Tax Tips You Can Use

Financing Retirement: IRA's
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There are many ways to save for retirement. Individual Retirement Accounts (IRA's) allow a taxpayer to have tax advantaged savings. Most people who work for an employer or have self employment income qualify to save for retirement using IRA's. For 2020, contributions are limited to $7000.00 for people over 49 and $6000.00 for people under 50. There are income limits on contributions to IRA's, so if you have over $60,000 of family income you should see your tax advisor before contributing to an IRA.

There are two kinds of IRA accounts; the traditional IRA and the Roth IRA. Both of these have the same contribution limits and qualifications. When you contribute to any IRA, you lock up the money until you are at least 59&1/2. If it is withdrawn before that age, there is a 10% penalty accessed in addition to any tax owed. The government wants you to save the money for old(er) age. There are several limited exceptions to the penalty for very special circumstances, but the 10% penalty surprises a lot of people because most hardships, for example job loss, are not on the list of exceptions.

The mechanics of a Traditional IRA start with the creation of the account at a bank, brokerage firm or other authorized agent. Monies are then contributed to the account. If you earned income and are not over the limits, the monies contributed are deducted from your income on your tax return and you defer the tax that you would have paid on that income. The money should grow over time and when you reach 59&1/2, you can withdraw any or all of the money. Regardless of how the money was invested, all of the money coming out of the account is considered ordinary income and taxed just like interest, pension, or wages.

The mechanics of the Roth IRA are different. Although the contribution limits and qualifications are the same as for a Traditional IRA, there is no immediate tax advantage to the Roth IRA. There is no reduction of your income (or income tax) in the year of the contribution. However, once the money is in the account it's growth is tax free. If you wait until

59&1/2, then you can withdraw any or all of the money and pay no tax. You paid the tax on the original amount and the growth is tax free.

Choosing to contribute to a Traditional IRA allows a taxpayer to defer tax now and pay it later. There is no “free lunch” with a Traditional IRA because you or your heirs pay the tax on the income and growth at some point. The theory is that the tax savings this year is greater than the tax one will pay in that later retirement year, because in retirement, income is less. As long as tax rates do not go up, this can be true for many people. The Roth IRA does have a “free lunch”. A taxpayer pays the tax on the contribution in this year. In the retirement year, when the money is taken out of the Roth IRA, the entire distribution is tax free.

A taxpayer can be in a situation where there is little or no tax due. This can happen because of child credits, energy credits, a low income year or high itemized deductions. In that case, a Traditional IRA is a bad idea because the tax you save is little or zero and the money is waiting to be taxed in future when the tax due might be much higher. In this situation, a Roth IRA is a great idea because the money is taxed at zero or a low rate and the contribution and all of the growth will never be taxed again.

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