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A GUIDE TO INDIVIDUAL RETIREMENT ACCOUNTS (IRA's)

AN INFORMATION PAPER

PREPARED BY THE STAFF OF THE

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UNITED STATES SENATE

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PREFACE

In 1981, Congress passed legislation enhancing the tax incentives for individuals to save for retirement. Under the old law, only workers not covered by a pension plan or profit-sharing plan were eligible for tax-sheltered savings under an individual retirement account (IRA). Beginning January 1, 1982, virtually everyone with earned income will be able to contribute to an IRA and build a nest egg for the future while paying less Federal income tax now.

Money put into an IRA is deducted from gross income, and the interest, dividends, and capital appreciation on the IRA contributions are tax deferred. IRA contributions and the earnings therefrom are taxed when the money is actually distributed to the individual, which may occur when the individual's tax bracket is lower because of retirement.

This consumer guide provides a general introduction to IRA's and discusses the various savings and investment vehicles available. For specific questions on tax aspects and rules, you should consult your attorney, or you can seek answers from the Internal Revenue Service by calling the toll-free number in your local directory.

The Special Committee on Aging does not endorse any particular kind of IRA. That decision has to be a personal one. But, as you go about evaluating the various investment options, this consumer guide should help you to ask the right questions and make an informed choice about whether you should set up an IRA—and how.

JOHN HEINZ,
Chairman.
LAWTON CHILES,
Ranking Minority Member.

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A GUIDE TO INDIVIDUAL RETIREMENT ACCOUNTS (IRA's)

HOW DOES AN IRA WORK?

Because the individual retirement account is a new opportunity for so many people, numerous questions have been asked about how an IRA actually works. The following are some of the most commonly asked questions:

ELIGIBILITY

Question. Who is eligible to set up an IRA?
Answer. Any person who earns compensation.

Question. How much money may I invest in an IRA each year?
Answer. A maximum of $2,000 or 100 percent of your taxable compensation for the year, whichever is less.

Question. Is this more than was permitted under the old law?
Answer. Yes. Previously, the maximum was $1,500 or 15 percent of your compensation for the year, whichever was less.

Question. What if both a husband and wife are wage earners?
Answer. Each may open an IRA and each may contribute each year up to $2,000 or 100 percent of their own compensation for the year, whichever is less. This could total $4,000.

Question. What kind of compensation qualifies?
Answer. Compensation may be wages, salaries, tips, professional fees, bonuses, and other amounts earned for providing personal services. Commissions and net income from self-employment also are compensation. If you are an active partner, your share of partnership earned income is compensation. However, unearned income, such as rental income, interest income and dividend income, is *not* compensation.

Question. What is the rule if a spouse is not a wage earner?
Answer. The working spouse can contribute to an account for the benefit of the nonworking spouse. This IRA belongs to the nonworking spouse. The total combined amount that may be contributed each year to the wage earner's own account and to the nonworking spouse's account is $2,250 or 100 percent of the working spouse's compensation for the year, whichever is less. A couple can divide the contributions between their accounts as they choose, but no more than $2,000 can be contributed to the account of either one.

Question. How is a divorced spouse affected?
Answer. A divorced person may contribute to an IRA set up for his or her benefit by a former spouse. Alimony or separate maintenance may be considered compensation that qualifies for investment in an IRA if the account was set up at least 5 years before the year of the divorce or legal separation, and the ex-spouse contributed to the account in at least 3 of the 5 years before the year of the divorce or legal separation.

Question. Is there a lower or upper income limit for IRA eligibility?
Answer. No.

Question. Is there a limit on the amount of time a person must work each year to qualify for an IRA?
Answer. No.

Question. Are part-time workers eligible?
Answer. Yes.

Making an IRA Investment

Question. Do I have to put $2,000 in my IRA every year to keep it alive?
Answer. No. There is no minimum contribution requirement.

Question. May I stagger my investment over the year?
Answer. Yes. Or the entire amount may be invested at one time. Contributions to an IRA must be in the form of cash, check, or money order.

