What’s All the Fuss About IRAs?

BY EDWARD FRONCZKOWSKI

IT’S THE MOST WONDERFUL TIME of the year. And by that, of course, I mean tax time. This is the time of year when many people wonder if they should contribute to an Individual Retirement Account (IRA). Investing in IRAs comes with tax benefits that will help you grow your money. There are two main types of IRAs, traditional and Roth.

With a traditional IRA, you can get a tax break when you contribute, and the earnings grow tax free. You pay tax on the money you withdraw after retirement, when you may be in a lower tax bracket.

A Roth IRA does not give you a tax break when you contribute but your withdrawals can be tax free. You can withdraw the amounts that you contribute at any time without paying taxes. The earnings can also be tax free if the withdrawal occurs at least five years after your first Roth IRA is established and you are at least 59 ½ years old.

Another difference is that traditional IRAs are subject to Required Minimum Distributions (RMD)[1] once you reach age 72, but Roth IRAs are not. For 2020, the maximum contribution to an IRA is your earned income up to $6,000. Individuals 50 or older can also make an extra $1,000 “catch-up”’ contribution. If your spouse earns little or no income, you can still fund an IRA on that person’s behalf based on your earned income. This is called a spousal IRA.

Almost anyone with earned income can set up a traditional IRA. However, you may not be able to deduct your IRA contributions if you are covered by a retirement plan at work. For a single person, that deduction phases out between $65,000 and $75,000. For married persons, the covered spouse can make a deductible contribution if their modified adjusted gross income (MAGI) is between $104,000 through $124,000. The thresholds for the non-covered spouse are $196,000 through $205,999. Either way the earnings will still be tax free.

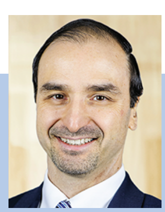
Your ability to contribute to a Roth IRA is phased out based on your MAGI. For a single person, the phase out begins at $124,000 and is reduced to zero once your MAGI reaches $139,000. For a married person, those amounts are $196,000 through $205,999[2]. Even if your income is over those amounts you may still be able to get money into a Roth IRA using a method called “the backdoor Roth,” but that is beyond the scope of this article.

Why are we talking about this now you may ask? It is now 2021 so you may think it is too late to contribute for 2020. I have good news for you, the IRS allows you to make your IRA contribution for a particular tax year up until April 15 of the following year. That means there is still time to contribute for last year.

IRAs are a good way to grow your money for retirement. The annual contributions may seem small, but with tax-free growth, a 25-year-old could contribute $6,000 today and see it grow to over $80,000 when he or she retires 40 years later. If that person contributes every year until they retire, they will wind up with a very nice nest egg. ■

1 The age requirement for RMD was changed for individuals who turned 70 ½ on or after January 1, 2020.

2 All income ranges are indexed for inflation each year. The income ranges referenced in this article apply to the 2020 tax year.



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