Overview of IRA alternatives

At one time, there was relatively little confusion about IRAs because there was only one type available. Now, however, IRAs have proliferated—there's the regular IRA, which may be funded with deductible and/or nondeductible contributions, Roth IRA, SEP-IRA, and SIMPLE IRA. Some of these IRAs are similar, but others have little in common. To compound the confusion, some IRAs are known by different names. For example, a non-Roth retirement-savings IRA sometimes is called a traditional IRA.

What do all these IRAs have in common? They can help you and your family save significant amounts for retirement on a tax-favored basis. Here's an overview of the different types of IRAs available today.

Traditional IRAs

Traditional IRAs can be funded with deductible and nondeductible contributions.

Deductible IRA contributions. You can make an annual deductible contribution to an IRA if:

> (1) you (and your spouse) are not an active participant in an employer-sponsored retirement plan, or
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> (2) you (or your spouse) are an active participant in an employer plan, and your modified adjusted gross income (AGI) doesn't exceed certain levels that vary from year-to-year by filing status.

For example, in 2005, if you are a joint return filer covered by an employer plan, your deductible IRA contribution phases out over $70,000 to $80,000 of modified AGI. If you're single or a head of household in 2005, the phaseout range is $50,000 to $60,000. For a married filing separately, the phaseout range is $0 to $10,000 (for all years). If you are not an active participant in an employer-sponsored retirement plan, but your spouse is, your deductible IRA contribution phases out with modified AGI of between $150,000 and $160,000.

Deductible IRA contributions reduce your current tax bill, and earnings within the IRA are tax-deferred. However, every dollar you take out is taxed in full (and subject to a 10% penalty if you withdraw money before age 59-1/2, unless one of several exceptions apply). You must begin making minimum withdrawals by April 1 of the year following the year you attain age 70-1/2.

Nondeductible IRA contributions. You can make an annual nondeductible IRA contribution without regard to your coverage by an employer plan and without regard to your AGI. The earnings in a nondeductible IRA are tax-deferred within the IRA, but are taxed (and subject to a 10% penalty if you withdraw money before age 59-1/2, unless one of several exceptions apply).

You must begin making minimum withdrawals by April 1 of the year following the year you attain age 70-1/2. Nondeductible contributions aren't taxed when they are withdrawn. If you've made deductible and nondeductible IRA contributions, a portion of each IRA distribution is treated as coming from nontaxable IRA contributions (and the rest is taxed).

If you can't make a deductible contribution to a traditional IRA, you should contribute (if eligible) to a Roth IRA instead of making a nondeductible contribution to a traditional IRA. That's because the Roth IRA offers a better package of tax benefits than you'd get by making a nondeductible contribution to a traditional IRA.

Deductible and nondeductible IRA limits. The maximum annual IRA contribution (deductible or nondeductible, or a combination) is $4,000 for 2005 ($4,500 if you are age 50 or over in 2005). Additionally, your IRA contribution for a year (deductible or not) can't exceed the amount of your compensation includible in income for that year. Deductible and nondeductible IRA contributions can't be made once you attain age 70-1/2.

IRAs often are referred to as “traditional IRAs” (or “regular IRAs”) to distinguish them from Roth IRAs.

Roth IRAs.

You can make an annual contribution to a Roth IRA if your AGI doesn't exceed certain levels that vary by filing status. For example, if you are a joint return filer, the maximum annual Roth IRA contribution phases out between $150,000 and $160,000 of modified AGI ($95,000 to $110,000 for single taxpayers). Annual contributions to Roth IRAs can be made up to the amount that would be allowed as a contribution to a traditional IRA, reduced by the amount you contribute for the year to non-Roth IRAs, but not reduced by contributions to a SEP IRA or SIMPLE IRA (see below). For example, if you don't contribute to a traditional IRA in 2005, you can contribute up to $4,000 to a Roth IRA for that year ($4,500 if you are age 50 or older in 2005).

Roth IRA contributions aren't deductible. However, earnings are tax-deferred within the Roth IRA and (unlike a traditional IRA) are tax-free if paid out (1) after a five-year period that begins with the first year for which you made a contribution to a Roth IRA, and (2) once you reach age 59-1/2, or upon death or disability, or (up to $10,000 lifetime) for first-time home-buyer expenses of you, your spouse, child, grandchild, or ancestor. And if a Roth IRA payout doesn't meet these dual conditions, you're treated as first withdrawing nontaxable Roth IRA contributions; the balance (representing earnings) is taxed and is subject to a 10% penalty for pre-age-59-1/2 withdrawals, unless one of several exceptions apply. Thus, for example, if you contribute $6,000 over the years to Roth IRAs and withdraw $9,000 at age 55 to buy a boat, only $3,000 is taxed (and is subject to the 10% penalty).

You can make Roth IRA contributions even after you attain age 70-1/2 (if you have sufficient compensation income), and you do not have to take minimum distributions from a Roth IRA after you attain that age. That makes Roth IRAs an excellent wealth-building vehicle for your family.

You can “roll over” (or convert) a traditional IRA to a Roth IRA in a year that your AGI, as specially computed, doesn't exceed $100,000, but the amount taken out of the traditional IRA is treated for tax purposes as a regular withdrawal (but it's not subject to the 10% early withdrawal penalty).

SEP IRAs and SIMPLE IRAs

Small businesses that want to provide employees with a retirement plan, but keep administrative costs low, may be able to set up a SEP (simplified employee pension) or SIMPLE (savings incentive match plan for employees) plan. In either type of plan, contributions are made to IRA-type accounts in the employees' names. Annual contributions to these plans are controlled by special rules and aren't tied to the normal IRA contribution limits. Distributions from a SEP IRA or SIMPLE IRA are subject to tax rules similar to those that apply to deductible IRAs.

Income tax credit for contributions to IRAs

If your adjusted gross income doesn't exceed specified levels, you may be entitled to a credit (saver's credit) against your income tax equal to a percentage of your contribution to any of the above IRAs. If you are entitled to the credit, you get it in addition to any deduction you may be entitled to for the same contribution.