Question. What is the cutoff date for contributions to the IRA each year?
Answer. Contributions may be made through the due date for your income tax return, including extensions. For most people that date is April 15 of the year following the year when the income was earned.

Question. When is the last date each year when I may set up an IRA?
Answer. The due date for filing your tax return, with extensions.

Question. Where may IRA money be invested?
Answer. IRA money may be invested in such things as passbook savings accounts, certificates of deposit, annuities, mutual funds (including money market funds), individual stocks and bonds, and certain kinds of real estate, such as limited real estate investment partnerships.

Question. Are any investments forbidden?
Answer. Yes. Assets used to acquire a collectible are treated as immediate distributions from the account and are taxed accordingly. They may also be subject to penalties for premature distribution. Collectibles include works of art, antiques, metals, stamps, coins, and alcoholic beverages. Money invested in life insurance contracts generally does not qualify for an IRA contribution. (Annuities do qualify.)

Question. Is there any limit on the number of IRA's a person may have?
Answer. No. But only a combined total of no more than 100 percent of compensation or $2,000, whichever is less, may be invested each year, no matter how many IRA's are set up.

Question. Is there a penalty for putting more than the deductible limit into an IRA in any one year?
Answer. Yes. An excise tax of 6 percent is levied on any amount contributed beyond the deductible amount—unless the excess and any earnings on the excess are taken out before the due date for filing an income tax return for the year.

Moving an IRA

Question. May I move my IRA account?
Answer. Yes, you may withdraw part or all of the assets from one IRA and invest them in another IRA, tax free. This is known as a "rollover."

Question. When must this investment be made?
Answer. By the 60th day after the day you receive the money from your IRA.

Question. How often may I do this?
Answer. You must wait at least 12 months between rollovers.

Question. Is there any way I may move my IRA from one institution to another more than once a year?
Answer. Yes. If the money does not pass through your hands but is handled exclusively by the institutions involved, the transaction is not considered a "rollover" and the 1-year waiting period does not apply.

Age Limits and Withdrawals

Question. At what age may I open an IRA?
Answer. There is no minimum age. You may not, however, deduct payments you make to an IRA if you will be 70½ before the end of the year.

Question. When may I withdraw money from my IRA?
Answer. Normally, you may start to withdraw your money at age 59½. (Early withdrawals are permitted upon disability or death.)

Question. Must my money be withdrawn by a certain age?
Answer. You must begin to receive payments from your account before the end of the year in which you become 70½, whether you are retired or not. You may not invest any money after you reach 70½. There is a heavy penalty for failing to make proper distribution of the money. Work closely on this with the institution where your IRA is set up.

Question. How is the money in my IRA paid out to me?
Answer. The money can be paid out in various ways. You may take the entire amount in a single payment between 59½ and the end of the year during which you reach 70½. Or you may elect to receive the money in regular payments over a fixed period of time that is not greater than the life expectancy or the combined life expectancy of you and your spouse. Or you may choose an annuity that would make regular payments for life or the combined lives of you and your spouse. Payments must begin by the end of the tax year during which you become 70½.

Federal Income Tax Aspects

Question. Do I pay any taxes on the money I put into an IRA each year?
Answer. No. That amount—the lesser of $2,000 or 100 percent of taxable compensation for the year—is taken off the top of your income and is not taxed until it is distributed to you.

Question. Is interest or other money earned by my IRA taxed each year?

Answer. Money is not taxed as it accumulates in your account. There may be a few special exceptions to this.

Question. When is my IRA taxed?

Answer. When you withdraw money from your IRA, it is taxed as ordinary income, unless you "roll it over," tax free, as described above. There is a tax penalty if you withdraw money before you are age 59½. A penalty-free withdrawal can be made upon disability or death.

Question. What is the penalty for withdrawing my money early?

Answer. The amount withdrawn will be taxed as ordinary income and a 10 percent additional tax will be charged on the amount withdrawn. The additional tax is nondeductible. This penalty does not apply to an early withdrawal that is "rolled over," tax-free.

