Traditional IRA – 7 Things You Need to Know

Traditional IRA is a basic savings plan that was created by the Congress. It started with establishing the Employee Retirement income Security Act of 1974 (ERISA). The IRA came into effect on September 2, 1974.

By some estimates, the traditional IRA accounts holds over $7.85 trillion. This is equal to about 85% of all IRA assets. An IRA can be used to invest in a host of assets ranging from equities to bonds and mutual funds.

Over 49 million Americans are said to hold part of their retirement savings in a traditional IRA. This savings and retirement tool allows you to minimize taxes and also invest in a range of markets. The performance of your traditional IRA account investments dictates how well you are prepared for retirement.

Since its inception, the IRA has become a significant component of U.S. household retirement assets.

An IRA is an individual retirement account. There are many different types of IRA accounts available. An IRA is a savings account, often referred to as a retirement account. It allows for big tax breaks and makes it easy to save cash for retirement.

An IRA is perhaps the most basic vehicle to use to plan your retirement. This whitepaper from the Investment Company Institute gives an overview on the investor profile for an IRA.

A common myth with IRA is that many think it to be an investment, but this is not the case.

An IRA is an individual account and is different from the 401(k) account which is provided by the company you work for. Anyone can open an IRA account, from self-employed individuals to small business owners and salaried employees. The only criterion is that you should be less than 70 and half years old.

There is also a cap on how you can contribute each year and most importantly, you will face penalties if you withdraw money early from your IRA account.

The main benefit of using a traditional IRA account is that you can let your account grow tax free. The income derived from interest, dividends or capital gains can therefore compound each year.

This makes for an ideal way to stash some cash away for your retirement. The taxes are usually paid when you start to withdraw funds from your traditional IRA account.

This is the main difference between a Roth IRA account and the traditional IRA account. With a Roth IRA account, you are taxed upfront.

But there are some limits on how much you can contribute to your traditional IRA account. There is a limit of $5,500 per year.

As an example, if you invest $5,500 a year into your traditional IRA, you can then subtract this amount from the annual income.

A traditional IRA can be opened at a bank or at a brokerage. Once you have your traditional IRA account you can start investing. However, there are a lot of rules to follow. The tricky part is that if you break one of the rules, then you will start getting hit with penalties.

Therefore it is important to understand what you can and

cannot do with a traditional IRA. Read this article to know more about the IRA accounts.

Here are 7 things you should know about a traditional IRA account.

1. Limit on traditional IRA contributions

The traditional IRA looks like an attractive incentive to save on tax. However, did you know that there is a cap on the annual amount you can invest? As of 2018, the maximum amount you can invest per year into a traditional IRA is $5,500. That is, if you are younger than 50 years.

For those who are 50 years, the limit is capped at $1,000. This is applicable even if you open an additional Roth IRA account. Let's take an example.

If you are under 50 years old and if you invest $3000 in a traditional IRA, then for the year, you can invest only $2,500 in a Roth IRA account.

When you overpay into your IRA account, the Internal Revenue Service (IRA) can hit you with a penalty. The penalty is 6% for excess contribution.

Another thing to bear in mind is that your earnings for the year must cover the IRA contribution.

Therefore, if your annual salary is just $4000, then your contributions to a traditional IRA is also capped at $4,000. The good news though is that there is no minimum age limit to contribute to the IRA. Therefore, youngsters who make money from summer jobs can start contributing into the IRA account.

There is an IRA for all types of people. Those who are self-employed or own a small business can open a SEP IRA. In this

case, your contributions are capped at 25% of your income.

As you can see, an IRA is a great savings incentive scheme. It works best when you start saving from an early age. You not only get the tax benefits but it helps you to build your *nest egg.*

2. You can open an IRA for the dependents/spouses

Did you know that you don't really need to hold a job to have a traditional IRA? The general conception is that you should have the earned income to contribute into your traditional IRA. However, exceptions are made for those who are dependent.

For example, a husband who works can contribute into a spousal IRA. This is possible as long as the yearly income is sufficient. In other words, a spousal IRA allows you to contribute $5,500 per year. On top of this, you can contribute to an additional $5,500 year towards your spouse.

This is ideal for stay at home parent or retirees with a spouse who is working. This exception is applicable for those who are out of a job or not working for a year but has a spouse who is earning income.

It should be noted that that income that is not earned, namely pensions, investments or social security are not eligible for investment into a traditional IRA.

However, be careful on the rules when it comes to spousal IRA. If you already have a retirement plan at work, the tax deductions to traditional contributions reduces.

