



IRA Assets Staying Put Despite Rule Changes

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By Marc Hogan

Investors with assets in IRA accounts have historically tended to keep them there until retirement age. That pattern hasn't changed, even though the restrictions against early withdrawals have loosened over the years.

That's according to a recent working paper by the Pension Research Council at the University of Pennsylvania's Wharton School. Co-authored by Sarah Holden, director of retirement and investor research, and Brian Reid, chief economist, both of the Investment Company Institute, the 44-page paper gives a history and analysis of IRA withdrawal trends.

Recent figures suggest the tax incentives and penalties to get people to use IRAs for retirement savings are working, the paper concludes. As of year-end 2006, IRAs held \$4.2 trillion in assets, out of an overall \$16.4 trillion in tax-deferred retirement savings.

From 1999 to 2004, just 6% of households headed by people younger than age 59 made withdrawals from their IRAs, according to the report, citing ICI annual tracking survey data. The average size of these withdrawals was \$17,000.

By comparison, 18% of households headed by individuals age 59 to 69 took IRA withdrawals, for an average of \$19,600. Another 56% of households age 70 and older did so, with an average withdrawal of \$12,200.

"About a quarter of the retirement assets saved in this country are in IRAs, and many of them come from rollovers," Holden says. "What we've seen so far is the bulk of the people are waiting to tap their IRAs until the law requires them to do so."

Current tax law typically hits investors with a 10% penalty on IRA withdrawals made before age 59½. At age 70½, the law requires traditional IRA owners to start making distributions from their accounts.

Congress has provided some exemptions allowing individuals to make IRA distributions without penalty in special situations even before age 59½.

In 1996, Congress started allowing IRA owners to withdraw assets for certain medical and health insurance costs. A year later, IRA owners received an exemption for distributions used to pay for qualified higher education expenses or a first-time home purchase up to \$10,000.

Despite these changes, early withdrawal rates from IRAs have remained relatively steady, Holden and Reid find. “This behavior is roughly consistent with research that was done several years ago using data from the mid-’90s,” Reid explains.

When people do tap their IRAs prior to age 70½, it’s often for reasons the tax incentives of the accounts would suggest. The probability of withdrawals before that age is higher for the retired, for individuals with poor health, and for those who have a home mortgage, according to the paper.

For policymakers, the findings underscore the importance of simplicity in encouraging participation, the co-authors say. “The rules here are pretty straightforward as far as government rules go,” Reid notes. “It makes them easy to understand, so people understand the incentives and the disincentives for withdrawing early.”

When the IRA rules have become more complicated, contributions have declined. For instance, Congress passed a law in 1986 that changed the eligibility for IRAs. Deductible contributions to traditional IRAs dropped the following year to \$14.1 billion, from \$37.8 billion in 1986, according to the paper.

Simplicity might not be the only reason investors generally don’t tap their IRAs early. Many IRA owners probably don’t even realize they’re allowed to do so, observes Chip Roame, managing principal at distribution consulting firm Tiburon Strategic Advisors.

Early IRA withdrawals could increase as more baby boomers approach the ages of 59½ or 70½ and experience health problems, Roame says. Future financial troubles could also cause the baby boomers to take distributions ahead of schedule.

In fact, the subprime mortgage crisis might have caused some IRA owners to take early distributions, Roame points out.

“When we look back at this year’s data, are more people tapping into their IRAs right now because they’re unable to meet their mortgage payments?” he wonders.

Others expect the current trend of low early withdrawals to continue.

“People who have IRAs are likely to have other assets and other income, which reduces the need for them to withdraw money prior to 59½ or even to withdraw money other than the required minimum distribution in their 70s,” says Ric Edelman, a financial planner and the founder of Edelman Financial Services. “When they do take the RMD, many of our clients don’t spend the money. They reinvest it in their taxable accounts.”

As IRAs begin to represent more of a core part of a household's wealth rather than just a supplement, the probability of withdrawals before age 70½ could increase, according to Reid. He doesn't expect similar increases before age 60½ except in cases of poor health or similar issues.

In any case, the trends for IRA withdrawals tend to be long-term and slow-moving, Holden points out. "I don't think any of us would predict an abrupt change in behavior, more a transitioning," she says.

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