Question. Does my IRA become part of my estate after I die?

Answer. The remaining amount in your IRA is not subject to Federal estate taxes if it is paid to your beneficiary during his or her lifetime or during a period of at least 36 months. However, a lump-sum payment to your beneficiary is included as part of your estate for Federal tax purposes.

Question. How about gift taxes?

Answer. A distribution payable to a beneficiary will not be subject to Federal gift taxes.

Question. Where can I get more information on IRA's?

Answer. No matter where you live there will be a tax information number in your telephone book. Look for it under United States Government, Internal Revenue Service. Call that number and ask for Publication 590, Tax Information on Individual Retirement Arrangements.

WHAT AN IRA CAN PRODUCE FOR YOU

What can an IRA do for you?

Take this example, developed by a financial organization:

You are permitted a maximum investment of $2,000 a year in an IRA.

After 20 years, you would have $161,397 if you invested all $2,000 on January 1 every year at 12 percent simple interest, compounded over 20 years.

After 40 years, the same investment would produce $1,718,285 and would make you a millionaire.

But let's keep things in perspective. You would still have a real nest egg. But allowing, say, for inflation of 5 percent a year, 40 years from now $1,718,285 would buy goods worth approximately $244,110 in 1981 dollars.

IRA OPTIONS

The simplest way to invest your IRA dollars is in a passbook savings account.

But, financial institutions are also offering other IRA investments with higher returns than the passbook savings rate.

Banks, credit unions, savings and loan associations, insurance companies, mutual funds, and investment brokers all are courting the IRA customer.

Here is a rundown on options private financial institutions are making available.

Banks

Banks are offering a variety of options on IRA's that are patterned after conventional certificates of deposit but are far more flexible.

Even within the same bank more than one option may be available.

Conventional certificates of deposit require sizable initial payments.

But an IRA account can be opened with a modest amount, perhaps $100. After that you can deposit as much as you like, whenever you like, depending on the legal limit per year. You can even stop paying and your account will remain active. Generally speaking, banks won't charge maintenance costs.

The different options in IRA's will revolve around the kind of interest being offered, the amount of interest, and the length of time of the certificate.

Some IRA's will have variable, or floating, interest rates. Others will have fixed interest rates.

Both rates generally will take as their guide the rates of U.S. Government securities and other investments. This does not mean the IRA necessarily will be paying the same amount as the securities. It could be paying more. But the variable, or floating rate, on the IRA would fluctuate along with the security's fluctuations. Interest on your account would be adjusted regularly.

The fixed rate will stay the same throughout the timespan of the certificate, when new terms would be set.

Although IRA certificates will have time limits of at least 18 months, some banks will renew IRA's with variable interest rates automatically if the customer wishes.

Your IRA probably won't have the same interest rate throughout its lifetime. When your certificate matures you can move your account elsewhere if you are dissatisfied with the new terms proposed. But the bank may charge a penalty if you move the money before the certificate's maturity.

Accounts in the vast majority of commercial and mutual savings banks are federally insured up to $100,000. Others are not, but they may be insured under your home State.

Credit Unions

Almost all credit unions will be offering IRA's. They expect to pay interest that is competitive with other financial institutions.

Credit unions are chartered by the Federal Government or by the States.

Every Federal credit union is free to decide what kind of IRA it will have, including the interest it will pay. State-chartered credit unions also will develop their own plans, although some States have interest ceilings.

Credit unions will design IRA's keyed to their size and nature. Interest will be set by the board of directors of the credit union. Some IRA's will have no time limit. Others may offer savings certificates with a time limit and would charge a penalty for premature withdrawal.

Convenience is one of the assets of a credit union, and many credit unions will maximize convenience by offering payroll deductions for their IRA's.

The initial deposit required generally would be very low, such as $25 or less. For those not taking advantage of payroll deduction, additional deposits generally could be made at any time and in any amount, as long as they don't exceed the legal limit each year. For the most part, no maintenance fees will be charged.

