Traditional IRA Accounts verses Roth IRA Accounts

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Individuals and their spouses may contribute to a traditional IRA or to a ROTH IRA based on the salary or wages of either one or both spouses. The choice of which type of account to use, and whether or not the contribution is deductible on your tax return, is subject to some rather complex rules. The purpose of this article is to help you understand these rules and make an informed decision when contributing to an IRA.

There are some general rules that are applicable to both types of accounts. The maximum contribution for 2004 is $3,000. If you were 50 or older as of December 31, 2004 you will be able to contribute an additional $500. These limits apply to both spouses if you are married. These limits apply if your salary or wages are above the limits, if you earn less than the above limits your contribution may not exceed the total of your salary or wages. A non-working spouse is deemed to share in the earnings of the working spouse for contribution purposes. The contribution to either type of account must be made by April 15, 2006 for a 2005 contribution.

<u>Traditional IRA Accounts</u>

You may contribute to this account as long as you have earned income and you are not older than age 70 and ½. The deductibility of the contribution is dependent on whether you or your spouse is covered by an employers retirement plan. If you are single or married and no one is covered by an employers plan then the contribution to an IRA is always deductible on your tax return.

If you or your spouse is covered by an employer's plan then the amount that is deductible on your tax return is dependent on your adjusted gross income.

If you are single and your adjusted gross income is less than $45,000, the full contribution is deductible on your tax return. If your adjusted gross income is $55,000 or higher, then the total contribution becomes non-deductible. Between $45,000 and $55,000 there is a phase-out of the deductible amount; i.e. if your adjusted gross income is $50,000, then $1,500 is deductible and $1,500 is non-deductible.

If you are married, these same rules apply except the adjusted gross income limits are $65,000 and $75,000. However, there is a special rule where one spouse is covered by an employer plan and the other spouse is not covered by an employer plan. In this situation, the phase-out limits become $150,000 and $160,000 of adjusted gross income to determine the deductibility of the IRA contribution of the non-covered spouse. One more rule that is of concern here is that, if one spouse is covered by an employer plan and the non-covered spouse files a married filing separate return, then the phase-out range is adjusted gross income on the separate return of $0 to $10,000.

Distributions from a regular IRA must begin when you reach age 70 ½ even if you are not retired. All distributions from a regular IRA are taxable unless some of your contributions were non-deductible. In that case, you have to allocate some of the non-deductible contributions to each distribution, so it is very important that you keep track of the amount of nondeductible contributions that you make to an IRA account, as you will need to know this amount when you start taking distributions from your IRAs. If you happen to take a distribution before you are age 59 ½, you will be subject to income tax and a 10% early withdrawal penalty. There are certain situations where the 10% penalty can be avoided that are beyond the scope of this article.

Roth Account

Contributions to a Roth IRA are never deductible on your tax return. The benefit of this rule is that if you meet certain requirements, nothing you take out of a Roth account is ever subject to income tax. Unlike the traditional IRA, anyone who is age 70 ½ or older and has earned income may still make contributions to a Roth IRA.

The ability to make contributions to a Roth account is based on your adjusted gross income. If you are single, the Roth contribution is phased out at income between $95,000 and $110,000. For married couples these phase out amounts are $150,000 to $160,000. The phase out amounts if you are married filing separate are the same here as for the regular IRA. The contribution amount that is phased out of the Roth account may still be contributed to a regular IRA under the rules discussed above. If you have contributed to a Roth account and find, when you prepare your income tax return, that you are phased out of some or all of the Roth contribution all is not lost, you have until October 15, 2005 to re-characterize some or all of this amount over to a regular IRA.

In order for distributions from a Roth account to be tax free you must have had the accounts open for a minimum of five years and not be under age 59 ½. If you take a distribution from a Roth account before you are 59 ½, you are considered to have received your original contributions first and then you will be considered to receive any income accumulated in the account. Such income will be subject to income tax and a 10% early withdrawal penalty. Again, there are exceptions to this penalty that are beyond the scope of this article.

As you can see these rules can be complex but there is no reason that you can't contribute to an IRA. The decision is what type of account and will any of it be deductible.

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