls into the $90,000-$110,000 phase-out range, so the highest and lowest dollar limit for this range is $110,000. Jack is under age 50 and is therefore able to contribute $5,000 to a Traditional IRA. Using the formula above, Jack calculates his maximum deductible amount:

\[
= (\$110,000 - \$95,000) \times \left[\frac{\$5,000}{\$110,000 - \$90,000}\right]
\]

\[
= $15,000 \times \left[\frac{\$5,000}{\$20,000}\right]
\]

\[
= $15,000 \times 0.25
\]

**Answer = $3,750**

Note: Calculations are rounded up to the nearest $10. For instance, a calculation that results in $555 would be rounded up to $560.

Jack has the following options for the $3,750:

- deduct the $3,750
- treat it as a nondeductible contribution

If Jack treats the amount as a nondeductible contribution, he will not pay income tax on the amount when it is distributed from the IRA.
**Tax-Filing Requirements**
Individuals who make nondeductible contributions to their Traditional IRAs must file IRS Form 8606 for the year the nondeductible contribution is made. Failure to file Form 8606 may result in a $50 penalty being owed to the IRS and may cause all the contributions to be subject to taxes upon distribution (generally, a distribution of a nondeductible contribution is not subject to income tax).

**Permissible Investments in IRAs**
One benefit of investing in an IRA is that the investment options are many and varied. The IRA owner's ability to choose the type of investment depends on the IRA product and the financial institution. Some IRAs may be limited to a preselected core group of investments or a specific investment, while for other IRAs the IRA owner is free to choose the investments. These are commonly referred to as "self-directed IRAs" (SDIRAs).

Permissible investments for IRAs include stocks, bonds, mutual funds, real estate, some coins and money market funds.

**Investment in Collectibles**
IRAs cannot invest in collectibles, which include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages and certain other tangible personal property. The one exception is that IRA assets can invest be invested in U.S. gold coins, silver coins minted by the Treasury Department, certain platinum, gold, silver, palladium and platinum bullion. Volume limitations apply. (To learn more, check out *IRA Assets And Alternative Investments*.)

Some financial institutions place further restrictions on IRA investments.

**Distributions**

**Distributions** from Traditional IRAs must occur eventually, but until the owner reaches the mandatory distribution age, distributions are optional. The tax and penalty applied to distributions from a Traditional IRA depend on the IRA owner's age at the time of the distribution and the tax-deductibility treatment of the contributions.

**Distributions That Occur Before Age 59.5**
Most taxpayers intend to retain assets in their IRA until their retirement years, but, for varying reasons, people are sometimes forced to distribute assets before these years. Distributions that occur before the IRA owner reaches the age of
59.5 are subject to a 10% early-distribution penalty, in addition to any income tax, but the IRS will waive this early-distribution penalty when distributions are used for reasons which include the following:

For Unreimbursed Medical Expenses
If the distribution is used to pay unreimbursed medical expenses, the amount that exceeds 7.5% of the individual's **adjusted gross income** (AGI) for the year of the distribution will not be subject to the early-distribution penalty. In other words, the amount paid for the unreimbursed medical expenses **minus** 7.5% of the individual's adjusted gross income for the year of the distribution can be distributed penalty free.

**Example: IRA Distributions For Medical Expenses**

Jack's AGI is $25,000, and he paid $4,000 for unreimbursed medical expenses.

The amount that exceeds 7.5% of his income = $4,000 - ($25,000 x 7.5%).
The amount that exceeds 7.5% of his income = $4,000 - $1875.
The amount that exceeds 7.5% of his income = $2,125.

The maximum amount Jack may claim for the early-distribution exception is $2,125.

To Pay Medical Insurance
Individuals can make a penalty-free distribution to pay medical insurance for themselves, their spouses and their dependents, provided the distribution occurs under the following four conditions:

- The individual has lost his or her job.
- The individual has received unemployment compensation paid under any federal or state law for 12 consecutive weeks.
- The individual receives the distributions during either the year he or she receives the unemployment compensation or the following year.
- The individual receives the distributions no later than 60 days after he or she has been re-employed.

For a Disability
If an individual becomes disabled before age 59.5 and makes a distribution from
his or her Traditional IRA while disabled, the distributions are not subjected to the early-distribution penalty. Individuals who are considered disabled may need to furnish proof that a physical or mental condition inhibits them from engaging in substantial gainful activities. A physician must determine that this condition can be expected to result in death or to continue for an indefinite duration.

As Distributions to the IRA Beneficiary
If the IRA owner dies before reaching age 59.5, the amounts distributed from the IRA by the beneficiary are not subject to penalty.

As Part of an SEPP Program
For penalty-free distributions that are part of a series of substantially equal payments over the life of the IRA holder and or his or her beneficiary, the payments must last five years or until the IRA owner reaches age 59.5 - whichever is longer - and the calculation of the payment amounts must be done under certain IRS-approved methods.