Accounts in Federal credit unions are federally insured up to $100,000. Some State-chartered institutions also are federally insured. Others may be insured by the State for a comparable amount.

Savings and Loan Associations

Savings and loan associations will be offering a range of options which are variations of conventional savings certificates that are tailored especially for IRA's. Some savings and loans will offer more than one option.

IRA's at savings and loans will differ in the kind of interest offered, in the rate of interest, and in the length of time the savings certificate runs.

Interest rates generally will be pegged to the rates of U.S. Government securities or other investments. Most savings and loan associations will choose an interest rate that the customer can understand easily, such as the rates on Government securities that are published regularly in newspapers.

This does not mean the interest rate must be the same as the rate on the Government security. The savings and loan could be offering higher or lower interest.

Some IRA's will have a variable, or floating, interest rate that will rise or fall when the rate changes on the security to which it is pegged. Adjustments in the interest rate would be made regularly.

Other IRA's will have fixed interest rates that will remain the same during the time period of the savings certificate, which could be for 18 months or could run for several years.

Your IRA plan probably won't have the same interest rate throughout its lifetime. When your savings certificate matures you are free to move your IRA elsewhere if you are not satisfied with the new terms proposed. However, if you take your money out before the certificate's maturity, the savings and loan association may charge a penalty.

Savings and loans generally require a modest deposit—for example, as low as $10—when you open your account. After that you may deposit what you like, when you like, as long as you don't exceed the legal limit each year. You can even stop paying and your account will remain active. Maintenance generally will be free.

Accounts in the vast majority of savings and loans are federally insured up to $100,000. Others are not, but they may be insured under your home State.

Insurance Companies

An IRA set up with an insurance company is an annuity.

An annuity guarantees you an income as long as you live. It is the only IRA that can provide this guarantee.

Insurance companies will tell you in the beginning what the fixed minimum rate of interest will be on your money through the years. The advantage is that guaranteed interest is not subject to market fluctuations. This interest rate could be spelled out in stages in your policy. For example, the guaranteed rate could be relatively high in the first or early years, and then lower for succeeding years.

On paper, the guaranteed rate of insurance companies has been considerably lower in recent years than rates offered by other financial institutions. In reality, insurance companies have been paying interest which is more than the guaranteed rate and is competitive with other institutions. The only *guaranteed* rate, however, is the one spelled out in the policy.

IRA's have flexible premiums. This means you can put as much as you like in your IRA at any time, as long as you don't exceed the maximum set by law each year. You can even stop paying and your policy still will be in force. Some companies will accept $50 or less as an opening amount.

Some companies are tailoring policies especially for IRA's by offering fixed interest annuities that have no "front loads," which are sales costs. Your entire investment will be earning money for you. But you can expect to pay sizable penalties if you withdraw your money prematurely, particularly in the early years of the policy. This is called "backload."

Maintenance fees for IRA's will run around $20 or $25 a year.

Your fixed annuity also guarantees a rate upon which payments to you will be based. You can never get less, but you could get more.

Some insurance companies will also offer IRA's that do not have guaranteed interest. They are called variable annuities. The value of the annuity fluctuates, depending on market conditions. They generally will have sales costs.

Money in your annuity will not be federally insured, but State agencies that regulate insurance companies emphasize safety and diversity in investments.

Mutual Funds

When you put your money in a mutual fund you are buying shares in a pool of money that is invested in securities chosen by professional money managers.

The most famous type of mutual fund is the money market fund, where money is invested in short-term securities and your rate of return varies daily.

Other mutual funds invest in stocks and bonds.

Every mutual fund is made up of a group of securities. There are hundreds of mutual funds, designed to meet different objectives of investors.

Mutual funds do not guarantee a specific rate of return on your investment. Some funds have far outstripped increases in the Consumer Price Index. But it also is possible to lose money in a mutual fund investment.

Mutual funds are known as load and no-load funds. The "load," or charge, is a sales commission paid to a broker or sales agent for advice and services. The sales charge usually is around 8.5 percent of the cost of every purchase of shares in the fund.

