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Personal Management

Individual Retirement Account

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The Pension Reform Act of 1974 will have an enormous effect on retirement planning for millions of individuals. While the Act provides greater protection of benefits earned by participants in company retirement plans, perhaps the single most important feature is the Individual Retirement Savings program. Enacted to encourage saving for retirement by individuals not covered by qualified private or governmental retirement plans, this allows individuals to establish their own personal retirement plans and contribute limited amounts of before-tax earnings.

Contributions and Deductions

Who Is Eligible? For taxable years beginning after December 31, 1974, individuals are eligible to make deductible contributions to an Individual Retirement Account (IRA) in any year in which they are not covered by an Employer plan, a Keogh plan, or a charitable annuity.

How Much Can Be Contributed and Deducted? An eligible employee can deduct cash contributions of up to 15% of compensation (or earned income) which is reported as gross income or $1,500, whichever is less. The contribution must be made before the close of the taxable year. Deductions are not allowed for contributions made in the taxable year during which the individual reaches age 70½.

What Is The Penalty For An Excess Contribution? Contributions which exceed allowable deductions are excess contributions. Unless such excess contributions, and any earnings thereon, are returned to the individual by the date his or her tax return must be filed (including extensions), they are subject to a 6% nondeductible excise tax. Interest earned on the excess contribution is included in the individual's income. The excise tax is cumulative and levied each year until the excess is returned to the individual or applied as a current contribution.

How Is The Deduction Taken? The income tax deduction is taken from gross income. This means the individual receives the deduction even if he or she doesn't itemize deductions. A husband and wife are both allowed the deduction if each is eligible and receives compensation. The deduction is computed separately for each spouse even in community property states which means that their combined deduction could be as much as $3,000 a year.

How Is The Investment Growth Taxed? Dividends and capital gain distributions are generally exempt from current taxation until distributed to the individual. Any unrelated business income received by the IRA would be taxable.

Special Provisions

What Happens In The Event Of A "Prohibited Transaction"? If an individual uses his or her IRA for personal benefit, such as borrowing from the IRA or using the IRA as collateral for a loan, this constitutes a prohibited transaction and will disqualify the tax exempt status of the IRA. Disqualification is retroactive to the first day of the taxable year and the fair market value of the assets are considered to be constructively distributed as of that date. The distribution is taxed as ordinary income and if the individual is not age 59½, a 10% penalty tax applicable to premature distributions is also levied.

Any income earned by the IRA after the effective date of disqualification will be included in the individual's income. The excise tax on prohibited transactions under new Internal Revenue Code Section 4975 will not, however, be imposed.

If the IRA is sponsored by an employer, an association of employees, or a union

and the participating individual is responsible for the prohibited transaction, only the responsible participant's account is disqualified. If the sponsoring organization participates in a prohibited transaction, the organization will be subject to the prohibited transactions excise tax under Internal Revenue Code Section 4975.

What Is A Rollover Contribution And Why Is It Important? A rollover contribution is a transfer of assets between IRAs or a transfer of assets from a qualified private retirement plan to an IRA, or vice versa. It is important because it is made on a tax-free basis and provides the individual with a degree of portability for his or her retirement plan assets.

Three general conditions must be met for rollover contributions:

1. The transfer must occur within 60 days after the individual receives the distribution.
2. If the individual receives property other than cash, that same property must be transferred to the new account.
3. A tax-free rollover of assets from an IRA may only be made once every 3 years.

In addition to the above rules a rollover contribution from a qualified retirement plan to an IRA must meet the following requirements:

1. The distribution must be a lump sum representing the individual's entire interest in the plan and must be made within one of his or her taxable years.
2. No amounts representing employee contributions can be included.
3. If the IRA is used as a conduit to transfer funds from one qualified plan to another qualified plan, no assets other than the qualified retirement plan distribution could be included in this IRA. Transfers cannot be made through IRAs from a corporate plan to a Keogh plan or vice versa.
4. It is important to treat the rollover money as a separate contract from any current or future IRA contracts the individual may have. This will allow identification of rollover monies should they have a different tax treatment in the future.

