

## IRA/Roth IRA

**In fact, IRAs are one of the most powerful retirement savings tools available. Even if your clients are contributing to a 401(k) or other plan at work, they might also consider investing in an IRA.**

### **What types of IRAs are available?**

There are two major types of IRAs: Traditional IRAs and Roth IRAs. Both allow clients to make annual contributions. Generally, they must have at least as much taxable compensation as the amount of their IRA contribution. Married individuals filing jointly can also contribute to an IRA, even if he or she does not have taxable compensation.

The law also allows taxpayers age 50 and older to make additional "catch-up" contributions. Additional contributions can also be made between the ages of 60-63. Both Traditional and Roth IRAs feature tax-sheltered growth of earnings. And both typically offer a wide range of investment choices.

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There are important differences between these two types of IRAs. You must understand these differences before you help your clients choose which type of IRA may be appropriate for their needs.

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### **Traditional IRAs**

- Individuals with taxable compensation can contribute to a Traditional IRA
- Individuals can contribute the maximum allowed each year or their taxable compensation for the year, whichever is lesser.
- Contributions to a Traditional IRA may be tax deductible on their federal income tax return and lower taxable income for the year, saving money on taxes.
- For spousal IRAs:
  - If neither spouse is covered by a 401(k) or other employer-sponsored plan, they can generally deduct the full amount of the annual contribution.
  - If one spouse is covered by such a plan, the ability to deduct contributions depends on annual income (adjusted gross income, or AGI) and income tax filing status. They may qualify for a full deduction, a partial deduction, or no deduction at all.

### **What happens when your client starts taking money from their Traditional IRA?**

Any portion of a distribution that represents deductible contributions is subject to income tax because those contributions were not taxed when they made them. Any portion that represents investment earnings is also subject to income tax because those earnings were not previously taxed either.

Only the portion that represents nondeductible, after-tax contributions (if any) is not subject to income tax. In addition to income tax, they may have to pay a 10% early withdrawal penalty if they are under age 59½, unless they meet one of the exceptions.

## **Roth IRAs**

Not everyone can set up a Roth IRA. Even if your clients can, they may not qualify to take full advantage of it.

The first requirement is that they must have taxable compensation. Your client's ability to contribute to a Roth IRA in any year depends on their AGI and their income tax filing status. Their allowable contribution may be less than the maximum possible, or nothing at all.

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Contributions to a Roth IRA are made with after-tax dollars and not tax-deductible; however, withdrawals from a Roth IRA will be completely free from federal income tax, including both contributions and investment earnings. To be eligible for these qualifying distributions, they must meet a five-year holding period requirement.

### **In addition, one of the following must apply:**

- Clients have reached age 59½ at time of the withdrawal
  - The withdrawal is made because of disability
  - The withdrawal is made to pay first-time home buyer expenses (\$10,000 lifetime limit from all IRAs)
  - The withdrawal is made by a beneficiary or estate after death
- Qualified distributions will also avoid the 10% early withdrawal penalty. This ability to withdraw their funds with no taxes or penalty is a key strength of the Roth IRA

Remember, even non-qualified distributions will be taxed (and possibly penalized) only on the investment earnings portion of the distribution, and then only to the extent that their distribution exceeds the total amount of all contributions that they have made.

Another advantage of the Roth IRA is that there are no required distributions after age 73 or at any time during your client's life. They can put off taking distributions until they really need the income.

The entire balance can be left to beneficiary without ever taking a single distribution. As long as they have taxable compensation and qualify, they can keep contributing to a Roth IRA after age 73 if you have earned income.

### **Making the choice**

Assuming your clients qualify to use both, which type of IRA might be appropriate for your needs?

The Roth IRA might be a more effective tool if they don't qualify for tax-deductible contributions to a Traditional IRA or if they want to minimize taxes during retirement and preserve assets for their beneficiaries.

A Traditional IRA that is deductible may be a better tool if they want to lower their yearly tax bill while they are still working (and possibly in a higher tax bracket than they will be in after they retire).

They can have both a Traditional IRA and a Roth IRA so long as total annual contributions to all IRAs do not exceed limits for the year.

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