A spousal IRA is offered only by IRS approved institutions. This includes select banks, brokerage companies and credit unions.

Contributing for the spousal IRA requires that you are legally married. Secondly you and your spouse need to file a joint tax return. It is also important to note that the IRA accounts must be kept separate even though one of the spouses contributes.

The IRA set up for your spouse should be on their name and include their tax identification number.

3. You can avoid the early withdrawal penalty

Generally speaking, you cannot withdraw from the traditional IRA account until you are 59 and half years old. If you withdraw funds early, you can face a penalty. However, there are some exceptions.

There is a penalty to pay when you withdraw funds early from your traditional IRA account.

For example you withdraw $10,000 from your traditional IRA account early, then you will have to pay a tax on this. The amount of tax you pay depends on your tax bracket. After paying tax, you will also attract a 10% penalty on the early withdrawal. In summary, you would end up paying the regular tax and the 10% early withdrawal penalty.

Anyone having an IRA account can withdraw up to $10,000 regardless of their age. But this money must be put towards the purchase of a first home, either for you or a relative.

You can also use your traditional IRA account for early withdrawals to pay for qualified education expenses. You can also pay your health insurance premium payments using your traditional IRA account. This feature is applicable only when you don’t have a job. Furthermore, the withdrawal can only cover medical expenses that are in excess of 10% of your adjusted gross income.

For those who agree to withdraw from their IRA funds in equal payments over the remainder of the life expectancy, there are no penalties to pay. But remember that the above tips help you only to save on the penalty. You will still need to pay the deferred taxes.

4. Traditional IRA required minimum distribution

The most ideal scenario for anyone is to never have the need to dip into their traditional IRA account. However, there is a required minimum distribution clause. This means that you need to start taking money from your traditional IRA account by April 1 of the year after you turn 70 and half.

If you do not withdraw regularly, your traditional IRA account can attract penalties. You can of course withdraw more than the required minimum distribution. When you fail to make the minimum required distribution, the IRS can slap you with a 50% penalty on the amount you should have withdrawn in the first place.

The required minimum distribution cannot be rolled over. You can read more about the required minimum distribution here.

The reasoning behind the required minimum distribution is to ensure that people do not accumulate in their retirement accounts. Accumulation would mean deferring on taxes and this could potentially turn the traditional IRA into an inheritance.

Therefore, the required minimum distribution is forces the traditional IRA account holder to withdraw at least some of the funds that are taxable.

5. You can invest in real estate using your traditional IRA

An interesting aspect about having a traditional IRA is that the funds can be used for real estate investment. Many people think only about stocks and bonds but this is not the case.

Real estate investment using a traditional IRA is possible but there are some rules to follow.

The real estate where you want to invest has to be a business property of some kind. You should also note that you cannot use the traditional IRA to pay off the mortgage or buy a second home. But you can buy and sell a house as an investment property.

There are strict rules when it comes to managing real estate using a traditional IRA. This is an option which only sophisticated investors should use.

6. You can have an IRA even if you don’t qualify for tax-deducted contributions

For those who are covered by a retirement savings plans such as the 401(k) or 403(b), you can continue with a traditional IRA. The only catch is that you cannot get tax deductions. Having non-deductible IRA contribution gives you the potential for the money to grow at a tax free rate until you withdraw.

This gives you some major benefits because when you invest from your traditional IRA, they can be tax free. The tax free applies to capital gains and dividends. A great way to compound your savings with a traditional IRA!

7. You are responsible for your investments in traditional IRA

A traditional IRA needs to be managed by you. This means that you need to pay attention to the assets you invest in. By some estimates, most people tend to allocate a major portion of their traditional IRA toward mutual funds. After mutual funds, stocks and bonds are the next most popular assets.

Some prefer cash as well.

Due to the fact that you need to manage your investments, there are times when your investment declines. Because taxes are deferred until you withdraw, there is no impact when you make some bad bets in the markets through a traditional IRA account.

In conclusion, the traditional IRA is one of the simplest of ways to get start to plan your retirement. There are many other forms of individual retirement accounts that one can choose. This depends on your professional status and the amount of income you make per year.

The above seven things to know about traditional IRA is a great starting point to research further. Depending on various factors you might be able to find an IRA that is more suited to your savings plan.

The traditional IRA is a great incentive to help you to build your nest egg. Although investments are manual, you will be able to take advantage of the traditional IRA. Carefully chosen investing strategies can help to compound your savings.