Distributions

When Can An Individual Receive A Distribution? Distributions are permitted without penalty in the event of death, disability or upon reaching age 59½. Distributions must in any event begin no later than the close of the taxable year in which the individual reaches age 70½.

How Are Distributions Taxed? All amounts will generally be taxed as ordinary income when received. Although the distributions are not eligible for capital gain treatment or the special 10-year averaging device available for other qualified retirement plan distributions, the general 5-year income averaging device may be used. A distribution to a beneficiary of an IRA owner is not excluded for purposes of Federal estate and gift taxes. In computing the retirement income credit, a distribution received by a retiree from an IRA is considered retirement income.

How Is A Premature Distribution Taxed? In addition to the above taxation, individuals receiving their IRAs before reaching age 59½ or becoming disabled must pay a penalty tax equal to 10% of the premature distribution.

How Is An Insufficient Distribution Taxed? If the individual does not receive the minimum required distribution (to be established by future Internal Revenue Service regulations) in any year commencing with the year in which he or she reaches age 70½, an excise tax is imposed on the excess accumulation. The tax rate is 50% and is applied to the minimum required distribution less the distribution actually received by the individual that year.

Establishing an IRA

How Will An Individual Establish An IRA? The individual has three ways of establishing an IRA. First, an individual can set up an IRA by formally adopting a master or prototype document. This document will be available from various institutions including mutual fund organizations. It is also likely that the Internal Revenue Service will develop a prototype document. The assets of an IRA will be held in a trust or custodial account. The trustee will generally be a bank, although other persons could act as trustee if they can demonstrate their ability to administer the trust in conformity with the law.

Second, the individual may use an individual retirement annuity. The participant's interest in the contract must be non-forfeitable and the contract must be non-transferable. The annual premium cannot exceed $1,500 and dividends must be used to reduce future premiums or purchase additional benefits.

Third, the individual may use individual retirement bonds. Government bonds issued under the Second Liberty Bond Act may be purchased as an Individual Retirement Bond. Such a bond will only be redeemable within 12 months of issuance or upon death, disability or the owner's attainment of age 59½. Interest will only be paid upon redemption except that no interest will be paid if redemption occurs within 12 months of issuance. Interest will cease when the owner reaches age 70½. In the event of death, interest will stop 5 years after death or when the participant would have reached age 70½, whichever occurs first.

Can An Employer, Association, Or Union Sponsor An IRA? Yes, an employer (corporate or individual), association, or union can sponsor an IRA for its employees or members if the other requirements just mentioned are met and separate accounting is provided for each participant. The assets held in trust for participants must be for the exclusive benefit of participants or their beneficiaries. Contributions made by the employer will be included in the participant's compensation and deductible by the employer.

The employer, however, will not be required to withhold Federal income taxes if it is reasonable for the employer to believe the participant will be able to deduct such contributions. Contributions will be subject to Social Security (FICA) and unemployment (FUTA) taxes.

What Plans Are Offered By Banks and Savings and Loans in the IRA Market?

Many banks and savings and loans associations are beginning to market in the IRA and Keogh markets. Their basic plan is to put the client's money into a 5¼ percent passbook savings account and allow the client to transfer to a Certificate of Deposit when $500 or $1,000 has been accumulated.

These financial institutions are indicating that they have no charges on IRA accounts. However, their contracts generally say that "a reasonable charge may be assessed to cover administration and management of the plan."

In addition to this, at retirement they are not offering the client an annuity type payout. If the client wants a guaranteed lifetime income, he or she must then purchase an annuity.

This is an ever-changing world and that certainly is evident in our laws and their interpretations and will be true of IRA. Many IRA plans are being offered, so check them thoroughly to be sure they satisfy financial planning requirements for you or your client.