STILL ONE MORE MONTH TO GO IN 1987?

Even though it’s March, you still have another month to take, a sizable deduction on your 1987 tax return by opening an IRA

By Joseph Arkin MBA, CPA

Individual Retirement Accounts (IRAs) should appeal to almost every taxpayer. Investments are deducted from current taxable income, while the tax on earnings is deferred until funds are withdrawn. But despite these advantages, only 20 million of 83 million eligible Americans have an IRA.

Many people believe IRA benefits are available only to those in the highest income tax brackets. Others believe opening an Individual Retirement Account is a complex and expensive process. Still others believe only sophisticated investors can manage an IRA.

All these beliefs are unfortunate misconceptions.

Opening and managing an IRA is usually easy and inexpensive.

The size of the immediate tax benefit depends upon an individual’s tax bracket, and the amount contributed to an Individual Retirement Account. Most employed individuals can invest up to $2,000 each year in an IRA, while married couples with one spouse working can contribute $2,250 (see box on new IRA deduction rules for tax year 1987). The amount invested appears on the tax return as a downward “adjustment” to the individual’s gross income. So tax benefits are available whether or not the individual itemizes deductions.

To demonstrate the tax benefits, consider an individual in the 28 percent marginal tax bracket who puts $2,000 into an IRA. Multiplying the $2,000 deduction by the 28 percent marginal tax rate, this taxpayer has reduced his income tax obligation by $560. From another perspective, it can be said this savings provides the first $560 invested in the IRA.

Additional benefits accrue because the tax on the earnings from an IRA are deferred.

An individual placing $2,000 annually into an IRA that earns 10 percent accumulates $400,993 after 30 years. If the same interest income had been subject to taxation at the 28 percent marginal tax rate, only $192,942 would have accumulated.

A two-income couple’s accumulation is even more startling. The $4,000 annual IRA deposits grow to $801,986 after 30 years. Only $385,388 would have been amassed if the income from a 10 percent account had been taxed at 28 percent.

IRA income doesn’t escape taxation, but earning are deferred until the owners begin withdrawing funds—presumably after retirement, when they are in a lower income tax brackets.

Withdrawals from an IRA account...
may begin when the owner reaches 59 1/2 years old. However, if not already initiated, withdrawals must begin when the account owner reaches 70 1/2 years of age.

If circumstances dictate an early withdrawal from an IRA account, the funds become subject to taxation. Moreover, the individual must pay a 10 percent penalty.

In any event, the tax benefits available from an Individual Retirement Account should make them very attractive for a large proportion of those eligible. Moreover, establishing an IRA is relatively simple. After you identify the specific investment vehicle, opening an IRA account requires only a few minutes to complete an “IRA Application and Adoption Agreement.”

Indeed, it’s so simple that the reluctance to contend with paperwork represents the weakest excuse for not opening an IRA account. That holds true particularly when you recognize the financial benefits that can develop from such accounts. In fact, the size of the tax savings from establishing an IRA justify borrowing the funds for the IRA if necessary. The interest costs are nominal when compared to the tax savings.

Now, let’s turn to the other concern associated with the decision to establish an IRA. That is, where do you invest the funds committed to an IRA? And how do you choose the investment that is most suitable for you?

In fact, IRA funds can be invested in a variety of forms—from certificates of deposit at your bank, to risky real estate ventures funded by a limited partnership. Funds can be juggled among stocks, bonds, mutual funds, money market accounts, or passbook savings accounts. Should an IRA holder later change his mind, funds can be moved into another investment.

Investment can be made and ignored. Or IRA holders can establish “self-directed” accounts with a broker that allows owners to buy and sell stocks in response to their perceptions of the vagaries of the stock market.

The maximum allowable investment need not be made all at once, but in several stages throughout the year. Investing earlier in the year starts earning tax-sheltered earnings sooner. But taxpayers can wait until April 15 of the following year to make an IRA contribution tax-deductible for the previous year. For income tax purposes, then, IRAs enjoy a 15½-month “year.”

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