Generally speaking, shares in no-load funds are not purchased from a broker. Money market funds, which are no-load funds, are an exception to this.

There is virtually no difference in the investments of no-load and load funds. You must be given a prospectus spelling out the objectives and terms of each fund.

You can move your IRA from one mutual fund to another as your own investment objectives change. Generally, there are no charge when you sell fund shares.

Some funds may require that you invest at least a minimum amount—perhaps $100—every time you buy shares. Others require no minimum.

Each year, there will be a management fee that is usually around 1 percent of the value of your shares. Money market funds generally charge half this amount. Many funds also charge a maintenance fee for your IRA of about $10 a year.

Mutual funds seek to achieve investment growth, safety, and stability through diversified investment, but you should carefully check the sales prospectus to evaluate how much risk is involved. In a mutual fund, your money is not insured against loss due to normal market action.

Investment Brokers

Brokers offer the widest range of IRA choices.

For example, brokers at investment firms can set up IRA's in mutual funds.

They can arrange to put your IRA in a limited partnership built around income-producing real estate.

They can help you select an annuity.

If you want to manage your own investments, they can help you arrange for a self-directed individual retirement trust that will qualify as an IRA.

Investing in securities, however, carries the risk of loss as well as gain.

You may find that some IRA investments made through a broker will have higher costs associated with them than other IRA's have. A broker will charge about 8.5 percent of the cost of every purchase of shares in a mutual fund. Even in a self-directed IRA, you will pay a broker's commission when you buy or sell stock. There also will be some costs for establishing the plan and administering it.

In some cases, the kind of investment you select will require commitment to a specific investment, up to the limit of the IRA. For example, you could be required to invest $2,000 at one time in a limited real estate partnership.

Investments made through a brokerage firm are not insured against loss due to normal market action. However, client accounts are insured up to $500,000 against loss due to failure of the firm.

POINTS TO CHECK

When it comes time to shop for your IRA, remember this: It's a buyer's market. Financial institutions are competing aggressively for your money.

First of all, find out if your employer is accepting deductible, voluntary IRA-type contributions to a pension plan.

Also, find out if your employer has agreed to a payroll deduction plan for IRA's that is not related to a pension plan. The money would be invested by a financial institution and you could select the IRA you want. The range and nature of investment options might be greater than if you went to the financial institution as an individual.

Still, you may prefer to locate an IRA on your own.

Be sure to shop around. Ask to talk to the IRA specialist at various financial institutions. They all have one.

Make sure the institution has been approved for IRA's. Banks, savings and loan associations, and federally insured credit unions are eligible to act as trustees automatically. Other institutions must be certified by the Internal Revenue Service. Ask the institution for written proof of certification.

Consider what you want an IRA to do for you and explore in those terms. Assess your temperament, age, and retirement income needs. Weigh the relative safety of your investment options. Generally speaking, the closer you are to retirement, the more conservative your investment choice may be, particularly if you will be depending heavily on IRA dollars. You might also consider opening IRA's in different financial institutions to diversify your retirement investments.

Make certain to get the disclosure statement required by law. The trustee must give you an explanation of all the income tax consequences of opening and maintaining an IRA account.

If the rate of return on the IRA is guaranteed or can be reasonably projected, this disclosure statement must give you a projection of the growth of the program at the end of *each* of the first 5 years of the contract and at age 60, 65, and 70. Among other things, the statement also must give startup and administrative costs.

If the investments are made in mutual funds or on the open market, you must instead be informed of what sales and administrative charges will be made against your contributions and how annual earnings are figured.

Ask about the minimum amount required by an institution to open an IRA.

Make a point of understanding the kind of interest, or other return, that is being offered. Ask how interest will be calculated, too. It makes a difference in the dollars coming to you.

Interest rates and fees will vary from institution to institution and from locality to locality. Understand, also, that in many cases, interest rates will not remain the same during the life of your IRA.

Keep in mind that you can move your IRA without incurring a tax penalty, but the institution you are leaving may charge a penalty for early withdrawal.

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