For Qualified Higher Education Expenses
Amounts are penalty free if they are used to cover qualified higher education expenses for the IRA owner and/or his or her dependents. These qualified education expenses are tuition, fees, books, supplies and equipment required for the enrollment to or attendance at an eligible educational institution. An eligible educational institution is any college, university, vocational school or other post-secondary educational institution eligible to participate in the student aid programs administered by the Department of Education. These eligible educational institutions include virtually all accredited post-secondary institutions, whether public, nonprofit or proprietary (privately owned and profit making). The educational institution should be able to indicate whether it is an eligible educational institution.

To Purchase a First Home
The IRA owner can make penalty-free distributions to purchase, build or rebuild a first home:

- For the IRA owner
- For the IRA owner’s spouse
- For a child of the IRA owner or of the IRA owner’s spouse
- For a grandchild of the IRA owner or of the IRA owner’s spouse
- For a parent or other ancestor of the IRA owner or of the IRA owner’s spouse

The first-time homebuyer distribution must be used to pay qualified acquisition costs before the end of the 120th day after the IRA owner receives the distributed assets.
The total distribution the IRA owner uses for first-time home purchases cannot exceed $10,000 during the IRA owner's lifetime. For married individuals, the $10,000 applies separately to each spouse, which means that the total for both is $20,000.

For payment of an IRS levy
The IRS may levy against an IRA, resulting in a distribution. The distributed amount is subject to income tax, but the early-distribution penalty is waived.

Additional Information
The 10% early-distribution penalty does not apply to amounts that are not subject to income tax. These amounts include the following:

- Distributions of nondeductible IRA contributions
- Amounts that are in excess of the contribution limit and are then removed from the IRA before the IRA owner's tax-filing deadline (plus tax-filing extensions)
- Distributions that are deposited to a retirement plan as a rollover contributions within 60 days of receipt, provided the amount is rollover eligible

Distributions That Occur on or After Age 59.5
Distributions that occur on or after the IRA owner reaches age 59.5 may be subject to income tax but will not be subjected to the early-distribution penalty.

Required Minimum Distributions
Traditional IRA distributions cannot be deferred indefinitely. An IRA owner must begin required minimum distributions (RMDs) the year he or she reaches age 70.5, at which time the IRA owner may distribute the full balance of the IRA or distribute a minimum amount each year.

The first RMD must be distributed by Apr 1 of the year after the year in which the IRA owner reaches age 70.5. For example, an IRA owner who reaches age 70.5 in June of 2011 must take his or her first RMD by April 1, 2012. IRA holders who elect to have a minimum amount distributed each year must, for subsequent years, distribute RMDs by December 31 of each year. This means that if the IRA holder defers the first RMD until April 1 of the year after he or she turns 70.5, the IRA holder will be required to take a second RMD amount in that same year, which counts as the second year for RMDs.

Example: Taking RMDs
Jill turns 70.5 in June of 2011, and she decides to defer her first RMD until April 1, 2012.

Jill is required to take a second RMD (for 2012) by December 31, 2012. For subsequent years, Jill must distribute her RMD amounts by December 31 of each year.

Generally, the IRA custodian/trustee will calculate the RMD amount and send the notification to the IRA holder. Alternatively, the IRA custodian/trustee may send an RMD reminder to the IRA owner with an offer to calculate the RMD amount upon request.

RMD amounts not distributed from the IRA by the due date are subject to a 50% excess-accumulation penalty.

**Example: Excess Accumulation Penalty**

John is 75 years old, and his RMD for 2011 is $5,000. By December 31, 2011, John has distributed only $4,000 from his IRA. Because John's RMD was short by $1,000, he must pay the IRS a 50% excess-accumulation penalty ($1,000 x 50% = $500).

The excess-accumulation penalty must be paid when the individual files his or her federal tax return. If the individual feels that the failure was due to reasonable circumstance, he or she may write to the IRS and request that the penalty be waived. If a waiver is requested, the penalty should be paid only if the IRS denies the request.
Conclusion

Let's recap:

- Any individual who has taxable compensation during the year and will not reach age 70.5 by the end of the year may make an IRA contribution for the year.
- Traditional IRAs must be established with institutions that have received IRS approval, such as most banks, brokerages and savings institutions.
- A Traditional IRA can be funded from your own contributions, spousal contributions, transfers or rollovers.
- All IRA participant contributions must be made in cash.
- IRAs cannot invest in collectibles, which include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages and certain other tangible personal property.
- The tax and penalty treatment applicable to distributions from a Traditional IRA is determined by the IRA owner’s age at the time of withdrawal and the tax deductibility treatment of contributions.